CLASSIFICATION:

AID 1120-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO.
520-0373 PAAD NUMBER 520-K 604

2. COUNTRY
GUATEMALA

3. CATEGORY
CASH TRANSFER

4. DATE
AUGUST 23, 1989

5. TO:
AAA/LAC, Frederick W. Schieck

6. OYB CHANGE NO.

7. FROM
LAC/DR, Jeffrey W. Evans

8. OYB INCREASE
NONE

TO BE TAKEN FROM:
ECONOMIC SUPPORT FUND (ESF)

9. APPROVAL REQUESTED FOR COMMITMENT OF:
$69,500,000

10. APPROPRIATION - 72-119/01037
LES989-35520-KG31 (970-65-520-00-50-91)

11. TYPE FUNDING: ☐ LOAN ☒ GRANT

12. LOCAL CURRENCY ARRANGEMENT: ☐ INFORMAL ☐ FORMAL ☐ NONE

13. ESTIMATED DELIVERY PERIOD
1989

14. TRANSACTION ELIGIBILITY DATE

15. COMMODITIES FINANCED

16. PERMITTED SOURCE
U.S. only:
Limited F.W.:
Free World:
Cash:
Grant: $69,500,000

17. ESTIMATED SOURCE
U.S.: 69,500,000
Industrialized Countries:
Local:
Other:

18. SUMMARY DESCRIPTION

The purpose of this cash transfer ($69,500,000) is to sustain and deepen the democratization and development processes in Guatemala through: (1) immediate foreign exchange support and (2) economic policy reform. Disbursement will be made upon evidence that the Government of Guatemala has made satisfactory progress in implementing the fiscal, monetary, exchange and structural adjustment measures contemplated in its 1989 economic program. The substance of the conditions precedent to disbursement will be contained in a side letter to the grant agreement. The dollar assistance will be maintained in a separate uncommingled account in a U.S. bank to be disbursed according to a prioritized list of eligible transactions, which includes imports of raw materials, intermediate goods, spare parts and capital goods from the U.S. Immediately following disbursement of ESF funds, the GOG will deposit an equivalent amount of local currency calculated at the highest rate of exchange which, at the time the deposit is made, is not unlawful in Guatemala, in a special account in the Bank of Guatemala. Associated local currency will be used for mutually agreed-upon development purposes, including a local currency trust account and counterpart funding for development programs, consistent with the Foreign Assistance Act, particularly Sections 103 through 106, and Section 123.

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

19. CLEARANCES	DATE
LAC/DP:WWheeler	8/23/89
GC/LAC:TGeiger	8/23/89
LAC/CEN:CCostello	
LAC/CONT:GByllesby	8/23/89
PFM/FM/PAFD:SOwens	8/23/89
PPC/EA:JLaPittus	8/23/89
ARA/ECP:DMarshall	8/23/89
PPC/PB:SRea	8/23/89

20. ACTION
☒ APPROVED ☐ DISAPPROVED

Frederick W. Schieck
Frederick W. Schieck
AUTHORIZED SIGNATURE

Aug. 23, 1989
DATE

Acting Assistant Administrator
TITLE

CLASSIFICATION:

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EXECUTIVE SUMMARY

I. RECOMMENDATION

The U.S. Country Team recommends authorization of a FY 1989 Economic Support Fund grant of $69,500,000 to the Government of Guatemala, represented by the Ministry of Finance.

II. PROGRAM SUMMARY

The proposed program continues the effort begun in 1986 to support and institutionalize democracy in Guatemala through balance of payments assistance. The democratically-elected Government of Guatemala has moved courageously and decisively since 1986 to restore financial stability and renewed growth to the economy. Progress in stabilizing the economy is evidenced in significantly lower inflation, resulting from disciplined fiscal and monetary management. The exchange rate has been devalued to a market-oriented level, and interest rates are again positive in real terms, inducing private capital to return to the country. By 1987, real economic expansion kept pace with the population growth rate for the first time in seven years, and for 1988, recent projections suggest that real per capita income will see a modest increase.

In 1988, the Government began giving the objective of increased and sustainable growth greater weight in its economic program, with the goal of economic stability nearly in hand. In the Government's program, fundamental structural changes are sought which will encourage greater economic efficiency and growth, but with the participation of Guatemala's least-advantaged groups. Reactivation of the agriculture sector is a centerpiece of the program, whose emphasis is diversification, particularly by the small farm subsector. The instruments of the growth program include not only policy changes to eliminate remaining anti- agriculture and anti-exports biases present within national policy, but also an acceleration of investment in rural infrastructure and services, to increase productivity as well as quality of life.

Guatemala's economic program for 1989 and beyond includes the discipline of quantitative targets for key monetary, fiscal and international reserve variables. Qualitative targets also make up part of the program, in the form of commitments to improve the policy and institutional framework and, in particular, the budgetary process, to allow agriculture- and export-led growth to take off. The U.S. Mission has reviewed the program and we feel confident that the actions and targets proposed are well-formulated and sound, and represent a serious effort to keep Guatemala squarely on its newly regained path of sustainable and broadly-based growth.

To reaffirm the support of the United States for Guatemala's serious and sound economic management and for the national leadership's efforts to deepen democracy and broaden the base of economic growth, the U.S. Country Team proposes a FY 1989 ESF grant of $69.5 million in balance of payments support.

V

I. INTRODUCTION

The Fiscal Year 1989 ESF program proposed in this PAAD represents a continuation of support for the Government of Guatemala's multi-year growth program, begun in 1988. As was described in the FY 1988 Concepts Paper and more fully detailed in the PAAD, the ESF program in that year changed significantly.

The principal distinguishing characteristics of the 1988 and 1989 program are the following:

- Growth joins stability as the top priority program objective.
- Initiation of sector-specific activities in agriculture become part of the program.
- Policy dialogue is broadened to include agriculture-specific topics and the group of interlocutors is expanded to include the Minister of Agriculture and USAID/Guatemala's Chief of the Office of Rural Development.
- The fiction of ESF delivering local currency is abandoned. The 1988 and 1989 programs recognize that ESF is funded with U.S. dollars only. In exchange, the GOG makes two commitments with respect to uses of its own local currency. First, it provides support to a trust fund for USAID and ROCAP operating expenses, and for technical project support and for audits. Second, the GOG agrees to disburse into a Core Development Budget a quantity of quetzales not less than the equivalent of the ESF balance of payments support less the amount paid into the trust fund cited above.
- The Core Development Budget of the GOG contains the highest priority development projects of the GOG. It was agreed to by the GOG as part of the FY 1988 ESF program. The GOG also agreed to discuss its contents with USAID/G,

and to subject it to the same restrictions against military and police expenditures, etc., as would apply to funds donated or loaned by the U.S.G.

As observed above, stabilization, the near exclusive focus of the 1986 and 1987 programs, was joined in FY 1988 by market-based, sustainable long-term growth at the top of the list of priority objectives. A digression on the reasons for the Mission's emphasis on agriculture may be in order here.

Perhaps what should be made clear at the outset is that the sectoral emphasis does not reflect any philosophical or ideological notion about agriculture being intrinsically preferable to any other sector. Rather, the selection of that sector for emphasis is based on two propositions. First, it is the sector that makes the greatest use of land and labor, Guatemala's two relatively abundant resources. In producing its one-fourth of GDP, the sector provides over half the jobs in the entire economy. Moreover, this sector uses less foreign exchange, and produces more, than any other sector. The evidence is compelling that natural international market forces bestow on Guatemala a strong comparative advantage in agriculture. Given the Mission's conviction that markets, not planners, should determine the structure of economic activity, this sector is a natural. We are betting, in effect, that market signals will call for expansion in agriculture.

The second proposition militating in favor of agriculture is that the 20 years of anti-agriculture bias has left the sector with inadequate infrastructure, an impoverished population base, and a dearth of the most basic public services. Under the circumstances it would be unable to respond adequately to market calls for robust growth.

Despite the strong case for agriculture, the Mission is fully cognizant of the fact that it cannot accurately forecast the distribution of market-rational growth across sectors and sub-sectors. For example, one nonagricultural area that is expanding rapidly at present, purely on the strength of private market response, is factory-type assembly operations. Such light manufacturing operations are, like agriculture, relatively labor-intensive. Given the widely reputed dexterity of Guatemalan workers and the low local wage rates, it was predictable that this industry would prosper, even without favored treatment or subsidies. Such industries, by virtue of

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their ability to compete effectively in tough international markets, are exactly the type that can lead Guatemala to a market-rational and self-sustaining long-term growth trajectory.

The Mission's agricultural thrust and light manufacturing development are mutually reinforcing. The difference is that manufacturing has not suffered from 20 or more years of policy bias. Moreover it is directed by relatively sophisticated local and foreign entrepreneurs. They know how private markets work and, by their demonstration effect, provide private enterprise models for the rest of the economy to emulate. Agriculture lags behind, but with water sources identified and developed, irrigation systems installed or renovated, farm-to-market roads established and research and extension made an efficient reality, it can be a spearhead of development.

What is of particular importance to foreign assistance donors is that they learn from mistakes made in the past and not repeat them. In retrospect, we can see that the nontraditional "export boom", of the 1970's was no boom at all, but was a economic drag. The export "earnings" were largely from sales on credit, denominated in soft regional currencies. But the debts weren't paid. And the "foreign exchange earnings" could not be used to pay for the massive quantities of imported inputs from hard currency countries. When the bubble burst, Guatemala was in debt and it became clear that the exports were worth less in real, hard currency terms than the imported inputs they consumed. And all this was encouraged and rewarded by forgiving the participants of taxes. Partly as a result of these policy mistakes, in 1986 real per capita GDP was back at its 1971 level, and the share of exports destined for Central America was back at its 1971 level.

In this paper the Mission provides a compelling case that Guatemala is now closer to the path it should have sought back in 1970 rather than the input-substitution path it took instead. Stability, at least in the domestic sector, has been substantially restored. The external sector, the most tenacious obstacle to robust growth, is starting to improve. Nontraditional exports are increasing at a brisk pace and, in 1987, agriculture led the way in the resumption of real growth.

The multi-year growth program appears to be solidly on the course established last year. Thus there are no major departures in the ESF program proposed for FY 1989 from that of last year. Monetary, fiscal and foreign exchange policy will have to be consistent with each other and with price and balance of payments stability and with positive real growth. The agricultural sector program will move further toward eliminating policy and institutional obstructions.

II. THE GUATEMALAN ECONOMY IN HISTORICAL PERSPECTIVE

A. Trends in Economic Aggregates Since World War II[1/]

From 1950 to 1980 the Guatemalan economy was, in many ways, a model of stability. Real GDP advanced at an average annual rate of 5 percent. Price inflation, as measured by the GDP deflator, averaged just 3.3 percent[2/], compared to 4.2 percent for the United States, and much higher rates for Guatemala's Central American neighbors[3/]. International reserves grew 10 percent annually and reached $700 million (10 percent of GDP) by 1979. Monetary management was moderately expansionary with average annual growth of the narrow money stock (M1) of 9 percent. There is compelling evidence, however, that this rate of monetary expansion was consistent with sound monetary, fiscal and balance of payments management. Not only was there relatively little price inflation, but the nation's balance of payments accounts also exhibited strength. The official exchange rate held firm at Q1.00= US$1.00, and no serious black market pressures developed. Finally, Guatemalans exhibited confidence in their national currency as their holdings of quetzales increased steadily from a little less than five weeks' income in 1950, to about five and one-half weeks' income in 1979.

Financial intermediation expanded dramatically in the post-war period. Bank debits moved from 5 to 17 percent of GDP; checking account balances rose from 34 to 51 percent of the money stock; debt to the banking system jumped Q1.1 billion, from 6 to 16 percent of GDP[4/]. The increased

1/ All data on economic performance, unless otherwise explicitly noted, are taken from International Financial Statistics, 1987 yearbook edition.

2/ For the first 22 years of the period, the rate averaged well below 1 percent, while from 1972 to 1979 it averaged 12 percent.

3/ Average inflation rates refer to geometric means.

4/ Interestingly, 92 percent of the increased bank credit in the full period went to the private sector. This is not surprising once it is observed that Guatemala's public sector has been, and remains, one of the smallest in the world. Before 1980 Government spending never exceeded 12.5 percent of GDP and Government deficits rarely exceeded 1 percent of GDP.

importance of financial intermediation and banking generally, was a natural concomitant of structural changes that occurred over this period. These changes are the subject to which we turn in the next section.

B. Structural Characteristics and Changes

Guatemala's economy has always been rooted in agriculture. Nevertheless, this sector, like the economy generally, is highly dualistic. Modern, internationally competitive agricultural production takes place mainly on large-scale holdings on the Pacific coastal plains. This sub-sector's five principal exports - coffee, sugar, cotton, bananas and meat - accounted for 52 percent of export revenue and 10 percent of GDP in 1980.

The share of these crops in total exports has fallen sharply - 91 percent in 1950 and 1960, 58 percent in 1970, 64 percent in 1975 and 52 percent in 1980. Interestingly, however, their share in GDP has been very stable - 11 percent in 1950, 10 percent in 1960, 9 percent in 1970, 11 percent in 1975 and 10 percent in 1980.

In the aggregate agriculture's share of GDP dropped 5 percentage points over this period, from 30 percent of GDP to 25 percent[1/]. Leaving aside the five key exports, therefore, it turns out that the remaining segments of agriculture grew at a slower pace than either GDP or traditional export agriculture. Most of this change in the structure of agriculture, with the traditional export crops rising from 33 to 40 percent of agricultural sector GDP, occurred from 1960 to 1980. In these two decades aggregate GDP grew a total of 196 percent, manufacturing's contribution advanced 289 percent and agriculture's contribution increased only 141 percent. The changes in GDP by principal sectors of origin are shown in Table 1.

1/ Source: Bank of Guatemala, Boletines Estadísticos, and BOG Department of Economics Research.

Table 1
GDP By Sector of Origin[1/]
(Five Year Averages of Annual
Percentage Shares)

	Agriculture	Industry	Commerce	Other
1955-59	29.9	12.4	27.2	30.5
1960-64	30.0	13.4	27.5	29.1
1965-69	27.9	15.4	28.4	28.3
1970-74	27.8	15.8	28.4	28.0
1975-79	26.6	15.9	28.0	29.5
1980-84	25.2	16.0	26.5	32.3

It is clear that the 1955-1979 period was one in which there was a clear structural shift with manufacturing contributing relatively more, and agriculture relatively less, to GDP. As seen earlier, the share of the traditional export crops in GDP was substantially unchanged. Thus the reduction in the aggregate agricultural share is accounted for by traditional crops for the domestic market and nontraditional agricultural exports. These changes in the structure of production had important implications for the relative intensities of demand for factors of production. Data covering the period 1967 to 1986 show imported inputs as a percentage of GDP and its agriculture and manufacturing components as presented below. A shift away from agriculture in favor of manufacturing clearly implies increased demand for imports relative to resources available domestically.

Aggregate GDP	12 percent
Manufacturing	56 percent
Agriculture	5 percent

The implications of this structural change for the economic well-being of the great majority of Guatemalans were stark as will be seen in succeeding sections of this paper. What is very plain and particularly noteworthy here is that the poor, primarily indigenous, subsistence farmers of Guatemala's western highlands lagged significantly behind both the commercial agricultural sector and the manufacturing sector. The process that brought this to pass was simultaneously eating away, like so many termites, at the soft timbers that underpinned the economy as it turned increasingly toward a kind of activity it had no chance of sustaining over the long run.

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Data in Table 2 below illustrate this point. The data, presented in five-year intervals, show the sharp increase in fixed capital investments relative to aggregate production (GDP), as (largely manufactured) exports to Central American Common Market countries increased. They show a major increase in the capital intensity of production. While domestic saving showed impressive gains as well they did not keep pace with investment. Consequently, foreign saving (and borrowing) became increasingly necessary to sustain the "new" exports surge.

Table 2
Fixed Capital Investment and Domestic Saving
as Percent of GDP
(Five year Average of Annual Data)

Period	Investment	Domestic Saving
1960-64	10.3	9.3
1965-69	13.1	11.0
1970-74	13.5	13.8
1975-79	18.8	15.6
1980-84	13.7	10.5

Table 3 below reveals similar changes in the import content of GDP. While there certainly are many demand side influences on the relationship between GDP and imports, it is clear that production became more capital- and import-intensive during this period. Without question, the increased import dependence of production goes a long way toward explaining the quadrupling of Guatemala's external debt that occurred between 1972 and 1981.

Table 3
Imports as Percent of GDP
(Five Year Averages of Annual Data)

1960-64	15.1
1965-69	18.8
1970-74	20.2
1975-79	26.1
1980-84	19.5

The increments in the import content of production contributed to increasingly serious deficits on the current account of the balance of payments (the source of foreign savings). As the data in Table 4 show, this deficit soared in the 1970's (the first large increase was in 197[illegible] when the current account balance reached $ -203 million compared to +$8 million the previous year). The following table, Table 4, goes a step further and shows the net effect of the foreign sector accounts (i.e., exports minus imports on a national income accounts basis) on Gross Domestic Product.

Table 4
Effect of Foreign Sector Transactions
on Gross Domestic Product
(Five Year Averages of Annual External
Drag, National Income Accounts Basis)

	External Boost (+)or Drag (-) (Millions of Quetzales)	External Drag as Percent of Avg. GDP
1950	0.0	0.0
1955	1.0	0.1
1959	- 25.0	2.4
1960-64	- 23.0	2.0
1965-69	- 21.8	1.5
1970-74	- 17.8	0.8
1975-79	-217.6	4.1
1980-84	-293.0	3.4

It is interesting to note that, in the intervals during which the traditional export crops contributed declining shares of total exports, their world market prices were significantly higher than in earlier years. Moreover, the interval in which the foreign sector was the heaviest drag, 1975-79, was a period of then record-high prices for all five of the traditional agricultural exports. Thus there remains no serious doubt that the export "boom" associated with 1970's (the dollar f.o.b. value of exports increased at an average annual rate of 18 percent from 1970-1980, and in the latter year was over five times the 1970 value) was in fact a reflection of policies that probably prevented the country from achieving growth rates far in excess of those actually realized.

Another important structural characteristic of the Guatemalan economy is the role that has been played by the public sector. For the thirty years prior to 1980, tax collections averaged less than 8 percent of GDP, and Central Government expenditures averaged just about a percentage point more. Of the relatively small tax collections, indirect taxes accounted for 86 percent, suggesting that the tax system has been anything but neutral as an influence on resource allocation.

While Guatemala has been second only to Costa Rica in income per capita, the country historically has spent less through its public sector than any of its Central American neighbors. Table 5 below shows tax and expenditure comparisons among Central American countries for selected years between 1950 and 1980.

Table 5
Revenue and Expenditures of Central Governments of Central America
(Percent of GDP)

	Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua	
	Revenues	Expenditures	Revenues	Expenditures	Revenues	Expenditures	Revenues	Expenditures	Revenues	Expenditures
959	NA	NA	12	14	9	10	11	12		
960	NA	NA	14	13	9	9	11	12	10	12
965	NA	NA	14	14	9	10	11	11	11	11
970	15	16	11	11	9	9	12	15	13	14
975	18	20	13	14	9	10	12	14	14	20
979	18	25	14	15	10	12	15	17	15	21
982	17	18	12	19	10	15	13	20	28	47

As suggested in the first section of this paper Guatemala's disciplined fiscal management up to 1980 contributed significantly to the price, wage and exchange rate stability the country enjoyed. However, there was a cost associated with the failure of the public sector to provide the social overhead capital required to conduct a modern, efficient economy. This cost was exacted in many ways. First, it must be regarded as a good recruiting tool for those who would promote violent insurrection. Second, when the time inevitably arrived for Guatemala to choose between joining the competitive world economy or accepting stagnation, the economic foundation for the former was seriously deficient.

Specific manifestations of the under-investment in public goods and services are shown in Table 6 below.

BEST AVAILABLE

Table 6

Guatemalan and other Central American
Social Indicators

	Guatemala	Costa Rica	El Salvador	Honduras	Nicaragua
GNP per capita US$(1985)	1,250	1,300	820	720	770
Percent Literacy 1/ (Last Census)	45.4	89.8	59.7	59.3	57.4
Crude Birth rate/ 1000 (1985)	40	29	38	42	43
Life expectancy at birth (years) 1985	60	74	64	62	59
Daily calorie supply per capita (1985)	2,294	2,803	2,148	2,211	2,425
Population/p physician (1980)	8,610	1,460	2,720	3,120	2,230
Estimated Average annual population change (1985-90)	2.88	2.44	3.10	3.10	3.36
Percent of population with access to Safe drinking water (Rural) (1983)	26	82	40	55	10
Percent of population with acess to sanitation services (Rural)	28	87	26	40	N/A
Estimated infant mortality (1985-1990)	59	18	59	69	62
Reported Malaria cases (1984)	74,132	569	66,874	27,332	15,702
Number enrolled in Primary School as percent of age group (1984)	80	101	69	102	100

Sources: World Bank, World Development Report, 1987.
UNICEF, The State of the World's Children, 1986.
World Resources Institute, World Resources, 1987.

1/ Source: VII Compendio Estadístico Centroamericano, SIECA, 1981

C. Summary

By "tilting" the economy in a manner that dampened the demand for labor relative to capital,1/ public policy exacerbated the perennial problem of low incomes in families with only the services of land and labor to sell. By artificially boosting the rate of return on investment in urban areas (where manufacturing is located), underinvestment in the poor rural areas was induced, and surpluses originating in agriculture were reallocated to capital formation in manufacturing. Low historical rates of public sector investment in health, education and other areas of human capital development have prevented the economically disadvantaged indigenous population from acquiring the ability to progress from subsistence agriculture to anything more advanced. Excessive reliance on indirect taxes as the principal revenue source deepened the impoverishment of the poor, as did the high prices and inferior quality of goods available during the import substitution period. Ultimately, it was certain to be the case that the nation as a whole would become unable or unwilling to support the import habit and productive inefficiency to which producers had become addicted. At the end of the 1970's, a series of events assured that the time had arrived. A Sandinista Government installed in Managua, fear of an effective armed Marxist insurgency, deep cuts in support from the United States, uncollectable debts from Nicaragua and others, falling traditional export commodity prices and rising petroleum prices all combined to deliver a crushing blow to investment, production and employment. In the next five years, attempts by the Government to ignore or nullify exogenous shocks in fact simply exaggerated them, and made their consequences deeper and longer lasting. We turn now to a closer look at that unfortunate episode in Guatemala's economic history.

1/ Formal time series analyses undertaken by Alfonso Martínez of OEPA show that, consistently with economic theory, changes in the capital stock are inversely and significantly related to changes in employment in Guatemala.

D. 1980-85: Stagnation, Instability and Structural Shocks

In 1980 gross export revenue reached an all time high of $1.5 billion, on the strength of nontraditional exports. GDP increased 14 percent in nominal terms and 3.7 percent in real terms in the same year. Tax collection growth matched the 10 percent price inflation, but declined from 9.1 to 8.7 percent of GDP. Government expenditures on the other hand jumped 29 percent from 12 to 14 percent of GDP. Government indebtedness to the banking system tripled as the public sector resorted to the banking system to finance its deficit. This along with a record $252 million loss of international reserves signalled that trouble was afoot, despite positive aggregate growth performance.

A dramatic drop in coffee prices in 1981 triggered the onset of a painful, though probably inevitable, period of economic contraction and adjustment. Export revenue dropped $304 million (19 percent) from the 1980 high, of which $169 million was accounted for by falling coffee revenue. International reserves dropped another $300 million as imports reached a record high of $1.5 billion. For the second successive year, public sector deficits resulted in a large increase (126 percent) in public indebtedness to the banking system. This did not result in a permanent large expansion of the money stock. Guatemalans extinguished the new quetzales quickly by trading them for imports and off-shore bank accounts. However, it effectively substituted claims against the Government for claims against foreigners on the asset side of the Bank of Guatemala's balance sheet. Thus what occurred was a deterioration of the quality of the nation's currency.

Real GDP barely registered a positive gain in 1981 and a period of six successive years of decline was underway. This contraction, which lasted through 1986, was accompanied, though with a lag, by a significant drop in imports.[1/] Thus it may very well have been a necessary concomitant of the structural changes needed to jar the economy off of the import-substituting, inward-looking development path of the past and onto one dictated by international market realities and Guatemala's comparative advantage and relative resource endowments.

1/ Imports surged again in 1987 and the first three quarters of 1988. However, there is good reason to believe that these are demand driven, largely by speculative motives, rather than a reflection of a resurgence of import intensity in production.

Over the 1980-85 period as a whole, real GDP declined at an average annual rate of 1.1 percent, leaving 1985 per capita GDP almost 20 percent below its 1980 value, or about equal to its value in 1971. In this half decade the following dramatic, and for Guatemala wholly uncharacteristic, economic phenomena occurred:

- Manufacturing and agricultural sector GDP declined on the average at annual rates of 1.8 and 0.5 percent respectively.

- The money stock (M_1) rose 79 percent (most of this in 1985 when it increased 55 percent).

- Government debt to the Bank of Guatemala quadrupled.

- Guatemalans (not including banks) deposited over $600 million in foreign banks (enough to pay for all the imported materials used in 6 months of 1980 GDP).

- The exchange rate reached an all time high on the parallel market (Q3.77=$1.00 in the third quarter of 1985).

- Employment declined by an estimated 415,000 jobs (to a level 16 percent below 1979 employment). 1/

- Net foreign assets became net foreign debt and reached an all time high $585 million (5 percent of GDP).

As indicated above, the manufacturing sector suffered more in the first half of the 1980's than did agriculture. More detail on the structure of the retrenchment in this period is presented in Table 7 below.

It is important to recognize that the anatomy of the contraction of the early 1980's is not simply the mirror image of the expansion that preceeded it. In the 1970's (through 1978 in any case) the quantity of money expanded rapidly. This occurred as the Bank of Guatemala purchased foreign exchange. Between 1970 and 1978, the proportion of the circulating money supply that was "backed" on the asset side by international

1/ Source: IGSS data and OEPA estimates.

Table 7
Percentage Changes in GDP
by Sector of Origin
1981-1985

	1981	1982	1983	1984	Percentage Change to 1980	Percentage Change to 1985
GDP	0.6	-3.5	-2.6	0.5	-0.6	-5.5
Agriculture	1.2	-3.1	-1.7	-1.6	0.3	-1.8
Mining	-40.1	22.2	-10.0	-11.1	-25.0	-56.0
Manufacturing	-3.1	-5.2	-1.9	0.4	-0.6	-10.1
Construction	19.4	-12.0	-26.2	-28.9	-7.4	-48.9
Utilities	--	-1.9	--	3.8	3.7	5.6
Commerce	0.6	-5.6	-4.1	1.2	-3.4	-4.6
Government	4.3	4.1	4.5	2.2	1.6	17.8
Transp. and Communication	-2.3	-4.7	-0.5	3.0	1.9	-2.8
Finance	1.9	0.9	-2.7	-0.9	1.9	1.0
Housing	2.9	2.1	2.8	2.0	1.9	12.3
Other	0.5	-1.1	-1.1	0.5	0.5	-0.7

Source: Bank of Guatemala, Department of National Accounts

assets, increased from 44 percent to 110 percent. After 1978, however, Guatemala's international reserves were quickly depleted as imports and capital flight together exceeded earnings, borrowings and gifts of foreign exchange. Policy makers declined to use either of the tools at their disposal- tight money or devaluation- to stem the loss of reserves. Consequently, although the domestic money stock had expanded as foreign reserves were entering the country, it did not contract as the reserves were leaving. In effect the monetary system was printing quetzales that the public was unwilling to hold. The public rid itself of the excess money by exchanging it for external bank accounts and imported goods and services. In 1983, the last of Guatemala's international reserves were used up. For the first time the country became a net debtor to the rest of the world.

As the system decomposed, both domestic saving and investment dropped off. Saving fell from an average of 15 percent of GDP in the last half of the 1970's to 10 percent in the next five years. Investment (excluding inventory accumulation) averaged only 13 percent of GDP for 1981-85 compared to 19 percent in the previous five years. Moreover, the decline was virtually uninterrupted from 1979 (19 percent of GDP) to 1985 (11 percent of GDP). While part of this decline reflects the relatively greater decline in capital-intensive outputs, it seems clearly to reflect a portfolio restructuring as well, in favor of foreign bank accounts at the expense of domestic productive assets.

By 1985 serious price inflation had made its historical debut in Guatemala. From the first to the fourth quarter of that year prices of home and export goods advanced 38 percent.

The economic task confronting the new, democratically elected government that took office in January 1986 would constitute a harsh, early test of its mettle in economic management. The new leadership needed only to control inflation, preside over a major shift in the structure of production, regain confidence of the private sector, manage a major short-term external debt service responsibility and induce hard-headed multilateral and bilateral donors of the soundness of its economic program. Complicating the tough situation further was the need to take difficult austerity measures amid the unrealistically high expectations of the public that the return to democracy would come hand in hand with rapid improvement in the economy.

As we will see in the section that follows, the Government's program has enjoyed remarkable success in unprecedented time in most areas. Nevertheless the external sector remains in disequilibrium. Our task in designing the FY 1989 ESF program will be to find that indispensable balance between the need to maintain fiscal and monetary discipline with financial stability, on the one hand, and socio-political stability with long-term sustainable growth on the other.

E. 1986-88: Stabilization and Economic Renewal

The first task the new Government set for its economic team was to restore financial stability. The Government recognized from the outset that any genuine improvement in the economic well being of the country could only occur through private sector investment and production. The Minister of Finance and the President of the Central Bank, themselves respected former private sector entrepreneurs, understood the importance to private investors of

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predictability. Under their guidance, the Government set the reestablishment of price, exchange rate and interest rate stability as the first objective of its economic program. Toward this end, the first order of business was to regain control of the growth of aggregate demand.

Although the public sector budget had been set by the outgoing Government, the new economic team had some control over the way it was financed. Thus in 1986 the banking system provided no additional credit to the Central Government. In fact, the Government made net repayments to the banking system. Growth of the money stock, which had reached 55 percent in 1985, dropped to 19 percent in 1986. The deficit of the consolidated nonfinancial public sector fell from 1.4 percent of GDP in 1985 to 0.3 percent in 1986. Although price inflation for the full year was above that of 1985, most of it occurred in the first half of the year. By the fourth quarter, the annualized rate of consumer price inflation was below 10 percent.

To focus its new, disciplined demand management more sharply on the foreign sector, the Government also introduced changes in the foreign exchange system which represented, _de facto_, an overdue devaluation of the currency. The combined effects of the somewhat tighter monetary policy and the devaluation, undoubtedly contributed to a striking improvement in the balance of payments current account. (The dramatic increase in coffee prices, however, was the major factor.) From a 1985 deficit of $246 million the deficit fell to $18 million in 1986. As commodities were progressively shifted into the parallel market, the parallel market exchange rate retreated from the exceptionally high levels it reached in late 1985 and early 1986. In this way, the economic distortions caused by the multiple exchange rate system were reduced and eventually eliminated.

On the production side, 1986 did not see a return to positive real growth. In fact, per capita GDP continued to fall. Nevertheless the achievement of a zero aggregate growth rate was an important step. It was widely interpreted in Guatemala as a signal that the contractionary phase of the economic adjustment was over. As it turned out this view was correct.

In 1987, the stabilization effort was highly successful. Positive real growth occurred and, perhaps most

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encouragingly, definite signs appeared of the kind of structural change required to integrate Guatemala into the international economy. Price inflation dropped to 12 percent or less in 1987. The 1986 increases in the interest rate ceilings on those borrowing and lending rates subject to control, assured that both lending and borrowing rates could be positive in real terms. Gaps between banking market and regulated market exchange rates remained narrow. The public sector deficit declined further and growth of the key monetary aggregates, M_1 and M_2, was held to 10 and 8 percent, respectively. Only a modest resumption of international reserves losses introduced a sobering hue to the picture painted by the economic aggregates.

Specific elements of the structural changes that appeared in 1987 included the following:

- Aggregate GDP increased 3.1 percent with agriculture's contribution gaining 3.6 percent.

- Gross domestic investment jumped sharply from 10.3 percent of GDP to 13.8 percent.

- Real wages in both private and public sectors, while still well below their 1982 values, increased in 1987 for the first time in 5 years.

- Nontraditional exports surged 35 percent above their 1986 level (over half the increase went to extra-regional markets).

- Employment increased by approximately 61,000 jobs of which it is estimated 39,000 were in agriculture[1/].

1/ Total gain in employment estimated by Alfonso Martínez, using OEPA's Macroeconometric Simulation Model. Distribution between Agriculture and "Other" is a seat-of-the-pants estimate based on historical Ag Sector GDP/Employment estimates.

As the U.S. Country Team reviewed the progress of the economy through 1987, we drew three conclusions. First, with 3.1 percent real growth in GDP, it appeared that the contraction in real per capita income had finally been arrested. Second, the demand management effort had shown exceptional success by 1987, particularly in getting price inflation more nearly under control.

The third inference was that serious problems remained to be dealt with if Guatemala was to build robust, long-term growth trajectory on the foundation of stability it had laid. In particular, domestic savings and the investment rate would have to rise, and the loss of international reserves (another facet of the low savings problem) would have to be reversed. Comprehensive stability of the economy could only be claimed when the foreign sector, as well as the domestic sector, was equilibrated.

Both the Guatemalan Government and the U.S. Country Team recognized that economic stability was a necessary condition for robust private sector-led growth, but that it was not a sufficient condition. Consequently, when 1987 results demonstrated that financial stability was on the way to being fully restored, GOG and USG economic teams broadened their focus by elevating the goal of market-rational and sustainable real growth to equal precedence with stability. This meant that the policy dialogue related to ESF assistance, and indeed ESF programs themselves, would focus not just on the policy management of broad aggregates such as the money stock and the budget deficit, but on the structural aspects of economic policy.

In the course of negotiating the FY 1988 ESF program, the GOG was asked to prepare indicative 3-year projections of GDP growth, including the principal sectoral contributions. Starting with historically plausible long-term growth trends, the projections were to estimate the supporting requirements for domestic investment and savings, and for imports. Comparing these requirements with actual results in recent years would indicate the magnitude of the gaps that would have to be filled by some combination of external assistance and domestic policy adjustments. Policy dialogue specific to the ESF program seeks some combination of policy commitments that both sides agree will, when combined with the available ESF, close all the gaps.

The indicative framework employed by the Mission in this exercise is presented in Table 8 below, with a set of estimates prepared in December 1988.

The agenda for the policy discussion pursuant to the FY 1988 program was derived from estimates for gross investment, domestic saving and foreign exchange gaps. The core issues were as follows:

Investment - Historical data suggest that gross investment must average about 10 percent of GDP just to cover depreciation of the capital stock. Over the period 1950-1980, investment averaged over 13 percent of GDP and real growth averaged about 5 percent per year. Abstracting from significant structural change, it seemed reasonable to expect real growth of 3 percent (the projection for 1988) to require investment somewhere in the neighborhood of 11 or 12 percent of GDP. Since 1986 investment was just 10 percent of GDP, and an acrimonious confrontation between private and public sectors over tax "reform" had occurred late in 1987, it seemed clear that serious positive signals would be needed to sustain private investment at its 1987 level of 12 percent.

Savings - Domestic saving had fallen to uncommonly low levels in the early 1980's averaging less than 7 percent of GDP. They dropped sharply in 1987 to 5.4 percent of GDP after having reached 9.1 percent in 1986. It was clear that the large current account deficit on the balance of payments (US$600 million, or 7.5 percent of GDP) could not be sustained for long. Policy measures to dampen demand for imported consumer goods, to permit higher real rates of interest and to restore confidence in Guatemala as an abode for private wealth, would be essential if 1988 growth targets were to be met.

External Gap - The balance of payments gap was far greater than any reasonable level of foreign assistance. Thus it seemed clear that balance of payments policy would have to be strengthened by some combination of devaluation and monetary policy tightening. Moreover, it seemed unlikely that either instrument by itself would be adequate. Too high an exchange rate would give production costs a sharp upward jolt. Too much credit restriction would choke off operating capital essential to private production.

TABLE 8
INDICATIVE PROGRAM ESTIMATES
(1988-1990)

	ACTUAL 1987	PRELIM 1988	PROJECTED 1989	1990
I. GROWTH SCENARIOS (MILLIONS OF Q)				
A. GDP BY SECTOR	17,595	20,490	23,244	26,291
1. Agriculture	4,477	5,238	5,720	6,276
(Export)	1,477	1,729	1,945	2,197
2. Manufacturing	2,815	3,278	3,719	4,207
3. Services	9,501	11,065	12,552	14,197
4. Other	801	909	1,253	1,611
B. EXPENDITURE BY TYPE	18,736	21,744	24,525	27,306
1. Gross Fixed Investment	2,150	2,727	3,217	3,689
a. Private	1,688	2,156	2,532	2,889
b. Public	462	571	685	800
2. Consumption	16,586	19,017	21,308	23,617
a. Private	15,212	17,491	19,622	21,785
b. Public	1,374	1,526	1,686	1,832
C. EXCESS OF GDP OVER EXPENDITURES				
(A - B):	(1,141)	(1,254)	(1,281)	(1,015)
(As % of GDP)	-6.5%	-6.1%	-5.5%	-3.9%
II. FINANCING INVESTMENT (MILLIONS OF Q)				
A. DOMESTIC SAVING	1,048	1,522	1,836	2,555
B. FOREIGN SAVING (=INV - DOM SAV)	1,102	1,205	1,381	1,134
C. TOTAL FINANCING (A + B)	2,150	2,727	3,217	3,689
III. FOREIGN EXCHANGE REQUIREMENT (MILLIONS OF Q)				
A. IMPORTS OF G & NFS	3,930	4,263	5,089	5,496
B. NET FACTOR SERVICES	507	551	656	620
C. AMORTIZATION	585	980	598	490
a. Public	585	980	598	490
b. Private (net)	0	0	0	0
D. TOTAL REQUIREMENT (A + B + C)	5,022	5,794	6,343	6,606
IV. FOREIGN EXCHANGE RECEIPTS (MILLIONS OF Q)				
A. MERCHANDISE EXPORTS	2,445	2,874	3,355	3,550
B. NON-FACTOR SERVICES	362	411	453	480
C. PRIVATE TRANSFERS	188	294	268	250
D. PRIVATE CAPITAL	998	965	1,075	1,104
E. OFFICIAL TRANSFERS	618	756	698	670
a. Non-AID	135	138	135	120
b. Public Sector	275	341	363	350
c. BOG	208	277	200	200
F. TOTAL RECEIPTS (A THRU E)	4,611	5,300	5,849	6,054
V. FOREIGN EXCHANGE GAP (III D - IV F) (MILLIONS OF Q)				
GAP (in Millions of Q)	411	494	494	552
(in Millions of US$)	164	190	183	204

Public Sector Investment Budget Execution - Within the realm of investment, the public sector was of particular concern. Private investment had shown itself to be resilient. When the private sector decides it makes sense to invest, it does so and things happen. The public sector investment program, on the other hand, has suffered not only from a dearth of funds, but from administrative and bureaucratic inability to get projects moving even when funds are readily available. Given that the public sector's investment program is minuscule to begin with, its inability to execute its investment program has had serious negative repercussions in the form of deficient social overhead capital- education, training, health care, roads, public utilities, transportation facilities, information dissemination, etc. The support of public services in this category is indispensable to an efficient, market-driven, private sector. It is also a symbol of a humane civilization. Whether on the grounds of hard-headed business sense or of compassion and humanitarian instincts, improvements in fiscal management and the conduct of policy are a precondition to serious and sustainable economic growth. This premise was another cornestone of our policy dialogue with the Government of Guatemala in FY 1988 and continues to be so now.

The policy program designed by GOG leadership for 1988 contained measures not only directed at maintaining stability, but also at achieving higher levels of real GDP growth. Quantitative targets were established for monetary expansion and the fiscal deficit, consistent with a modest increase in net international reserves, inflation of around 10 percent and GDP growth of 3.5 percent in real terms.

By mid-year in 1988, however, the GOG realized that despite having contained monetary expansion to well within their target, the country was experiencing a hemorrhage of foreign currency reserves. The GOG economic cabinet moved quickly to correct the external imbalance by adopting measures to restrain import demand and more tightly control expansion of the monetary aggregates. These measures included:

-- Reunification of the multiple exchange rate, and devaluation from Q2.50 to Q2.70 per dollar.

-- An increase of two percentage points in the interest rate ceilings for commercial bank deposits and lending.

-- Withdrawal of public sector deposits from the banking system.

With these measures, by yearend the GOG was able to meet its quantitative targets in all areas except the external accounts. The latter showed some improvement in the last half of the year, but not enough to compensate for the substantial outflow of reserves in the first semester of 1988. As a result, Guatemala will end 1988 with an estimated $56 million decrease in net international reserves.

The table below shows Guatemala's performance against the major quantitative targets stated in the FY 1988 ESF side letter.

Table 9
GOG Performance Targets
Under FY 1988 ESF Program

	Target	Projected Actual (Nov. est.)
Fiscal		
Central Government Deficit (percent of GDP) (excluding grants)	-3.3%	-2.5%
Monetary		
Central Bank Credit to Central Government (Q millions)	+Q35.0	+Q35.0[1]
Percent Growth in Money Supply (M2)	+ 9.7	+ 8.3
External		
Change in Net International Reserves (2nd half of 1988) (US$ millions)	+10.0	+ 0.0

1 Through December 9, Central Bank credit to the Central Goverment was negative 9.8 million, but the GOG expects substantial investment project execution in the last weeks of the year.

For 1988, it appears that inflation will be somewhat above the 10.0 percent target, at around 13 percent. Growth in real GDP is projected to reach at least 3.5 percent this year, possibly as high as 4.0 percent.

Economic growth in 1988 in part reflects measures taken by Guatemalan policymakers to increase investment and expand production by exporting sectors. These included:

(1) Laws sent to Congress for export promotion and for the establishment of private sector free zones.

(2) Process by which airlines seek rights to serve Guatemala simplified, and privatization options for AVIATECA, the national airline, studied.

(3) Programs to promote Guatemalan tourism and attract foreign investment in the sector.

(4) De-emphasis of price controls as a stabilization tool continued.

(5) Initiation of a program of customs improvement.

(6) A Core Development Budget adopted for 1988 and 1989, to help raise public investment in priority areas.

Clearly, some elements of the policy programs described above were loosely articulated and hence difficult to monitor. Nevertheless it was agreed between the USG and the GOG that the program in the aggregate offered good prospects for maintaining financial stability and moving toward a healthy and sustainable long-term growth path.

F. <u>The GOG's stabilization and Growth Programs: Status as of the End of 1988</u>

As calendar year 1988 closes, the USG and GOG economic teams are reviewing performance in both the ongoing stabilization effort and in the first year of the Government's three-year growth program. As discussed in more detail in the sections which follow, satisfactory progress toward the program's objectives, as well as a mutually agreed-upon policy program for 1989 that is consistent with the long-term growth program, will be the basis for the second year of ESF support.

Table 10 which follows is based on program projections made by the GOG economic team in support of its request for ESF assistance to help meet the objectives of its stabilization and growth program. The table gives evidence of some early successes in the growth program -- public and private investment and savings are up from last year, and nontraditional exports are enjoying significant growth.

TABLE 10
SELECTED MEASURES OF ECONOMIC PERFORMANCE

	1985	1986	1987	1988/p
GDP GROWTH (%)	-0.6	0.5	3.1	3.5
AGRICULTURE	-0.8	0.3	3.6	3.0
MANUFACTURING	-0.2	0.1	1.7	2.5
COMMERCE	-3.7	-1.8	2.5	3.1
GOVERNMENT	1.2	4.0	4.5	3.2
OTHER	0.3	2.7	3.9	4.8
PRICE INFLATION (DEC. TO DEC.)	19.0	32.7	12.0	13.0
MONEY SUPPLY GROWTH (M1,%)	54.8	18.1	11.8	6.4
PUBLIC SECTOR DEFICIT (AS A PERCENTAGE OF GDP)/a	5.9	2.7	2.3	3.2
TAX REVENUES (% OF GDP)	6.1	7.9	8.1	8.8
NON-TRADITIONAL EXPORTS (MILLIONS OF US$)	127.0	127.8	171.6	215.0
PERCENT OF TOTAL EXPORTS	12.0	12.2	17.6	19.4
OVERALL BALANCE OF PAYMENTS DEFICIT (-) OR SURPLUS (+) (N.B. MILLIONS OF US$, INCLUDES EXCEPTIONAL FINANCING)	68.6	48.0	-73.0	-56.0
FIXED INVESTMENT (% OF GDP)	11.1	9.8	12.2	13.3
PUBLIC	2.7	1.9	2.1	2.8
PRIVATE	8.4	7.8	10.1	10.5
DOMESTIC SAVING (% OF GDP)	7.8	9.3	5.4	7.4
PUBLIC	1.3	1.1	0.8	1.0
PRIVATE	6.5	8.2	4.6	6.4
NET INTERNATIONAL RESERVES OF BANKING SYSTEM (MIL. US$)	-457.0	-443.9	-465.0	-566.0

a/Includes exchange losses of the Central Bank and deficit of non-financial Public Sector
p/Projected

Source: Bank of Guatemala, Ministry of Finance, and IMF

III. GUATEMALAN ECONOMIC POLICY IN 1989 - 1990 AND THE ESF POLICY DIALOGUE

The Guatemalan economic recovery is now in its second year. Stronger economic performance in 1987 and thus far in 1988 reflects the Cerezo government's commitment to see its stabilization program through, and to make adjustments in that program as required by economic conditions. During 1988, Guatemalan policy makers began broadening the program's scope to emphasize economic growth through revision of policies holding back the agriculture sector and export production. At the same time, the Cerezo government's commitment to improving the wellbeing of the urban and rural poor continues to be reflected in the budget process.

A. The 1989 Stabilization Program

The Guatemalan authorities adopted a major correction to their stabilization program in June of 1988, in response to a growing imbalance in the external accounts. The Monetary Board and Congress took a series of actions to reverse the outflow of international reserves, including devaluation of the quetzal, unification of the multiple exchange rate, an increase in interest rate ceilings, a tightening of credit growth targets and a public sector budget cut. To raise revenues and slow demand for imported petroleum products, gasoline and diesel prices were raised.

Despite these difficult measures, a serious balance of payments shortfall will continue in the near term. The shortfall is due to heavy external debt commitments and rising demand for imported inputs as the economy expands. As shown in Table 11 on the following page, the balance of payments "gap" is projected to reach about $183 million next year.

The Guatemalan policymakers have proposed the following program to close this gap, and even end the year with a $60 million increase in net international reserves. The program contains the following targets for 1989:

(1) Achieve an overall public sector deficit of 2.6 percent of GDP.

(2) Limit Central Bank credit to the Central Government to negative Q48 million.

TABLE 11 GUATEMALA: SUMMARY OF BALANCE OF PAYMENTS 1986-1989
(In Millions of US Dollars)

	1986 GOG	1987 GOG	1988 Nov. ESTIMATES	1989 AID PROJECTIONS
CURRENT ACCOUNT	-48.8	-531.6	-538.5	-578.1
Trade Balance	168.1	-355.2	-371.1	-321.4
Exports FOB	1043.8	977.9	1105.4	1242.6
Imports FOB	-875.7	-1333.1	-1476.5	-1564.0
Services/Transfers Net	-216.9	-176.4	-167.4	-249.6
CAPITAL ACCOUNT	40.1	387.1	332.8	395.2
Private Capital Net	95.2	399.0	361.3	378.0
(short-term net)	-9.9	239.3	219.8	260.6
(long-term net)	105.1	159.7	141.5	117.4
Official/Banking Capital net	-55.1	-11.9	-23.5	17.2
short-term net	5.9	25.3	-39.9	-33.1
(of which AID TCIP)	(5.7)	(23.0)	(59.4)	(15.0)
(of which EXIMBANK)	(20.7)	(10.3)	(48.2)	(12.5)
long-term net	-61.0	-37.2	16.4	50.3
(of which CCC)	(15.1)	(7.6)	(5.4)	(18.0)
ERRORS AND OMISSIONS	10.0	19.8	10.0	----
EXCEPTIONAL FINANCING REQUIREMENT	1.3	-164.3	-190.7	-182.9
(of which AID ESF)	(47.4)	(90.75)	(75.0)	(69.0)
(of which IMF)	(0.0)	(0.0)	(59.7)	(68.0)
(of which IBRD Export Promotion Project)	(0.0)	(0.0)	(0.0)	(64.0)
NET CHANGE IN INTERNATIONAL RESERVES (- equals increase)	-48.6	73.5	56.0	-18.1

SOURCE: BANK OF GUATEMALA

(3) Restrain monetary growth, as measured by M2, to 9.7 percent.

(4) Approve all valid foreign exchange requests within five working days.

(5) Eliminate most external payments arrears by June 30, 1989.

This program alone cannot fill the external financing gap. However, the proposed monetary, fiscal and exchange policies which underlie the targets listed above have been judged as appropriate and sound by the International Monetary Fund and World Bank, both of which who are prepared to offer a significant amount of exceptional balance of payments financing in 1989. Still, as shown in Table 11, reserves will not increase sufficiently to reach the $60 million target. Rather than tighten the monetary program further and perhaps cut GDP growth, the country is seeking additional exceptional financing from sources such as the IMF and Japan. More detail on international agency support of Guatemala's macroeconomic program is provided in Section IV E.

As noted in previous sections of this paper, while the stabilization program outlined above is judged to be feasible and sound, its success depends in part on growing private sector confidence. The strong support of the U.S. government to the Guatemalan economy has been a visible signal to private sector producers that Guatemala's economic program merits international economic support. Accordingly, the U.S. Country Team recommends that the 1989 ESF program be disbursed as soon as possible to help bolster public confidence in the economy.

B. <u>The Agriculture Sector Component of the GOG Economic Program</u>

Earlier sections of this document showed that GOG policies of the 1960's and 1970's promoting import-substititution industrialization have held agricultural development back. Agriculture lagged despite its natural competitive advantage. The industrial sector growth Guatemala achieved then was at the expense today of high external debt service payments, and a heavy import dependency of its manufacturing sector. Both of these problems contribute to the

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balance of payments gap that is behind the Government of Guatemala's request for ESF assistance in recent years and today.

Making the playing field more level, to allow the country to realize higher levels of growth that are sustainable in the long run, requires attention on three fronts:

(1) Improvement in Guatemala's agricultural policy framework.

(2) Adjustment of industrial policies that artificially contravene market signals and draw resources away from agriculture.

(3) Accelerated public investment in agricultural infrastructure and rural services, to compensate for 20 years' underinvestment.

All three areas will be addressed by the FY 1989 ESF program, as detailed below. Formulating and implementing an agriculture sector growth strategy called for policy discussions among a wider group of Guatemalan public sector agencies than those who have participated in macroeconomic policy discussions in the past. As a first step, the FY 1988 ESF agreement established a multiagency working group on agricultural policy. The group has the following representation.

Ministry of Agriculture (Chair)
Ministry of Economy
Ministry of Finance
National Planning Council
Central Bank

Each participating institution has named two representatives to the group - one a Viceminister and one a department chief. USAID participates as an observer to the group's work, with staff of the Rural Development Office and the Office of Economic Policy Analysis taking part in the discussions.

The working group, now a legally established entity, has prepared the first draft of its three-year plan of action, as provided for under the FY 1988 ESF agreement. The document states the objectives of the GOG policy toward agriculture to be:

a. Modernize Guatemalan agriculture, and increase rural employment.

b. Increase and diversify agriculture exports, and develop greater capacity for agroindustrial production.

c. Rationalize the existing food security programs.

d. Improve rural infrastructure, especially irrigation and roads.

e. Provide land to landless laborers through voluntary market mechanisms.

f. Improve natural resource management.

The three-year plan outlines strategies to meet these objectives during the near term. During the document's formulation, however, it became painfully clear that not only is there a tremendous lack of information upon which to base agricultural decisions, but also that there are inconsistencies within the public sector's agricultural strategy itself. Also, the three-year plan does not address the problems caused to agriculture by policies not specific to the sector, such as the tariff.

An example of inconsistency is the potential for conflict between the Guatemalan government's strategies of food security and diversification. The food security program cites as an objective increasing production of basic consumer crops such as corn and beans in the Western Highlands. Instruments of this policy objective are crop support prices, storage facilities and import restrictions, all to stimulate domestic production. At the same time, the Guatemalan policymakers are proposing subsidy of certain agricultural inputs to promote diversification of Highland farms out of basic consumption crops such as corn and beans into higher profit crops such as vegetables. There has been little, if any, public sector analysis of whether actions to promote food security and diversification are complementary (e.g. increasing productivity) or contradictory (e.g. promoting crop substitution).

The information gaps present in the draft plan led USAID to propose a two-pronged approach to the agriculture sector program. In areas where policy problems and investment needs are well defined, commitments under the FY 1989 ESF program will be for immediate action. In areas where there are contradictions in the GOG's agriculture strategy, or for which little information or analytical work is available, commitments under the FY 1989 ESF program will be for completion of studies and improvement in the database.

The commitments sought for the FY 1989 ESF agreement are:

Agriculture Policy - The ASWG has noted possible areas of conflict between its traditional policies promoting food security, and its more recent drive toward small farmer crop diversification. Accordingly, the ESF side letter will contain as a covenant:

(1) The ASWG will contract an evaluation of the food security program, its economic costs and benefits, its budgetary implications, and its impact on domestic food supply and prices, to be completed no later than September 30, 1989.

Industrial Policy - The US negotiating team has raised the topic of industrial policy with the ASWG, and with the GOG economic team. The FY 1989 ESF program will support ongoing GOG efforts in two areas: (1) reduction of the anti-export bias against extraregional exports and (2) review of any remaining fiscal incentives oriented toward production for the protected Central American Common Market. (NOTE: Most of these incentives were eliminated in 1986.) The specific covenants to be contained in the ESF side letter will be:

(1) Continued progress in 1989 in reforming the external tariff, to make rates more uniform across products.

(2) Passage of an export incentive law which compensates exporters for payment of duties on imported inputs, thus reducing the bias against exports inherent in the tariff.

(3) Review of industrial fiscal incentive policy, in the context of the design work for USAID's FY 1989 Fiscal Administration Project.

<u>Investment in Support of Agriculture Development</u> - The ASWG has prepared a comprehensive program of actions to accelerate public sector investment in support of agriculture. The program includes the following commitments for immediate action:

(1) Fix the budgetary process of agriculture-related public sector investment, by taking the following actions:

-- The Ministry of Agriculture will present a unified budget request to the Ministry of Finance for the 1990 budget, a departure from the previous system where individual agencies of the agricultural public sector deal directly with Finance, with no overall coordination of budgetary allocations.

-- The Ministry of Agriculture will prepare investment project profiles for all 1989 projects, which include information such as current year and life of project costs, and expected outputs. Up until now, many investment projects have been funded year-by-year, without any analysis of total cost.

-- The Ministry of Agriculture will establish a formal system to monitor project implementation, and will prepare quarterly reports on project execution rates, which identify problem areas and projects.

-- The GOG will establish targets for execution of investments contained in the Core Development Budget, and the Ministry of Agriculture subcomponent of the CDB, which represent substantial increases over the rates achieved in the 1988 CDB. (These target will be quantified as soon as 1988 CDB execution rates are known, in February).

(2) The Ministry of Agriculture, working with USAID, will complete an irrigation sector assessment.

(3) The ASWG will provide a workplan to improve the efficiency of operation of the land registry

process. The excruciating difficulties involved in gaining clear titles to land are a serious impediment to the success of voluntary land transfer programs, as well as to private sector investment in agriculture.

(4) The GOG will carry out the initial steps of its time-phased plan for decentralization of BANDESA, the national agriculture bank.

To promote greater private sector investment generally, the following longer-term commitments will be pursued in the FY 1989 ESF program:

(1) Further progress toward "open skies" and "open seas". Review with GOG reason for delay in dissolving FLOMERCA.

(2) Progress toward timely execution of public investment programs in the areas of energy generation, telecommunications improvement, parts and road construction, and review of policies in these sectors.

(3) Passage of a law permitting private sector investment in free zones.

(4) Commitment to pursue realistic and market-oriented interest and exchange rate policies.

The above commitments will have positive impacts on investments in agriculture and in other sectors as well.

C. Spread of Growth's Benefits

The questions of equity and reaching our target group have entered the ESF dialogue in two explicit ways. The first--the level and implementation of public investments in rural infrastructure and social services--was discussed in the preceding sections. The second issue relates to the question of agricultural growth. What impediments do small farmers face to expanding their production, when macroeconomic policy provides incentives to do so? What agricultural policies and institutions stand in the way of increased incomes for the rural poor?

The policy and institutional improvements contained in the conditions precedent and convenants cited in the previous section are oriented toward these questions. The items on this agenda are closely tied to GOG strategies to improve the well-being of the rural poor, namely:

1. Increase access to land.

2. Improve the operations of BANDESA, the national agriculture bank which is the primary institutional source of credit for Guatemala's small farmers.

3. Allocate public investment funds for agriculture more rationally, and improve implementation of investment projects.

4. Refine the GOG's food security policy and reduce its budgetary cost

5. Refine and implement programs to provide irrigation systems to small farmers.

D. <u>The Side Letter</u>

In accordance with the policy dialogue outlined in this section, the FY 1989 ESF side letter will have the following format:

1. Description of economic performance in 1988.

2. Update of a three-year quantitative projection of the major economic variables, and identification of fiscal, foreign exchange and savings/investment gaps which could prevent Guatemala from meeting its growth targets.

3. Description of planned stabilization and growth policies to be adopted in 1989, and policy directions for 1990.

4. Description of any immediate policy actions to be taken to improve growth and development of the agriculture sector, as developed in the GOG three-year plan of action.

5. A request for USG ESF assistance to support the adoption of the economic policies described in the letter.

IV. PROGRAM DESCRIPTION

A. U.S. Interests and CDSS Relationship

The FY 1989 Guatemala CDSS describes the inequitable distribution of the country's considerable wealth. The low incomes of the majority of Guatemalans have been severely eroded in recent years, both by the regional recession and by the 1985-86 burst of inflation. The CDSS documents the impact of the economic crisis and the lack of hope for improvement of living standards in the absence of a comprehensive stabilization plan. The Mission also noted the danger to Guatemalan political stability and regional security if the population was left without hope that economic conditions would ever improve.

The Report of the National Bipartissan Commission on Central America (NBCCA) identified a clear need for a rapid build-up in economic assistance to Central America to address the dual problems of growth and equity. Nonetheless, because of Congressional concerns about the lack of commitment of previous Guatemalan governments to addressing the problems of the disadvantaged population and to respecting human rights, assistance levels for the country were held to much lower levels than those for regional neighbors. The progress toward elections and the return to a civilian government, however, led to the restoration in FY 1985 of foreign assistance, including badly needed ESF support.

The proposed FY 1989 ESF program is consistent with NBCCA and Mission strategy for Guatemala, as most recently articulated in the 1989-90 Action Plan. The program will assist the government to undertake policy reforms to stabilize the economy and to stimulate growth through greater investment and export, building on the courageous and far-reaching economic policies enacted during the past two years. The proposed agricultural emphasis of the FY 1989 ESF program meets the CAI mandate to focus increasingly on sector growth programs as the Guatemalan economy stabilizes. The ESF orientation toward agriculture sector growth will complement PL 480 program investments and self-help measures. The development objectives of the strategy will be furthered through programming of local currencies and through protection of the Guatemalan public investment budget in support of rural infrastructure and small-farm production.

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Economic stability and steady growth in real incomes, particularly of the country's least-advantaged groups, will give a strong boost to the institutionalization of democracy in Guatemala. In the near term, the ESF policy dialogue will be directed toward protection and expansion of the economic gains made during the Cerezo's goverment's first three years in office. A steady hand in economic management is needed now more than ever as political pressures heighten over the upcoming elections. At the same time, a smooth transition will depend on the current government's ability to keep the economy on an even keel, and showing steady improvement. The FY 1989 ESF program will assist in that effort by boosting availability of foreign exchange for essential inputs to production, and by providing budget support to expand the level of services and infrastructure available to the country's poor.

B. Policy Dialogue

The U.S. Country Team has maintained a close dialogue with the Government of Guatemala on economic policy issues since the signing of the FY 1986 ESF agreement. Beginning with the adoption of the economic package in June 1986, the Government of Guatemala has enacted measures in support of its stabilization agenda and also to stimulate private sector production and investment. These are detailed in Annex A, which updates the inventory of economic policy progress under the Cerezo government.

Discussions leading into the FY 1989 ESF agreement have centered on macropolicy management and GOG commitment to remove distortions which adversely affect the agriculture sector, particularly the small farm subsector. The U.S. Country Team has reviewed recent and planned GOG economic policy measures, and recommends that the FY 1989 ESF agreement be based on the actions which follow.

The following steps must be taken prior to disbursement of the ESF dollars and will serve as de facto conditions precedent:

(1) Presentation of a side letter which outlines the GOG's broad economic program for 1988 through 1991, and the specific program for 1989, including proposed policies to be taken and targets for key macroeconomic variables. The specific macro policies and

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targets were listed in Section III.A of this document.

(2) Presentation by the Government of Guatemala of a time-phased plan of work, including actions to be taken immediately, to analyze and make improvement in agricultural sector policies and institutions. The details of the agriculture sector component were given in Sections III.B and III.C.

There will also be the following condition precedent to disbursement of local currencies for budget support from the Special Account:

Establishment of a Core Development Budget within the 1989 investment budget.

In addition, the side letter will contain the following general commitments:

(1) Commitment to jointly track, with USAID/Guatemala, progress toward meeting stabilization and structural adjustment goals, and progress toward meeting the goals established in the agricultural sector program.

(2) Commitment to make substantial progress toward the objective of full (100 percent) execution of the Core Development Budget in 1989. This objective will be quantified in the side letter.

C. Local Currency Programming

Beginning in FY 1988, the Government of Guatemala adopted the policy of channelling into the Government of Guatemala's Core Development Budget (CDB) a sum of local currency equivalent to the dollar value of ESF balance of payments assistance less the GOG contribution to the USAID/ROCAP local operating, technical support and audit expense trust account.

The Core Development Budget (CDB) contains the top-priority development investments contemplated in the central government budget, including other donor and USAID projects and their counterpart. Guatemala's CDB for 1989 is now being developed with technical assistance provided by the Mission to the Office of the Minister of Finance. The strong orientation of the CDB toward agriculture and rural development makes it an ideal vehicle for disbursement of local currencies destined as investment budget support. For local currencies used as budget support, a special account will be established within the Ministry of Finance to finance expenditures within the CDB, 10 days after the agreement is signed.

The Mission has adopted the Core Development Budget as a tool to accomplish the following objectives:

1. Prioritization of public sector investments by the Ministry of Finance, and a commitment to provide full funding to those contained within the CDB.

2. A vehicle to address the level of investment in key agricultural areas such as irrigation, natural resource management and research.

3. A vehicle for USAID to raise with the Government of Guatemala the issue of deficiencies in the national budgeting system. This effort will be coordinated with activities under the Mission's FY 1989 Fiscal Administration Project.

4. Progress toward full (100 percent) execution goal (implementation rate) for the CDB as a whole, to be stated in the side letter.

5. A mechanism whereby the Mission ESF dollar assistance can provide general budget support to the GOG, without the need for line item-by-line item, quetzal-by-quetzal approval of each local currency expenditure.

6. Under the new framework, once the CDB is approved by USAID, the Ministry of Finance may disburse local currency into those budget line items without further approval from USAID, thus reducing the voluminous

paperwork the former system of item-by-item approval has created. The CDB will be a subset of investment activities contained in the national budget approved by Congress. Once the CDB is approved, USAID expects there will be no revisions during the year.

Finally, USAID and the Government of Guatemala will program $6.95 million in ESF local currencies to supplement OE and technical support and audit needs of USAID/Guatemala.

For FY 1989, no local currencies identified with ESF will be programmed for activities with PVO's and the private sector. The Mission will use dollar DA resources for such programs.

Thus the breakdown of ESF local currency uses for the FY 1989 program will be:

Support to Core Development Budget	$62.55 million
AID Trust Funds	$ 6.95 million
TOTAL	$69.50 million

D. <u>Mechanism for Disbursement of ESF Dollars</u>

Upon the GOG meeting all conditions precedent to disbursement, USAID/Guatemala will request disbursement in the form of an electronic funds transfer to a separate Government of Guatemala bank account in the Federal Reserve Bank of New York. Evidence must be presented to support the establishment of a separate bank account for the dollar grant funds by providing the bank account number, name of the bank account and address of the bank to USAID/Guatemala. Once this information is provided along with evidence that all conditions precedent to disbursement have been satisfied, USAID/Guatemala will request that AID/Washington process an electronic transfer of funds for deposit into the separate Guatemalan Federal Reserve Bank Account. Withdrawals from this account will be made in accordance with procedures established with the USAID/Guatemala Controller's Office. Withdrawals will be supported by agreed-to documentation to permit monitoring of disbursements.

E. Other Donor/Lender Coordination

Up until recently, the U.S. Government the only provider of significant exceptional balance of payments support to the Cerezo government. We have taken the lead in policy discussions with Guatemalan economic authorities, and our programs served as a bridge to commitments for balance of payments support from other sources.

As of October 1988, we are no longer swimming alone in the lake. Guatemala has signed a Stand-by Agreement with the International Monetary Fund, and has agreed to the policy actions necessary to move the World Bank Export Development Loan forward. The latter is now on track for board approval in March and disbursement in June.

So far, the three policy-based programs have been mutually supporting, and no major areas of conflict have arisen. In large part this harmony reflects that we are all supporting the policy initiatives of the current government, rather than imposing programs of our own design. In fact, the IMF agreement accepted the Guatemala program virtually "as is", with no significant policy changes required prior to disbursement.

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V. ACCOUNTABILITY OF ESF DOLLARS AND LOCAL CURRENCIES

A. ESF Dollars

During the past year, USAID/Guatemala has developed and implemented a highly effective system of managing the separate dollar account mandated by Congress. The system works as follows:

1. The ESF agreement stipulates as a condition precedent that the Bank of Guatemala establish a separate, noncommingled account for the dollar disbursement, and provides AID with audit rights over the account and its associated import transactions.

2. USAID worked with the Bank of Guatemala to develop a computer program which sorts and collects information on completed import transactions which fit the eligibility criteria contained in the ESF agreement. Only imports of inputs to private sector production are eligible. The eligibility period is the fiscal year during which the ESF assistance is obligated.

3. The Bank of Guatemala periodically submits to USAID a computerized list of eligible commodity transactions.

4. The USAID Controller's Office reviews the list presented by the Bank of Guatemala, and discards any transaction which appears not to meet eligibility criteria. USAID then authorizes withdrawal of ESF dollars from the separate account in the amount of the nonrejected transactions contained in the list.

5. After approval by USAID, the Controller's Office conducts a financial review of the import documentation (which is housed at the Bank of Guatemala) for transactions on the list and requires redeposit into the separate account of any dollars disbursed against rejected import transactions.

6. Any interest earned on the dollar account is treated in the same manner as the principal.

USAID/Guatemala has streamlined procedures through the establishment of a special unit within the Controller's Office which reviews ESF dollar and local currency documentation and which conducts related financial reviews. At present, detailed financial reviews are being conducted of dollar uses in prior ESF programs. So far, no problems have been encountered.

B. ESF and Local Currencies

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

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

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

1. The Guatemalan government determines its highest priority development investments for the upcoming budget year. These investments, together with a limited number of operating expense-funded activities necessary to their execution, form the Core Development Budget. USAID participates in the prioritization process, through provision of technical assistance in investment project evaluation.

2. The GOG submits the Core Development Budget to USAID for approval. Mission approval is based on two elements: (1) that the CDB was prepared using sound budgetary principles, and (2) that it does not contain military and other expenditures prohibited under U.S. foreign assistance legislation. (These prohibitions are also cited in the ESF agreement.) Through the FY 1989 Fiscal Administration Project, USAID/Guatemala will provide assistance to the Ministry of Finance to improve the budgetary process, particularly for capital budgeting.

3. Once the CDB is approved, ESF local currencies may be disbursed to finance any activity it contains. In FY 1988, for example, Q182 million in ESF local currencies partly financed a Q450 million 1988 CDB.

4. The GOG commits to improving execution rates of the investments contained within the CDB over the low rates of execution traditionally seen in Guatemala. In addition, the Ministry of Finance will undertake implementation reviews of the slowest-moving CDB projects (ESF-financed or not) and take steps to improve their execution. A quarterly report showing execution rates by project is submitted to USAID.

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

6. Primary responsibility for audit of the CDB rests with the Guatemalan Controller General

Office. USAID retains full audit and document inspection rights.

GOG audit capability is being upgraded under both ROCAP and USAID-funded projects. Peat Marwick and Mitchell has been contracted to carry out an assessment of the technical assistance needs of the Controller General Office, for which work will begin in January of 1989. Funds have been reserved under the Mission's Development Training and Support Project to finance needed technical assistance and training. The CDB includes the expenditures of the Controller General Office and other units which administer of monitor donor projects and programs.

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

For USAID trust funds, the full amount for OE, technical support and audit accounts must be transferred to the U.S. Disbursing Officer's interest-bearing account in the Bank of America after receipt of the U.S. dollar disbursement by the Guatemalan Goverment. Programming, management and audit responsibilities for these funds are established in Mission Order 19-7.

For programs with the private sector under the FY 1987 ESF agreement, subagreements provide for audits to be carried out by private accounting firms designated by USAID. USAID financial reviews are financed from the audit trust fund established by the Mission with local currency under the FY 1987 ESF agreement. IQC's with two local affiliates of U.S. accounting firms have been signed for this purpose. Financial and management reviews of GOG budget line items financed with FY 1986 and 1987 ESF local currency are underway. In addition, the USAID Controller's office will schedule a review of the Ministry of Finance under an IQC mechanism to assess internal controls pertaining to the programming implementation and monitoring of local currency.

VI. NEGOTIATING STRATEGY AND OPTIONS

The negotiating strategy will build on the approach and mechanisms established for prior years' ESF disbursements. Discussions have been scheduled with the GOG economic authorities to jointly evaluate early progress of the economic package, with the USAID Director serving as head of the negotiating team. The team also includes the Embassy Economic Counselor and the USAID Office of Economic Policy Analysis staff, with backstop support from the Controller's, Program, Rural Development, Project Development and Support and Private Sector Offices. Within USAID, ESF strategies are developed jointly with those for DA and PL480 assistance. This past year, a joint ESF-PL480 committee was established to improve policy dialogue coordination for agriculture sector issues. Positions to be taken and terms of negotiations will be cleared for Country Team purposes in prior discussions between the USAID Director and the Ambassador and DCM, and through joint State/AID cables to Washington.

On the Government of Guatemala side, ESF negotiations have been held in the past with staff of the Bank of Guatemala and the Ministry of Finance. With the introduction of a sector policy dialogue in agriculture, the negotiating table now includes staff of the Ministry of Agriculture.

AID's LAC Bureau will coordinate and ensure clearances of other Washington agencies involved in the ESF approval process. Data collection, analysis and preparation of policy statements, and liaison with key Guatemalan counterparts at the technical and policy levels of the Central Bank, the Planning Council and the Ministry of Finance will continue to be principally the responsibility of the staff of the USAID Office of Economic Policy Analysis, working together with the Embassy Economic Counselor. For the Agricultural Sector activities, negotiations have been initiated with the Minister of Agriculture and his staff. Supporting information will be gathered through USAID and Embassy contacts with other donors, private sector representatives and other economic leaders.

VII. CONDITIONS AND COVENANTS

The economic policy-related conditions and covenants to be sought in the ESF agreement are outlined in Sections III and IV of this document. In addition, the conditions and covenants of the FY 1989 agreement will reflect the local currency amount and uses, the deposit into the USAID/Guatemala Trust Fund, provisions regarding the Separate Account for dollars mandated by Congress, and provision for independent audits. The draft ESF agreement will be reviewed by the Regional Legal Advisor. The final PAAD document has been leared by the Mission Director and Controller.

VIII. SCHEDULE FOR ESF PROGRAM

The Country Team proposes the following schedule for actions required for the FY 1989 ESF program:

PAAD received in AID/W	December 30
AID/W receives IEE determination cable from USAID	December 30
Issues Meeting	January 24
DAEC Meeting	January 27
ESF program authorized	January 31
Target Date for Signed Agreement	February 20
ESF Disbursed	March 1

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ANNEX A

GUATEMALA:

1. Inventory of Policy Progress Under Cerezo Government

Prior to Signing of FY 1986 ESF Agreement
January 14 - June 6, 1986:

- Simplification of the exchange system, ending commodity imports under the official (dollar parity) exchange rate and creating incentives to export.

- Effective devaluation of quetzal from Q1.90 to Q2.30 per dollar (based on June 1986 level of parallel market).

- Restrictive monetary policies to control inflation, including raising of interest rate ceilings, increases in reserve requirements, and increases in intra-governmental interest rates.

- New revenue measures, including a new valuation system for imports based on the parallel market exchange rate, a temporary export tax and temporary surcharge on international telecommunication rates.

- Conversion of budgetary accounting system to reflect Q2.50 exchange rate rather than previous one-to-one parity.

- Increase in telephone tariffs consistent with regulated market exchange rate (international tariffs raised by 250 percent).

- Price controls lifted on part of the list of controlled products. The number of individual items under price control dropped from more than 400 to less than 20.

<u>Prior to Signing of FY 1987 ESF Agreement</u>
<u>June 7, 1986 to April 13, 1987</u>:

- Progressive movement toward merging of the banking and regulated foreign exchange markets through passing of items from the former market to the latter.

- Import documentation requirements simplified, with approval time only a few days, down from a few weeks.

- A systematic approach to external debt management implemented, with over $100 million renegotiated in 1986. These renegotiations were accomplished on the strength of the new government's economic program and without the benefit of an IMF agreement or a Paris Club.

- Establishment of a high level Exchange Policy Committee to set the exchange rate in the regulated market. This measure was designed to take decisions about the exchange rate out of the political (into the technical) fray.

- Public statements by high officials of the government that full unification would be accomplished during mid-year 1987.

- Additional open market operations approved to further restrict money supply, especially a program to sell central attractive interest rate and terms.

- A concrete program to improve tax administration in the areas of customs, property and income taxes.

- Establishment of the Value-Added Tax Lottery, where receipts showing payment of the VAT are valid as lottery tickets, to encourage payment of the value-added tax and use of receipts.

- Budget austerity in 1986 which left the end of year estimate of the deficit at 1.2 percent of GDP, instead of 2.5 percent as projected in the original budget. (Net credit to the public sector was actually negative in 1986.) The budget law for 1987 is based on a goal of 2.5 percent of GDP for the deficit, mostly due to higher levels of public investment planned in 1987.

- Further items removed from the price control list, most recently milk and meat.

- Urban water tariffs increased and a proposal for a 35 percent increase in electricity tariffs under public discussion.

- Establishment of National Export Council (CONAPEX) to provide high-level public and private sector attention to correcting the constraints to export.

- Establishment of high-level mechanism to assist importers and exporters in cooperating with procedures to avoid over- and under-invoicing, with the goal of resolving individual problems within 24 hours.

- Legal base established for one-stop export window ("ventanilla única").

- Establishment of high-level committee to consider privatization of parastatal enterprises.

- Formation of a Commission to reform civil aviation law (as part of effort toward "free seas and skies.")

- Adoption of the DICA payments mechanism for Central American trade.

<u>Prior to Signing of FY 1987 Supplemental ESF Agreement April 13 to September 30, 1987:</u>

- Unification of all commodity trade into regulated market. Banking market reduced to cover only invisibles (tourism, private capital movements and remittances).

- Formation of a private creditor group for Guatemala in New York to negotiate restructuring of external debt with commercial banks.

- Opening of the "Bolsa de Valores" (bond market) to trade in Guatemalan public and private sector financial instruments.

- Implementation of tax reform package to increase central government revenues by about Q20 million in 1987, and by Q245 million in 1988.

- A cut in the 1987 Central Government operating budget of Q60 million. The 1987 budget deficit ended as 1.4 percent of GDP including grants, 2.5 percent excluding grants.

- Adoption of a 1988 Central Government budget with a deficit target of 2.5 percent of GDP.

- Reduction in the list of commodities under price control.

<u>Prior to Signing of FY 1988 ESF Agreement October 1, 1987 to June 27, 1988</u>:

- Increase of 25 percent in electricity tariffs.

- Achievement of 9.3 percent inflation (12-month) in 1987, down from 21.5 percent in 1986.

- Further progress toward open skies, with introduction of new international carrier on Houston-Guatemala City route.

- Completion of process of reunification of the quetzal and devaluation from Q2.50 to Q2.70 per U.S. dollar.

- Increase of 8 percent in gasoline prices and 38 percent in diesel prices.

- Increase in interest rate ceilings from 11 to 13 percent for deposits, and from 14 to 16 percent for lending.

June 28, 1988 to date:

- Increased flexibility in foreign exchange rules governing re-export of capital.

- Adoption of a 1989 Central Government Budget with a deficit target of 1.8 percent of GDP.

- Withdrawal of remaining public sector deposits from commercial banking system.

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STATISTICAL APPENDIX

TABLE C-1
GUATEMALA: PRINCIPAL ECONOMIC INDICATORS

	1986 Actual	1987 Actual	1988 Estimated	1989 Projected/b
ANNUAL PERCENTAGE CHANGE				
Real GDP	0.5	3.1	3.5	4.0
Real GDP per capita	-2.5	0.3	1.2	1.4
Consumer Prices (CPI)	32.7	12.0	13.0	9.0
Central Gov. Revenues (Nominal)	68.4	27.5	23.0	10.4
Central Gov. Expenditures (Nominal)	59.6	22.8	24.8	11.9
Money + Quasi-Money	20.2	15.3	8.3	9.7
Net Domestic Credit to Central Gov.	-20.2	-19.4	-9.2	-4.2
Net Domestic Credit to Private Sector	9.6	26.5	14.0	10.0
Merchandise Exports (FOB)	-1.5	-6.3	13.0	12.4
Merchandise Imports (FOB)	-18.7	52.2	10.8	6.6
RATIOS TO GDP (%)				
Exports (Goods + Non-Factor Services)	16.1	16.0	16.0	16.4
Imports (Goods + Non-Factor Services)	14.6	22.4	22.1	21.9
Central Gov. Revenues	9.2	10.6	11.1	10.8
Tax Revenues	7.9	8.1	8.5	8.6
Central Gov. Expenditures	10.8	11.9	12.8	12.6
Overall Public Sector Deficit/a	-2.7	-2.3	-3.2	-2.6
Money + Quasi-Money (end of year)	25.7	26.4	24.7	23.9

a/Includes consolidated non-financial public sector plus exchange losses of the central bank
b/Bank of Guatemala and AID projections

Source: Bank of Guatemala, Ministry of Finance, and IMF

TABLE C-2

GUATEMALA GDP BY SECTOR OF ORIGIN AND EXPENDITURE
(In Millions of 1958 Quetzales)

	1984	1985	1986	1987	1988/e
PRIMARY PRODUCTION					
Agriculture	756.5	750.4	752.9	780.1	803.0
Mining	7.6	6.5	8.5	8.4	8.8
SECONDARY PRODUCTION					
Manufacturing	468.4	467.3	467.9	475.6	487.5
Construction	54.3	49.1	51.3	56.6	67.0
Public Utilities	54.0	56.3	63.2	68.1	73.0
SERVICES					
Transport	206.3	208.6	210.7	220.0	230.5
Commerce	773.1	744.6	731.0	749.3	772.5
Finance	105.7	108.6	111.1	115.0	121.1
Housing	151.9	155.0	158.2	161.1	164.8
Public Administration/Defense	188.8	191.0	199.4	208.8	215.4
Other	186.8	187.7	186.1	189.1	195.7
GROSS DOMESTIC PRODUCT	2935.5	2925.1	2940.3	3032.1	3139.5
(Memo: Annual Real Growth Rate)	0.5	-1.0	0.5	3.1	3.5
Plus: Imports of Goods and NSF	287.2	249.4	212.6	318.6	323.5
Less: Exports of Goods and NSF	440.2	454.0	390.5	414.8	444.3
DOMESTIC EXPENDITURE	2782.5	2720.5	2758.7	2935.9	3018.7
CONSUMPTION	2508.5	2485.9	2525.9	2676.0	2750.3
Private	2272.5	2257.2	2283.7	2418.3	2483.7/a
Public	236.0	228.7	242.2	257.7	266.6
INVESTMENT	234.9	222.3	222.3	259.9	282.3
Private	155.8	159.7	160.9	183.4	192.6
Public	79.1	62.6	61.4	76.5	89.7
STOCK ADJUSTMENT	57.1	12.3	10.5	32.0	N/A

a/ Includes Stock Adjustment
e/Estimates

Source: Bank of Guatemala

TABLE C-3

REGIONAL COMPARISON OF SELECTED DEVELOPMENT INDICATORS

	GUATEMALA	HAITI	HONDURAS	COSTA RICA	EL SALVADOR
Per Capita Income (1985)	1,250.0	310.0	720.0	1,300.0	820.0
Tax Revenues/GDP (1985)	6.1	12.7(83)	14.7	14.0	11.6
HEALTH					
Population/Physician (1980)	8,610.0	8,200.0	3,120.0	1,460.0	3,220.0
%POP. w/Potable Water (1983)	51.0	33.0	44.0	79.0	51.0
Child Mortality, Age 1-4 (1984)	5.0	22.0	7.0	(.)	5.0
Infant Mortality (Est. 85-90)	59.0	117.0	69.0	18.0	59.0
Daily Calorie Supply as Percentage of Requirement (82-84)	100.0	84.0	94.0	114.0	92.0
Estimated Life Expectancy at Birth (years) 1985-90	62.0	54.7	62.6	73.7	67.1
EDUCATION					
%Primary Age Population Enrolled in Primary Schools (1983)	78.0	74.0	101.0	102.0	69.0
%Population Age 12-17 Enrolled in Secondary Schools (1983)	16.0	13.0	33.0	44.0	24.0
Literacy Rate (Last Census)	45.4	40.0	59.5	89.8	59.7

Notes: (.) = less than 1
Numbers in parentheses refer to year

Sources: World Bank, World Development Report, 1986
UNICEF: The State of the World's Children, 1986
World Resources Institute, World Resources 1987
SIECA: Estadisticas Macroeconomicas de Centroamerica, 1987
SIECA: VII Compendio Estadistico Centroamericano, 1981

TABLE C-4

FINANCIAL OPERATIONS OF THE CENTRAL GOVERNMENT

1984-1987

(In Millions of Quetzales)

	1985	1986	1987	1988/e	1989/p
MEMO ITEM					
CPI % increase	19.0	32.7	12.0	12.0	9.0
REVENUES	965.0	1456.8	1858.1	2284.6	2521.2
Tax Revenues	750.5	1250.8	1430.8	1744.0	1989.3
Import	78.5	136.2	273.1	390.0	447.0
Value- Added	214.3	309.3	411.7	503.9	534.0
Stamp	55.5	71.7	91.6	104.6	117.0
Liquor/Cigarettes	76.3	84.6	103.9	114.7	125.0
Petroleum Production	42.6	45.5	47.1	69.0	72.0
Income	108.0	169.7	250.8	324.5	433.0
Vehicle	9.8	10.2	11.2	20.0	25.0
Property	17.6	15.6	21.0	38.6	50.0
Exports	9.9	213.1	150.8	142.7	90.0
FX Transactions	50.5	27.7	0.0	0.0	0.0
Compensation Fund	71.0	139.5	68.1	36.0	36.0
Other	16.5	27.7	1.5	0.0	60.3
Non-Tax Revenue/a	114.5	206.0	427.3	540.6	531.9
EXPENDITURES	1068.3	1704.9	2093.6	2612.8	2923.0
Operating	837.7	1406.6	1715.2	2114.9	2337.4
Investment	230.6	298.3	378.4	497.9	585.6
DEFICIT	-201.7	-238.1	-235.5	-328.2	-401.8
Internal Financing (net)	119.0	147.3	147.3	117.2	268.6
External Financing (net)	82.7	90.8	88.2	211.0	133.2
Taxes/GDP	6.1	7.9	8.1	8.5	8.6
Investment/GDP	2.1	1.9	2.2	2.4	2.5

a/Includes capital revenues and grants

e/estimates

p/projections

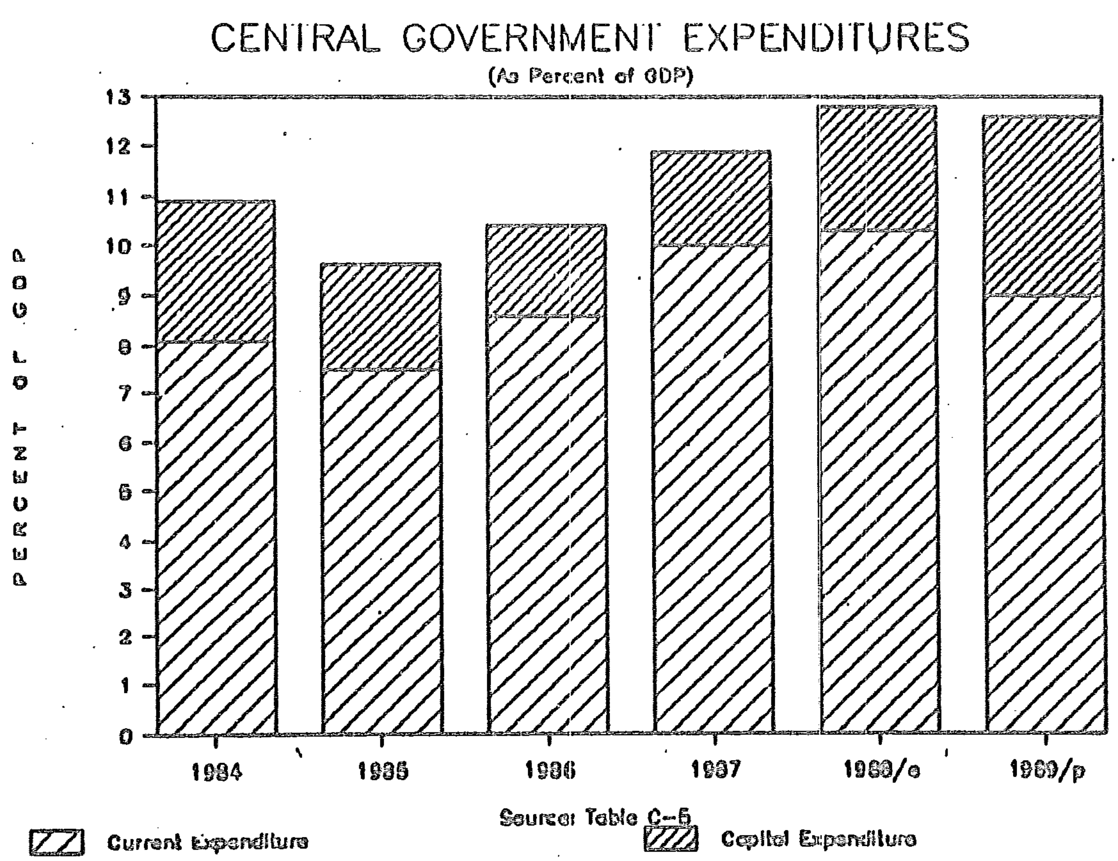
SOURCE: BANK OF GUATEMALA AND MINISTRY OF FINANCE

TABLE C-5

GUATEMALA:
TRENDS IN CENTRAL GOVERNMENT EXPENDITURES
1973-1988
(as a percent of GDP)

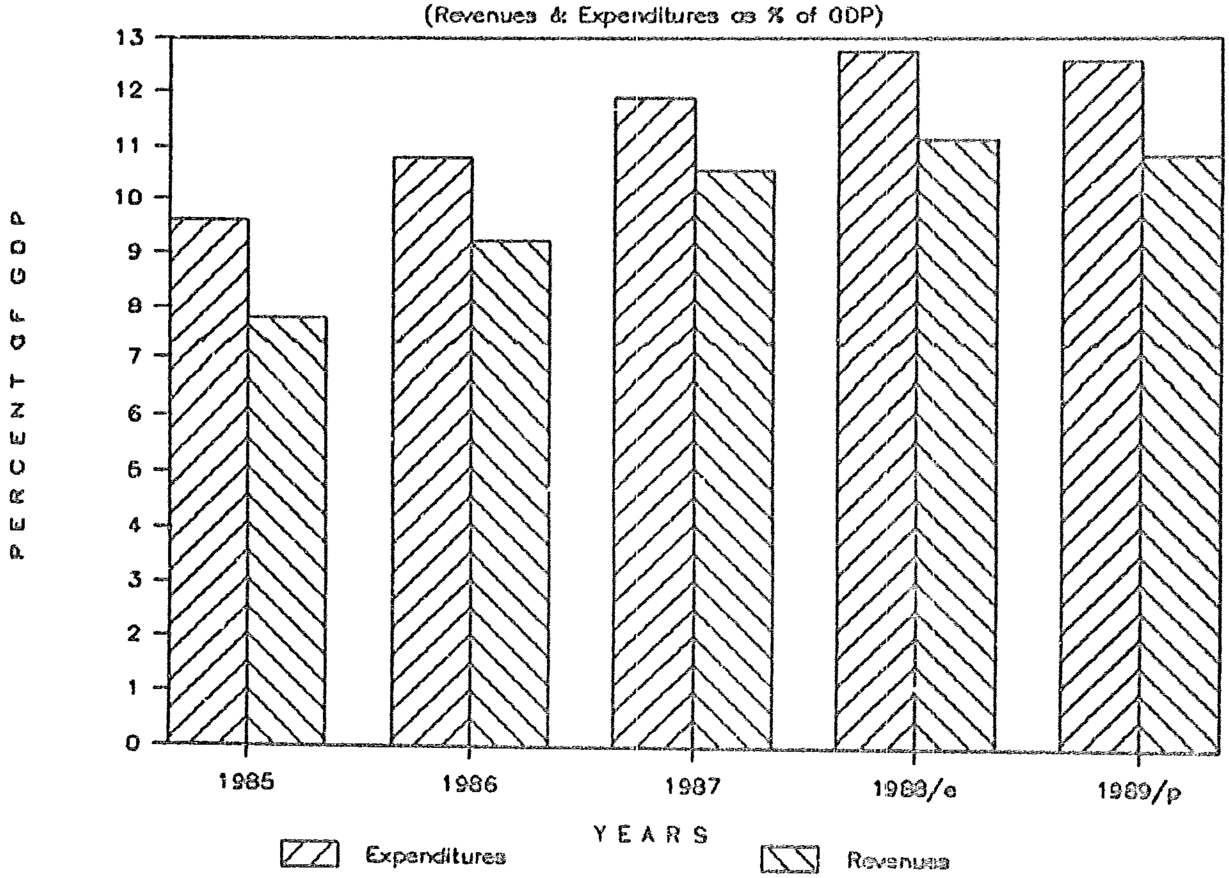
YEAR	CURRENT EXPENDITURE	CAPITAL EXPENDITURE	TOTAL
1973-1975 Avg.	7.1	3.1	10.2
1976	7.6	5.9	13.5
1977	7.3	4.2	11.5
1978	7.7	3.7	11.4
1979	7.7	4.6	12.3
1980	8.3	5.9	14.2
1981	8.4	7.6	16.0
1982	8.1	5.0	13.1
1983	7.9	3.6	11.5
1984	8.1	2.8	10.9
1985	7.5	2.1	9.6
1986	8.6	1.8	10.8
1987	10.0	1.9	11.9
1988/e	10.3	2.5	12.8
1989/p	9.0	3.6	12.6

e/estimates
p/projections
n.b. Current expenditure includes repayment of public debt
Source: Bank of Guatemala, and Ministry of Finance



GUATEMALA: CENTRAL GOVERNMENT

(Revenues & Expenditures as % of GDP)



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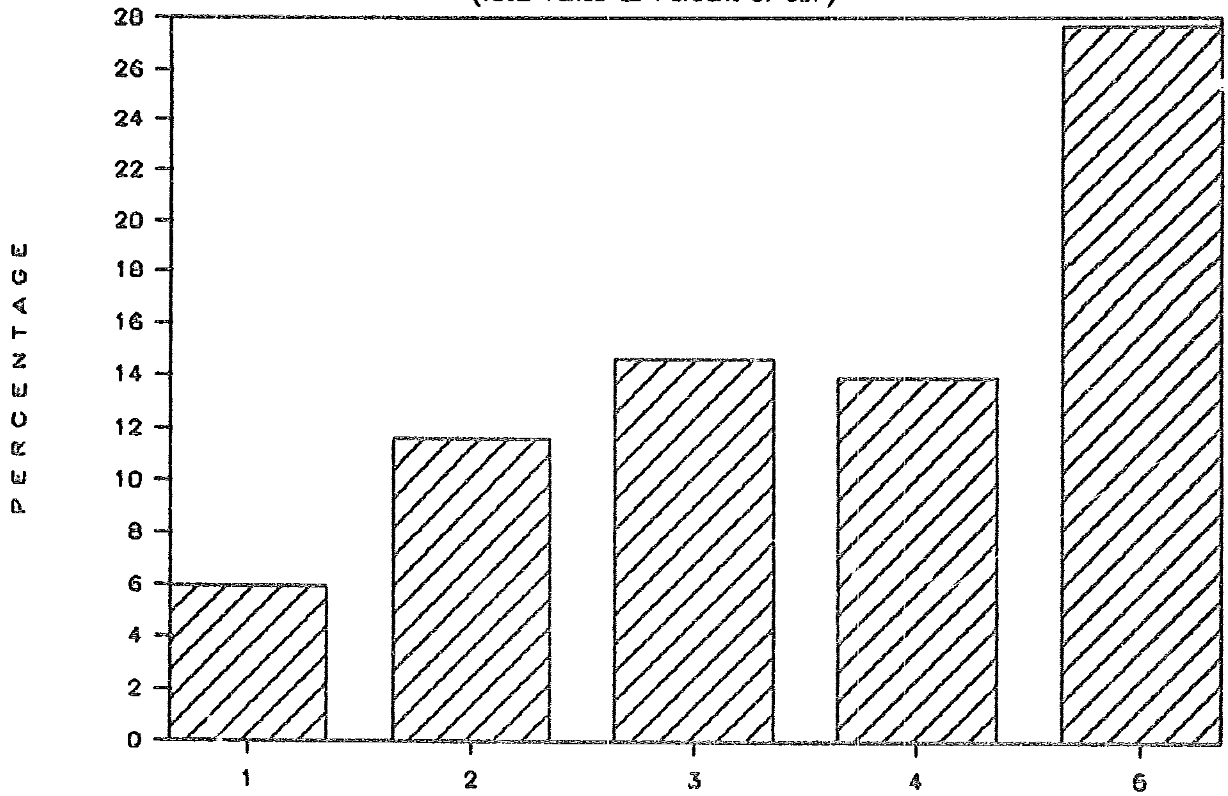
CENTRAL AMERICA: TAX BURDEN 1985

(Total Taxes as Percent of GDP)



1) Guatemala
2) El Salvador
3) Honduras
4) Costa Rica
5) Nicaragua

Source: SIECA, Estadísticas Macroeconómicas de Centro América, 1987.

TABLE C-8

GUATEMALA: BALANCE OF PAYMENTS
(In Millions of US$)

	1985	1986	1987	1988/e	1989/p
CURRENT ACCOUNT BALANCE	-245.8	-25.4	-440.8	-463.5	-511.5
Trade Balance	-17.0	168.1	-355.2	-371.1	-331.4
Exports	1059.7	1043.8	977.9	1105.4	1242.6
Imports	-1076.7	-875.7	-1333.1	-1476.5	-1574.0
Services/Transfers Net/1	-228.8	-193.5	-85.6	-92.4	-180.1
CAPITAL ACCOUNT BALANCE/2	329.0	64.0	387.1	372.5	575.7
Private Net	242.9	95.2	399.0	351.3	398.0
Official/Banking Net	86.1	-31.2	-11.9	21.2	177.7
ERRORS AND OMISSIONS	-14.5	10.0	-19.8	10.0	0.0
Change in abs. res. (- = increase)	68.7	-48.6	73.5	81.0	-64.2
NET INTERNATIONAL RESERVES					
INCLUDING ARREARS (Millions of US$)	-457.3	-443.9	-465.2	-566.0	-465.2
MEMO ITEMS					
GDP in Current Q's (Millions of Q's)	11129.8	15820.2	17594.7	22490.3	23244.3
GDP Deflator (Base: 1980 = 100)	150.1	211.9	218.5	226.2	235.2
Guatemalan Exports to US (% of Total)	38.4	44.9	42.0	44.0	46.0
Exceptional Financing	-	47.4	90.75	134.7	201.0

1/Includes exceptional financing (ESF) in 1986-89
2/Exceptional financing (except ESF) included in capital account
e/Estimated
p/Projected

Source: Bank of Guatemala

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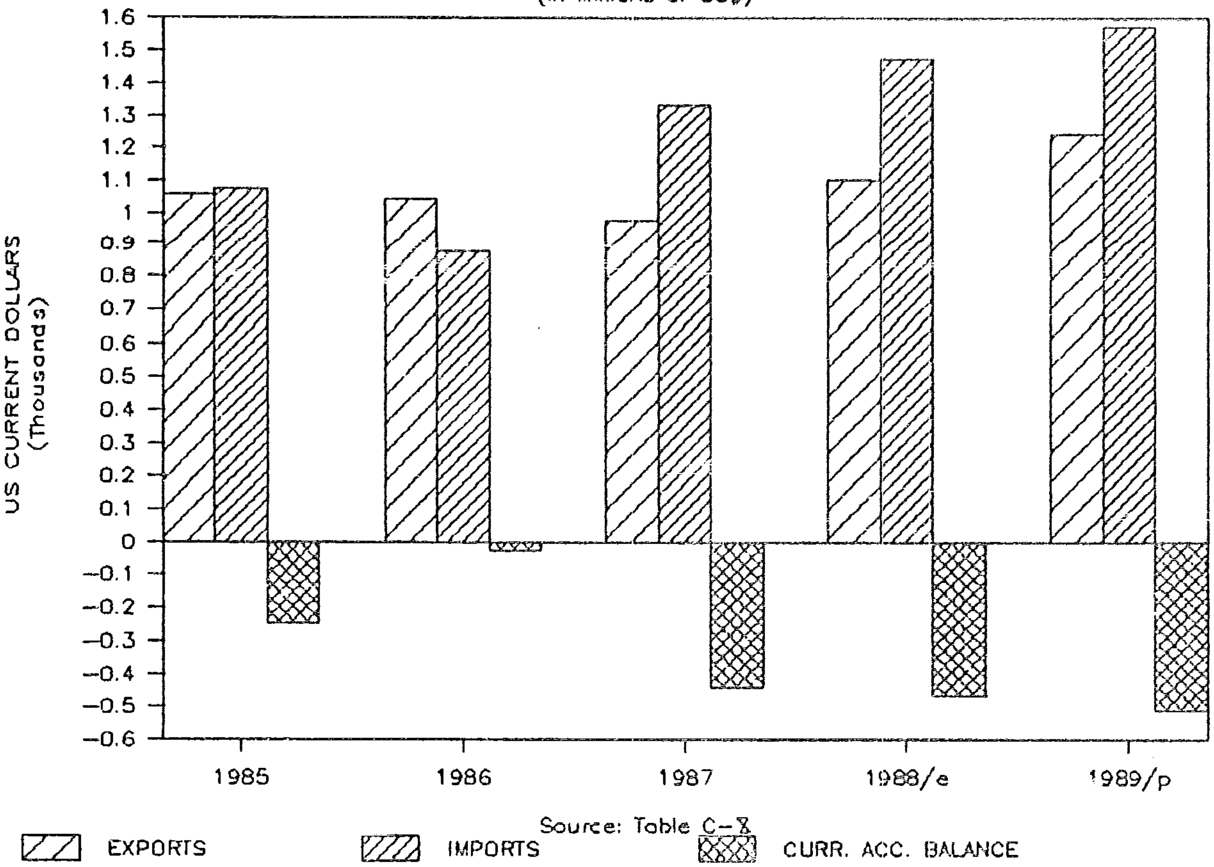
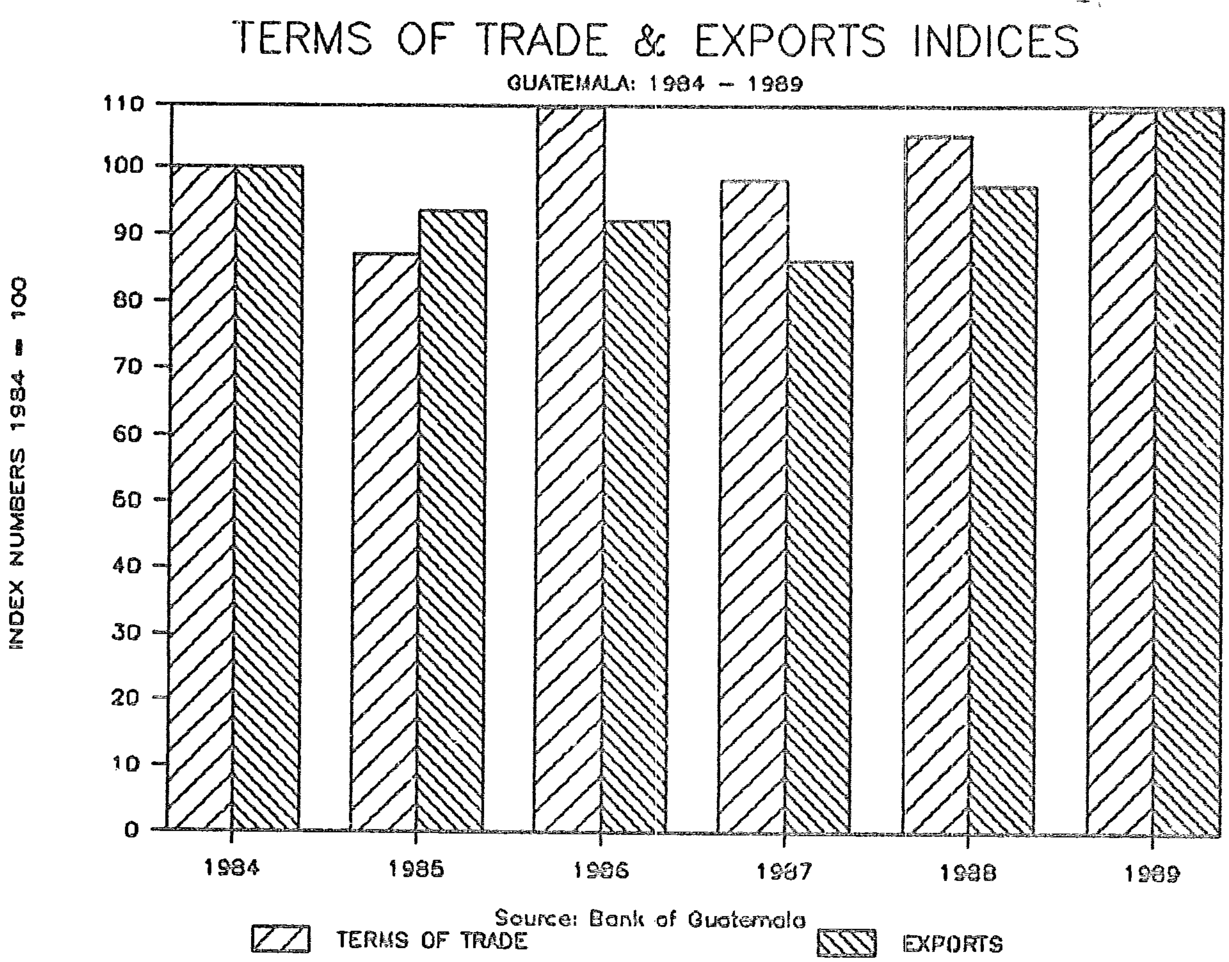
GUATEMALA: BALANCE OF PAYMENTS

(In Millions of US$)



Source: Table C-X

C-10



TERMS OF TRADE & EXPORTS INDICES
GUATEMALA: 1984 - 1989
INDEX NUMBERS 1984 = 100
110
100
90
80
70
60
50
40
30
20
10
0
1984
1985
1986
1987
1988
1989
Source: Bank of Guatemala
TERMS OF TRADE
EXPORTS

68

TABLE C-11

GUATEMALA: EXPORT VALUE, VOLUME AND PRICE BY MAJOR COMMODITY

COMMODITY	1985	1986	1987	1988/e	1989/p
COFFEE					
Export Value	451.5	502.3	354.5	384.5	429.7
Volume (qq's)	4041.1	2934.7	3216.6	3126.8	3350.0
Unit Price	111.73	169.95	110.21	122.97	128.27
COTTON					
Export Value	73.1	24.3	16.2	37.0	43.5
Volume (qq's)	1253.6	674.0	350.3	628.4	725.0
Unit Price	58.31	36.00	46.25	58.88	60.00
SUGAR					
Export Value	46.4	51.7	51.4	73.2	74.6
Volume (qq's)	6158.2	7961.8	6408.9	8142.0	8160.0
Unit Price	7.53	6.49	8.02	8.99	9.14
BANANAS					
Export Value	70.9	73.4	74.6	84.4	85.8
Volume (qq's)	7062.6	7331.5	73[illegible].1	7632.3	7800.0
Unit Price	10.04	10.01	10.12	11.06	11.00
MEAT					
Export Value	10.0	4.3	14.5	12.1	15.0
Volume (qq's)	200.5	63.9	194.6	162.7	200.0
Unit Price	49.88	67.82	74.51	74.37	75.00
CARDAMOM					
Export Value	60.7	47.7	45.1	45.1	45.5
Volume (qq's)	144.4	177.8	240.4	316.0	350.0
Unit Price	420.00	268.28	187.60	142.72	130.00
PETROLEUM					
Export Value	11.9	27.0	19.4	14.1	18.0
Volume	458.3	1784.1	1300.0	1000.0	1200.0
Unit Price	26.00	15.14	14.92	14.10	15.00
EXPORTS TO CACM					
Export value	207.8	185.3	230.0	240.0	260.5
OTHER(Non-Trad.)					
Export Value	127.4	127.8	171.6	215.0	270.0
TOTAL EXPORTS FOB	1059.7	1043.8	977.9	1105.4	1242.6

e/estimated p/projected

Notes: Values are given in millions of US$'S
Volumes are given in thousands of quintals, with 1 quintal = 101.5 lbs.
Petroleum export volume given in thousands of barrels.

Source: Bank of Guatemala

VA

TABLE C-12

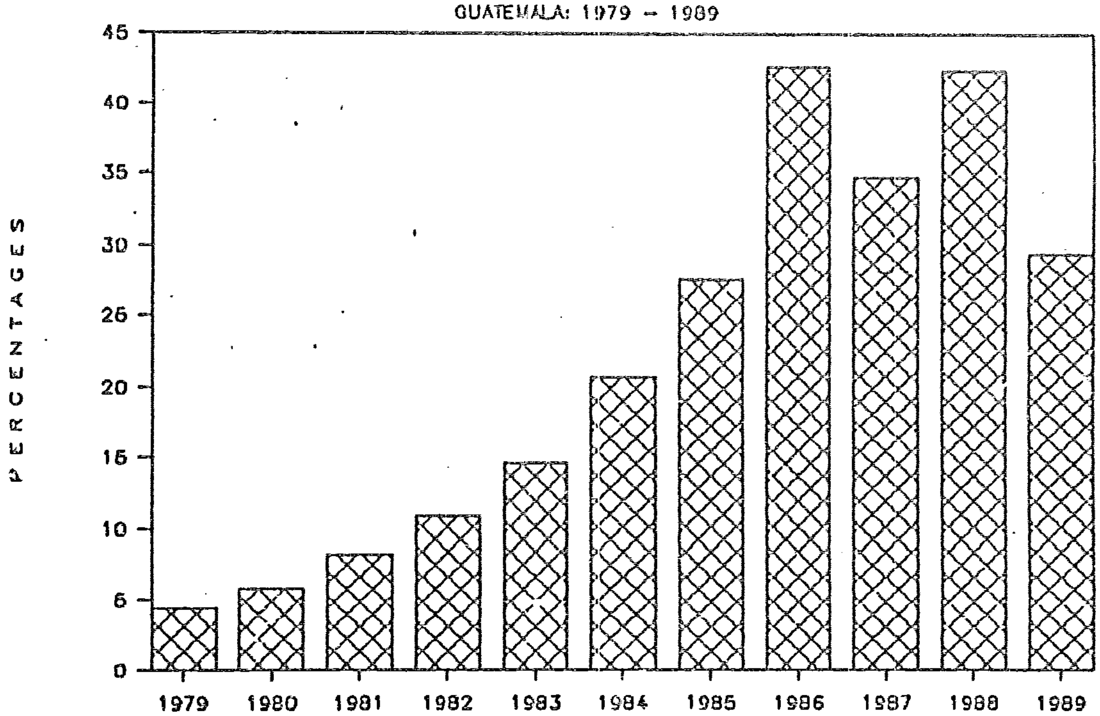
GUATEMALA: PUBLIC EXTERNAL DEBT PAYMENTS/1
(In Millions of US$)
1986 - 1989

	1986	1987	1988/e	1989/p
TOTAL DEBT SERVICE	494.0	395.3	536.1	414.3
Principal	317.5	233.8	377.1	221.4
Interest	176.5	161.5	159.0	192.9
BANK OF GUATEMALA	378.1	285.0	391.1	250.2
Principal	263.3	177.9	297.1	140.2
Interest	114.8	107.1	94.0	110.0
PUBLIC SECTOR	115.9	110.3	145.0	164.1
Principal	54.2	55.9	80.0	81.2
Interest	61.7	54.4	65.0	82.9
OUTSTANDING DEBT	2516.6	2506.7	2517.1	2698.5

1/ Excluding stabilization bonds converted into quetzales.
e = Estimates
p = Projections
Source: Bank of Guatemala

DEBT SERVICE RATIO

GUATEMALA: 1979 - 1989



Total Debt Service/Exports of Goods NFS

Source: Table C-12

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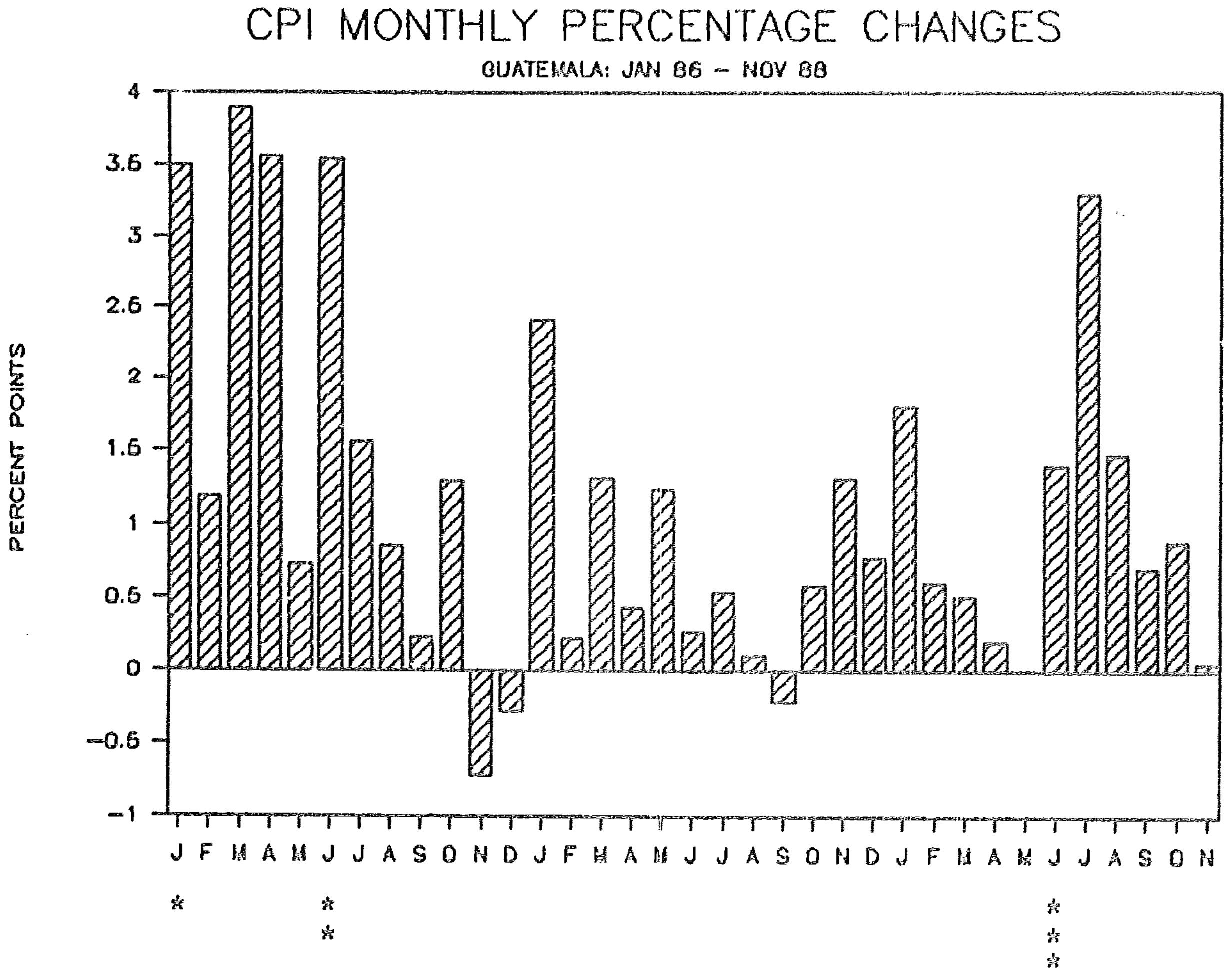
TABLE C-13
CONSUMER PRICE INDEX
GUATEMALA CITY
(March-April 1983 = 100)

		CPI	Percentage Change
1986	JANUARY	152.3	3.5
	FEBRUARY	154.1	1.2
	MARCH	160.1	3.9
	APRIL	165.8	3.6
	MAY	167.0	0.7
	JUNE	172.9	3.5
	JULY	175.6	1.6
	AUGUST	177.1	0.9
	SEPTEMBER	177.5	0.2
	OCTOBER	179.8	1.3
	NOVEMBER	178.5	-0.7
	DECEMBER	178.0	-0.3
1987	JANUARY	182.3	2.4
	FEBRUARY	182.7	0.2
	MARCH	185.1	1.3
	APRIL	185.9	0.4
	MAY	188.2	1.2
	JUNE	188.7	0.3
	JULY	189.7	0.5
	AUGUST	189.9	0.1
	SEPTEMBER	189.5	-0.2
	OCTOBER	190.6	0.6
	NOVEMBER	193.1	1.3
	DECEMBER	194.6	0.8
1988	JANUARY	198.1	1.8
	FEBRUARY	199.3	0.6
	MARCH	200.3	0.5
	APRIL	200.7	0.2
	MAY	200.7	0.0
	JUNE	203.5	1.4
	JULY	210.2	3.3
	AUGUST	213.3	1.5
	SEPTEMBER	214.8	0.7
	OCTOBER	216.7	0.9
	NOVEMBER	216.8	0.0

Source: NATIONAL INSTITUTE OF STATISTICS (INE)



* : January 1986 Cerezo government takes office
** : June 1986 Stabilization program initiated
*** : June 1988 Devaluation of quetzal from US$1.00 = Q2.50 to US$1.00 = Q2.70

TABLE C-15

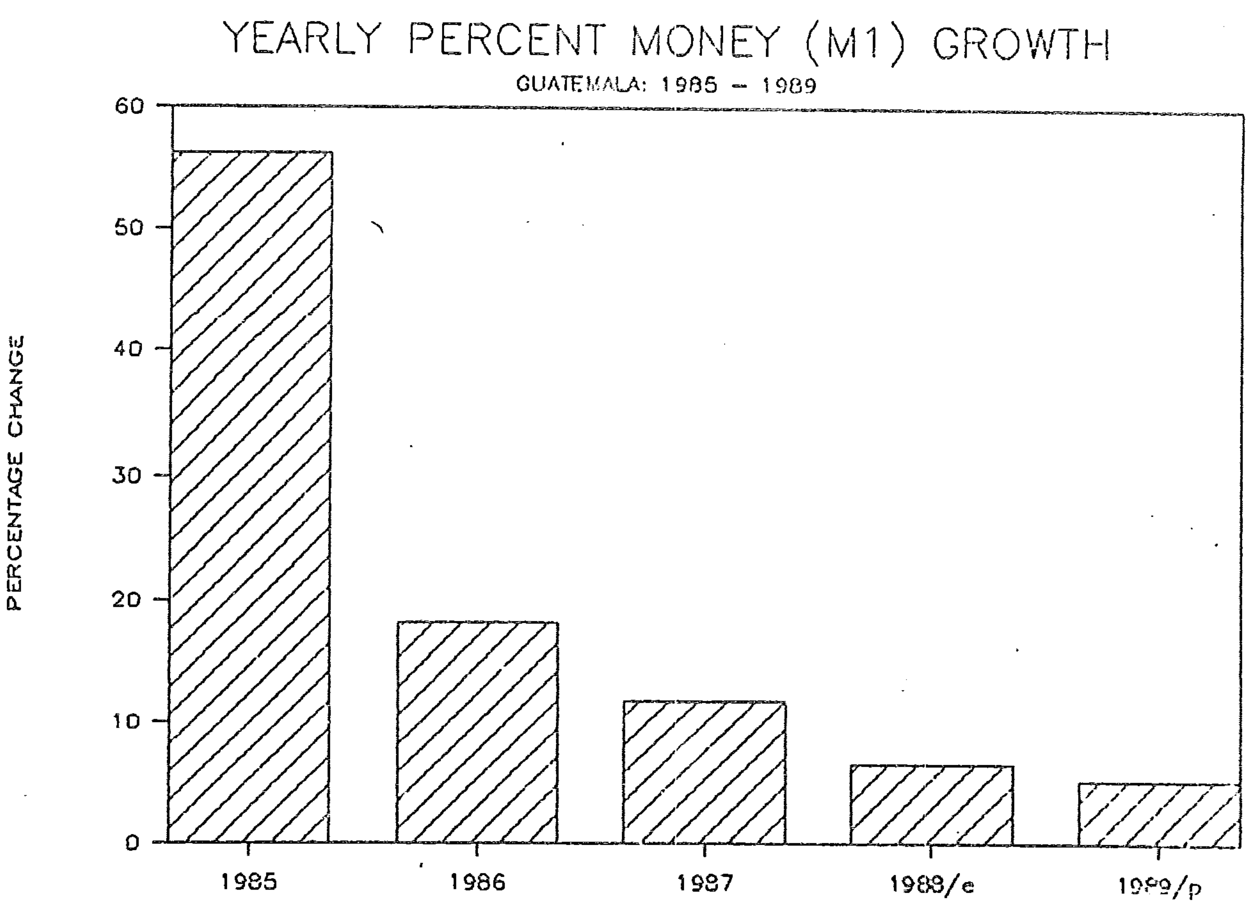
GUATEMALA
SELECTED BANKING SYSTEM INDICATORS 1985-1988
(Percentage Rates of Change)

	1985	1986	1987	1988/e	1989/p
NET DOMESTIC ASSETS	21.9	17.4	14.2	9.5	6.9
Net Credit to the Central Government	11.5	(20.2)	(19.4)	(9.2)	(5.2)
Net Credit to the Rest of the Public Sector	20.4	(26.5)	(7.7)	(11.8)	(4.2)
Credit to the Private Sector	8.3	9.6	26.5	14.0	10.0
LIABILITIES TO THE PRIVATE SECTOR	28.4	20.2	15.3	8.3	9.7
Money(M1)/1	56.3	18.1	11.8	6.4	5.1
Quasi-Money	15.1	21.5	17.4	9.5	12.4

1/equals currency outside banks plus demand deposits other than those of the central government.

e/estimated p/projected

Source: Bank of Guatemala



Source: Table C-15

TABLE C-16

GUATEMALA: PRODUCTION, SUPPLY AND DEMAND FOR MAIN CROPS
(1986-1987-1988)
(In '000 Ha & '000 MT except where noted)
(1987/1988 estimates, 1988/1989 projected, except when noted)

Commodity	Area Harvested	Production	Imports	Exports	Consumption	Ending Stocks
COFFEE	'000 60 Kg Bags					
(Oct-Set)						
1986/1987	260	2,843	0	2,717	300	45
1987/1988	260	2,600	0	2,200	300	145
1988/1989	260	2,700	0	2,300	300	245
SUGAR						
(Nov-Oct)						
1986/1987	87	644	0	394	294	50
1987/1988	87	650	0	360	300	20
1988/1989	87	690	0	390	300	20
BANANAS						
1986	8	425	0	330	95	0
1987	8	430	0	335	95	0
1988	8	430	0	335	95	0
TOBACCO		(Dry Weight)				
(Jan-Dec)						
1986/1987	4.2	5.1	0	4.7	1.2	3.0
1987/1988	4.4	5.7	0	4.8	1.2	2.7
1988/1989	4.5	6.0	0	5.1	1.3	2.3
COTTON						
(Oct-Sept)						
1986/1987	31	2[illegible]	2	9	21	8
1987/1988	42	4[illegible]	2	25	21	0
1988/1989	60	[illegible]3	2	43	22	8
CARDAMON						
(Sept-Aug)						
1986/1987	27.5	9	0	8.3	0	4.0
1987/1988	25.0	9	0	11.8	0	1.2
1988/1989	25.0	9	0	10.0	0	0.2
RUBBER						
1985	16.1	12.3	0	6.4	5.8	0.5
1986	16.1	11.8	0	8.1	3.6	0.6
1987(Est.)	19.6	11.8	0	8.1	3.6	0.7

SOURCE: U.S. Agricultural Attache, Guatemala

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable to: (A) FAA funds generally; (B)(1) Development Assistance funds only; or (B)(2) the Economic Support Fund only.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FY 1989 Appropriations Act Sec. 578(b). Has the President certified to the Congress that the government of the recipient country is failing to take adequate measures to prevent narcotic drugs or other controlled substances which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully? NO

2. FAA Sec. 481(h); FY 1989 Appropriations Act Sec. 578; 1988 Drug Act Secs. 4405-07. (These provisions apply to assistance of any kind provided by grant, sale, loan, lease, credit, guaranty, or insurance, except assistance from the Child Survival Fund or relating to international narcotics control, disaster and refugee relief, narcotics education and awareness, or the provision of food or medicine.) If the recipient is a "major illicit drug producing country" (defined as a country producing during a fiscal year at least five metric tons of opium or 500 metric tons of coca or marijuana) or a "major drug-transit country" (defined as a country that is a significant direct source of illicit drugs significantly affecting the United States, through which such drugs are transported, or through which significant sums of drug-related profits are

laundered with the knowledge or complicity of the government): (a) Does the country have in place a bilateral narcotics agreement with the United States, or a multilateral narcotics agreement? and (b) Has the President in the March 1 International Narcotics Control Strategy Report (INSCR) determined and certified to the Congress (without Congressional enactment, within 45 days of continuous session, of a resolution disapproving such a certification), or has the President determined and certified to the Congress on any other date (with enactment by Congress of a resolution approving such certification), that (1) during the previous year the country has cooperated fully with the United States or taken adequate steps on its own to satisfy the goals agreed to in a bilateral narcotics agreement with the United States or in a multilateral agreement, to prevent illicit drugs produced or processed in or transported through such country from being transported into the United States, to prevent and punish drug profit laundering in the country, and to prevent and punish bribery and other forms of public corruption which facilitate production or shipment of illicit drugs or discourage prosecution of such acts, or that (2) the vital national interests of the United States require the provision of such assistance?

YES

N.A.

3. <u>1986 Drug Act Sec. 2013; 1988 Drug Act Sec. 4404</u>. (This section applies to the same categories of assistance subject to the restrictions in FAA Sec. 481(h), above.) If recipient country is a "major illicit drug producing country" or "major drug-transit country" (as defined for the purpose of FAA Sec 481(h)), has the President submitted a report to Congress listing such country as one (a) which, as a matter of government policy, encourages or facilitates the production or distribution of illicit drugs; (b) in which any senior official of the

N.A.

government engages in, encourages, or facilitates the production or distribution of illegal drugs; (c) in which any member of a U.S. Government agency has suffered or been threatened with violence inflicted by or with the complicity of any government officer; or (d) which fails to provide reasonable cooperation to lawful activities of U.S. drug enforcement agents, unless the President has provided the required certification to Congress pertaining to U.S. national interests and the drug control and criminal prosecution efforts of that country?

4. <u>FAA Sec. 620(c)</u>. If assistance is to a government, is the government indebted to any U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies, (b) the debt is not denied or contested by such government, or (c) the indebtedness arises under an unconditional guaranty of payment given by such government or controlled entity?

   A.I.D. knows of no such cases

5. <u>FAA Sec. 620(e)(1)</u>. If assistance is to a government, has it (including any government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?

   There is no evidence of such action

6. <u>FAA Secs. 620(a), 620(f), 620D; FY 1989 Appropriations Act Secs. 512, 550, 592</u>. Is recipient country a Communist country? If so, has the President determined that assistance to the country is vital to the security of the United States, that the recipient country is not controlled by the international Communist conspiracy, and that such assistance will further promote the independence of the recipient country from international communism? Will assistance be provided

   No.

either directly or indirectly to Angola, Cambodia, Cuba, Iraq, Libya, Vietnam, South Yemen, Iran or Syria? Will assistance be provided to Afghanistan without a certification, or will assistance be provided inside Afghanistan through the Soviet-controlled government of Afghanistan?

7. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, damage or destruction by mob action of U.S. property?

No.

8. FAA Sec. 620(l). Has the country failed to enter into an investment guaranty agreement with OPIC?

No.

9. FAA Sec. 620(o); Fishermen's Protective Act of 1967 (as amended) Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing vessel because of fishing activities in international waters? (b) If so, has any deduction required by the Fishermen's Protective Act been made?

There is no evidence that an action of this natu has occurred for many years

10. FAA Sec. 620(q); FY 1989 Appropriations Act Sec. 518. (a) Has the government of the recipient country been in default for more than six months on interest or principal of any loan to the country under the FAA? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the FY 1989 Appropriations Act appropriates funds?

a.No

b.No

11. FAA Sec. 620(s). If contemplated assistance is development loan or to come from Economic Support Fund, has the Administrator taken into account the percentage of the country's budget and amount of the country's foreign exchange or other resources spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of

Yes, taken into account by the Administrator at the time of approval of Agency OYB

Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

12. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have relations been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

    NO

13. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the A.I.D. Administrator in determining the current A.I.D. Operational Year Budget? (Reference may be made to the "Taking into Consideration" memo.)

    Country is not delinquent.

14. FAA Sec. 620A. Has the President determined that the recipient country grants sanctuary from prosecution to any individual or group which has committed an act of international terrorism or otherwise supports international terrorism?

    NO

15. FY 1989 Appropriations Act Sec. 568. Has the country been placed on the list provided for in Section 6(j) of the Export Administration Act of 1979 (currently Libya, Iran, South Yemen, Syria, Cuba, or North Korea)?

    NO

16. ISDCA of 1985 Sec. 552(b). Has the Secretary of State determined that the country is a high terrorist threat country after the Secretary of Transportation has determined, pursuant to section 1115(e)(2) of the Federal Aviation Act of 1958, that an airport in the country does not maintain and administer effective security measures?

    NO

17. <u>FAA Sec. 666(b)</u>. Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA?

NO

18. <u>FAA Secs. 669, 670</u>. Has the country, after August 3, 1977, delivered to any other country or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards, and without special certification by the President? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.)

NO

19. <u>FAA Sec. 670</u>. If the country is a non-nuclear weapon state, has it, on or after August 8, 1985, exported (or attempted to export) illegally from the United States any material, equipment, or technology which would contribute significantly to the ability of a country to manufacture a nuclear explosive device?

NO

20. <u>ISDCA of 1981 Sec. 720</u>. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. on Sept. 25 and 28, 1981, and did it fail to disassociate itself from the communique issued? ~~If so, has the President taken~~ it into account? (Reference may be made to the "Taking into Consideration" memo.)

Guatemala was not represented at this meeting.

21. <u>FY 1989 Appropriations Act Sec. 527</u>. Has the recipient country been determined by the President to have engaged in a consistent pattern of opposition to the foreign policy of the United States?

NO

22. FY 1989 Appropriations Act Sec. 513. Has the duly elected Head of Government of the country been deposed by military coup or decree? If assistance has been terminated, has the President notified Congress that a democratically elected government has taken office prior to the resumption of assistance?

NO

23. FY 1989 Appropriations Act Sec. 540. Does the recipient country fully cooperate with the international refugee assistance organizations, the United States, and other governments in facilitating lasting solutions to refugee situations, including resettlement without respect to race, sex, religion, or national origin?

YES

Department of State

PAGE 01 GUATEM 09981 01 OF 06 221545Z 1426 ARA5563
ACTION AID-00

INFO FILE-01 OCEN-01 ES-01 GT-02 CS-02 RO-01 /006 A3 RD.

INFO LOG-00 CIAE-00 EB-00 DODE-00 ARA-00 /000 W
------------------318373 221546Z /38

O 221637Z AUG 89
FM AMEMBASSY GUATEMALA
TO SECSTATE WASHDC IMMEDIATE 4022
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA
AMEMBASSY SAN JOSE

UNCLAS SECTION 01 OF 06 GUATEMALA 09981

AIDAC

FOR LAC/DP:WWHEELER; LAC/DR:TBROWN; LAC/CEN:CCOSTELLO

E.O. 12356: N/A
SUBJECT: UPDATE INFORMATION FOR FY 1989 ESF PROGRAM

REF: (A) STATE 58035; (B) GUAT 4492, (C) SKOCSTAD MEMO DATED 4/24/89 (D) STATE 147571

SUMMARY

1. IN JANUARY OF THIS YEAR, THE MISSION SUBMITTED A PAAD DESCRIBING A PROPOSED FY89 ESF PROGRAM. AT THAT TIME, THE GOVERNMENT HAD SET FORTH THE BROAD OUTLINES OF A MULTIYEAR PROGRAM OF STABLE GROWTH FOR WHICH IT SOUGHT ESF SUPPORT. THE MISSION REQUESTED, AND AID/W GRANTED, PROVISIONAL APPROVAL OF THE PROPOSED PROGRAM, PENDING SUBMISSION BY THE GOG OF THE REMAINING DETAILS ON THE SUPPORTING POLICY FRAMEWORK. AS IT TURNED OUT THE MACROECONOMIC POLICY PACKAGE BECAME A SIGNIFICANTLY MORE CONTENTIOUS POLITICAL ISSUE THAN EXPECTED WITHIN THE GOG CABINET. MUCH PATIENCE AND PERSEVERANCE WAS REQUIRED ON THE PART OF THE GOG ECONOMIC TEAM TO WIN APPROVAL FOR A PROGRAM THAT, WHILE WHOLLY APPROPRIATE TO THE ECONOMIC CIRCUMSTANCES, WAS SURE TO PROVIDE AMMUNITION FOR POLITICAL OPPOSITION GROUPS ACCROSS THE FULL POLITICAL SPECTRUM.
PRESSED BY POLITICAL PRESSURES ON THE SIDE OF INACTION AND BY TOUGH BUT FRIENDLY DONORS ON THE SIDE OF DISCIPLINED POLICY ADJUSTMENTS IT WAS MAJOR FEAT FOR THE GOG ECONOMIC TEAM TO PUSH THROUGH A POLICY PROGRAM OF THIS SIGNIFICANCE AND EMERGE WITH ITS POLITICAL INFLUENCE APPARENTLY IN TACT.

2. REFLECTING THE TEAM'S INFLUENCE, THE MONETARY BOARD (JUNTA MONETARIA) LAST WEEK ADOPTED AN ECONOMIC PROGRAM WHICH, IN OUR VIEW, REPRESENTS THE STRONGEST-POSSIBLE RESPONSE TO THE ECONOMIC CONDITIONS NOW FACING THE COUNTRY. THIS MESSAGE PROVIDES AID/W WITH THE REMAINING INFORMATION REQUIRED PER REF (D), FOR A FULL AND FINAL APPROVAL OF THE FY89 ESF BALANCE OF PAYMENTS GRANT OF US DOLS 69.5 MILLION.

BACKGROUND

3. AS DESCRIBED IN THE PAAD, DURING 1988 THE GOG ADOPTED AN ECONOMIC PROGRAM DESIGNED TO CONSOLIDATE THE BENEFITS ACHIEVED DURING THE FIRST TWO YEARS OF THE CEREZO ADMINISTRATION. THE 1988 ECONOMIC PROGRAM, DEVELOPED AS THE FIRST PART OF A ROLLING-THREE-YEAR PROGRAM, WAS LARGELY SUCCESSFUL. CONTROL OVER INFLATION WAS MAINTAINED AND PER CAPITA REAL GDP GROWTH WAS POSITIVE FOR THE SECOND YEAR IN A

ROW AFTER DECLINING STEADILY SINCE 1980. NON-TRADITIONAL EXPORTS CONTINUED TO GROW STRONGLY AND POLICY DISINCENTIVES TO AGRICULTURE AND OTHER LABOR INTENSIVE ACTIVITIES CONTINUE TO FADE. ALTHOUGH SOME DETERIORATION OCCURRED IN THE FINANCING OF THE NONFINANCIAL PUBLIC SECTOR AND IN THE NET INTERNATIONAL RESERVE POSITION OF THE BANK OF GUATEMALA, MEASURES TAKEN AT MID-YEAR IN CONJUNCTION WITH THE FY88 ESF PROGRAM BROUGHT THE ECONOMY BACK ONTO A PATH TOWARD RECOVERY.

4. IN LATE 1988 AND EARLY 1989 THE REDEMPTION OF STABILIZATION BONDS ISSUED IN 1983 AND 1984 INITIATED AN UNEXPECTED EXPANSION OF CREDIT. DOMESTIC PRESSURE RESULTED IN THE REDEMPTION OF APPROXIMATELY US DOLS 77 MILLION OF THE BONDS. THIS REDEMPTION, TOGETHER WITH THE SEASONALLY-HIGH CREDIT DEMAND BY BOTH THE NONFINANCIAL PUBLIC SECTOR AND THE PRIVATE SECTOR, RESULTED IN A SHARP INCREASE IN THE NET DOMESTIC ASSETS OF THE BANK OF GUATEMALA. THE BOG EITHER FAILED TO RECOGNIZE OR WAS UNABLE TO ACT TO OFFSET THE EXPANSIONARY CONSEQUENCE OF THE REDEMPTIONS. A CORRESPONDING REDUCTION IN THE BANK'S NET INTERNATIONAL RESERVE POSITION FOLLOWED INEXORABLY.

5. THESE DEVELOPMENTS, AND SUBSEQUENT RUMORS OF IMPENDING DEVALUATION, ACCELERATED THE LOSS OF THE BANK'S INTERNATIONAL RESERVES.

MACROECONOMIC POLICY PROGRAM

ACTION AID-00

INFO SECT-01 FILE-01 DCEN-01 ES-01 GT-02 CS-02 RO-01
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O 221837Z AUG 88
FM AMEMBASSY GUATEMALA
TO SECSTATE WASHDC IMMEDIATE 4023
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA
AMEMBASSY SAN JOSE

UNCLAS SECTION 02 OF 06 GUATEMALA 09981

AIDAC

FOR LAC/DP:WWHEELER; LAC/DR:TBROWN; LAC/CEN:CCOSTELLO

E.O. 12356: N/A
SUBJECT: UPDATE INFORMATION FOR FY 1989 ESF PROGRAM

6. SINCE THE CEREZO GOVERNMENT'S FIRST YEAR IN OFFICE THE DISEQUILIBRIUM IN THE EXTERNAL SECTOR HAS PROVED REPEATEDLY TO BE THE MOST INTRANSIGENT MACROECONOMIC PROBLEM. THE GOVERNMENT HAS CONSISTENTLY HOPED THAT RELATIVELY MORE RELIANCE ON DOMESTIC MONETARY POLICY WOULD PERMIT RELATIVELY LESS EXCHANGE RATE ADJUSTMENT. BUT FIXED INTEREST RATES AND EXCHANGE RATES MADE THAT TRADE-OFF INEFFECTIVE. THE CONTINUED LOSS OF FOREIGN RESERVES FINALLY MADE IT CLEAR THAT DRASTIC POLICY REFORM WAS NEEDED. LAST WEEK THE MONETARY BOARD IMPLEMENTED SUCH A FUNDAMENTAL CHANGE IN THE WAY IN WHICH POLICY IS CONDUCTED IN GUATEMALA. THAT POLICY PACKAGE NOT ONLY ADDRESSED THE EFFECTS OF THE SHORT-TERM DEVIATION WHICH OCCURRED EARLY THIS YEAR BUT ALSO REDUCED THE LIKELIHOOD THAT FURTHER SHORT-TERM POLICY ADJUSTMENTS WILL BE NEEDED IN THE FUTURE. THE PRINCIPAL MEASURES WERE:

(A) EXCHANGE RATE REGIME: A SHIFT FROM THE HISTORICAL TRADITION OF A FIXED EXCHANGE RATE SYSTEM TO A CRAWLING PEG SYSTEM WHEREIN THE EXCHANGE RATE WILL BE ADJUSTED AUTOMATICALLY ACCORDING TO A REAL EFFECTIVE EXCHANGE RATE CALCULATION (I.E. IN LINE WITH THE DIFFERENTIAL BETWEEN THE REAL EXCHANGE RATE IN GUATEMALA AND IN GUATEMALA'S PRINCIPAL TRADING PARTNERS).

(B) EXCHANGE DEVALUATION: AN INITIAL DEVALUATION OF THE OFFICIAL EXCHANGE RATE FROM Q2.70 PER US DOLLAR TO Q2.73 PER US DOLLAR;

(C) INTEREST RATE DETERMINATION: THE COMPLETE LIBERALIZATION OF DOMESTIC INTEREST RATES, ANOTHER DEPARTURE FROM HISTORICAL TRADITION; AND

(D) OPEN MARKET OPERATIONS: FOR THE FIRST TIME IN RECENT HISTORY THE CENTRAL BANK ACQUIRED EXPLICIT AUTHORITY AND AN APPROPRIATE INSTRUMENT TO UNDERTAKE OPEN MARKET OPERATIONS.

7. AS A RESULT OF THESE MEASURES, THE GOG EXPECTS THAT THE PRESENT LEVEL OF INTERNATIONAL COMPETITIVENESS WILL BE MAINTAINED AND THAT THE RAPID INCREASE IN NONTRADITIONAL EXPORTS, EXPERIENCED SINCE 1987, WILL CONTINUE. FURTHERMORE, THE FREEING OF DOMESTIC INTEREST RATES IS EXPECTED TO FACILITATE DOMESTIC SAVINGS MOBILIZATION AND TO MAKE DOMESTIC

INVESTMENT MORE EFFICIENT IN GUATEMALA.

8. IN ORDER TO ENHANCE THE CHANCES OF SUCCESS OF THIS REVISED POLICY FRAMEWORK IN GUATEMALA, A NUMBER OF SUPPLEMENTAL DECISIONS WERE ALSO MADE. AMONG THOSE DECISIONS ARE:

A. THE MONETARY BOARD AUTHORIZED THE BANK OF GUATEMALA TO ENGAGE IN OPEN MARKET OPERATIONS TO ENSURE THE SUCCESS OF ITS MONETARY PROGRAM. THE BANK WILL INTERMEDIATE PUBLIC SECTOR BONDS WITH MATURITIES OF ONE TO THREE MONTHS AND WITH INTEREST RATES THAT RANGE FROM 13 PERCENT TO 14 PERCENT. THE COMMERCIAL BANKS CAN SWAP THE NEW INSTRUMENTS FOR LOW YIELD (5 PERCENT) SIGHT BONDS AND FOR EXCESS BANK RESERVES. THE PRIVATE SECTOR IS ALSO PERMITTED TO HOLD THESE INSTRUMENTS.

B. IN ELABORATING THE ACCOMPANYING MONETARY PROGRAM, THE MINISTRY OF FINANCE AGREED TO A TIGHT FISCAL POLICY THROUGHOUT THE REMAINDER OF THE YEAR. IT IS ESTIMATED THAT THIS TIGHTENING OF FISCAL POLICY WILL REDUCE THE OVERALL DEFICIT OF THE NONFINANCIAL PUBLIC SECTOR PLUS THE BANK OF GUATEMALA LOSSES FROM A TOTAL OF 3.2 PERCENT OF GDP IN 1986 TO NO MORE THAN 2.5 PERCENT OF GDP IN 1985. IN ORDER TO FACILITATE THIS REDUCTION, CONGRESS HAS APPROVED A TWO-MONTH AMNESTY FOR DELINQUENT TAXPAYERS WHICH IS PROJECTED TO GENERATE ABOUT Q50 MILLION IN ADDITIONAL TAX REVENUES. ALSO, CONGRESS IS CONSIDERING A BILL INTRODUCED BY THE MINISTER OF FINANCE TO LIMIT CURRENT EXPENDITURES AND FREEZE ALL TRANSFER PAYMENTS FROM THE

ACTION AID-00

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FM AMEMBASSY GUATEMALA
TO SECSTATE WASHDC IMMEDIATE 4874
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA
AMEMBASSY SAN JOSE

UNCLAS SECTION 03 OF 05 GUATEMALA 05981

AIDAC

FOR LAC/DP: WWHEELER; LAC/DR: TBROWN; LAC/CEN: CCOSTELLO

E.O. 12356: N/A
SUBJECT: UPDATE INFORMATION FOR FY 1989 ESF PROGRAM

CENTRAL GOVERNMENT. THE MINISTRY OF FINANCE EXPECTS THESE MEASURE TO ENSURE THE DEFICIT REDUCTION OBJECTIVE IS ACHIEVED REGARDLESS OFOUTLAYS THAT MAY OCCUR DURING THE YEAR.

C. IN ORDER TO FACILITATE COMPETITION IN THE FINANCIAL SYSTEM, THE MONETARY BOARD HAS THIS YEAR APPROVED TWO NEW BANKS AND ONE NEW "FINANCIERA". THE BOARD EXPECTS TO APPROVE THE OPENING OF ANOTHER LOCAL BANK AND THE RE-OPENING OF A BRANCH OF AN INTERNATIONAL BANK (CITIBANK) DURING THE THIRD QUARTER OF THE YEAR.

D. AS PART OF THE GOG'S EXPORT PROMOTION POLICY, A TARIFF REDUCTION PROGRAM WILL BE INITIATED BEFORE THE END OF 1989. AN OFFSETTING MOVEMENT IS ALSO EXPECTED IN THE OFFICIAL EXCHANGE RATE TO PREVENT AN APPRECIATION OF THE REAL EFFECTIVE EXCHANGE RATE.

E. AS PART OF ITS ECONOMIC PROGRAM, THE GOG HAS ALREADY ENACTED A PRO-EXPORT FREE ZONE LAW AND HAS PRESENTED TO CONGRESS AN EXPORT PROMOTION LAW.
F. THE GOG HAS TAKEN THE FIRST STEPS TO MAKING MORE COMPETITIVE THE DOMESTIC TRANSPORT SYSTEM BY THE PRIVATIZATION OF AVIATECA.

G. FINALLY, THE GOG IS COMMITTED TO IMPROVING BOTH THE TRANSPORTATION AND THE COMMUNICATION SECTORS. INVESTMENT PROGRAMS TO THAT END HAVE BEEN APPROVED AND THEIR IMPLEMENTATION WILL BE MONITORED AND MADE PART OF THE AGENDA FOR DISCUSSION DURING REVIEWS OF PROGRESS UNDER THIS ESF PROGRAM. SUCH POLICIES WILL BE FURTHER DEVELOPED AND IMPLEMENTED DURING THE REMAINDER OF 1989.

9. THE GOVERNMENT OF GUATEMALA IS CONVINCED THAT THIS ECONOMIC PROGRAM WILL BEGIN DEFINITIVELY TO REBUILD THE ECONOMY'S INTERNATIONAL RESERVES BASE, AN ESSENTIAL PRECONDITION TO SUSTAINED GROWTH WITH STABILITY. WE CONCUR IN THIS JUDGEMENT, AND PARTICULARLY ENDORSE THE USE OF BOTH THE EXCHANGE RATE AND THE DOMESTIC MONETARY POLICY TOOLS FOR THAT PURPOSE. THROUGH THE ADOPTION OF MEASURES THAT ALLOW A GREATER ROLE TO MARKET FORCES, IT IS EXPECTED THAT PRIVATE SECTOR CONFIDENCE AND HENCE INVESTMENT WILL BE STRENGTHENED.

IMPACT OF THE ECONOMIC PROGRAM

10. THE POLICY PROGRAM THE GOG HAS NOW ADOPTED IS WELL SUITED TO GUATEMALA'S ECONOMIC CIRCUMSTANCES. WITH PRICE INFLATION SUBSTANTIALLY UNDER CONTROL, MODEST BUT NEVERTHELESS POSITIVE REAL GROWTH UNDER WAY, THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS WITHIN A MANAGEABLE DISTANCE FROM EQUILIBRIUM AND STRUCTURAL CHANGE BROADENING PARTICIPATION IN ECONOMIC PROCESSES, SLEDGEHAMMER AUSTERITY IS NOT CALLED FOR. IN FACT, THE SDR 54 MILLION IMF STAND BY AGREEMENT WITH GUATEMALA, WHICH STARTED IN OCTOBER 1988 BUT ENDED AFTER THE FIRST DISBURSEMENT WHEN GUATEMALA WAS UNABLE TO MEET THE DECEMBER OR MARCH PERFORMANCE TARGETS, HAD AS ITS CENTRAL OBJECTIVE A SHARP IMPROVEMENT IN INTERNATIONAL RESERVES. IT IS CLEARLY TOO LATE NOW TO GET THAT PROGRAM BACK ON TRACK. HOWEVER, WE BELIEVE THE NEW POLICY SET HAS AN EXCELLENT CHANCE OF WINNING A NEW FUND AGREEMENT. THE GOG HAS INFORMED THE IMF OF THE RECENT MEASURES AND IS EXPLORING THE POSSIBILITY OF NEGOTIATING A NEW IMF PROGRAM. HOWEVER, AS FORMAL DISCUSSIONS HAVE NOT YET BEGUN, IT IS UNLIKELY THAT A NEW STAND BY ARRANGEMENT CAN BE CONCLUDED THIS YEAR.

11. THE POLICY MEASURES ADOPTED BY THE GOG ARE EXPECTED TO REVERSE THE SHARP DETERIORATION IN THE NET INTERNATIONAL RESERVE POSITION OF THE BANK OF GUATEMALA. AFTER FALLING BY ABOUT US DOLS66 MILLION DURING THE FIRST SIX MONTHS OF THE YEAR, THE NET INTERNATIONAL RESERVES OF THE BANK ARE EXPECTED TO INCREASE BY ABOUT US DOLS74 MILLION IN THE SECOND SIX

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FM AMEMBASSY GUATEMALA
TO SECSTATE WASHDC IMMEDIATE 4825
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA
AMEMBASSY SAN JOSE

UNCLAS SECTION 04 OF 05 GUATEMALA 05581

AIDAC

FOR LAC/DP:WWHEELER; LAC/DR:TBROWN; LAC/CEN:CCOSTELLO

E.O. 12356: N/A
SUBJECT: UPDATE INFORMATION FOR FY 1989 ESF PROGRAM

MONTHS OF THE YEAR (TABLE 1).

TABLE 1 MONETARY ACCOUNTS OF THE
BANK OF GUATEMALA
(MILLIONS OF QUETZALES)

	1988 JUNE	1988 DECEMBER	1989 JUNE	1989 DECEMBER
NET INTERNATIONAL - RESERVES	-357	-764	-941	-742
NET DOMESTIC - ASSETS	1363	1942	2078	1855
PUBLIC - SECTOR	931	1002	867	728
COMMERCIAL - BANKS	-471	-600	-558	-649
- CREDIT	121	157	142	157
- DEPOSITS	-592	-757	-691	-835
OTHER	903	1538	1763	1817
CURRENCY	1006	1176	1137	1154
MEMORANDUM ITEM NET INTERNATIONAL RESERVES (US DOLS MILLIONS)	-132	-283	-349	-275

INCLUDES STABILIZATION BONDS, EXCHANGE ADJUSTMENT.

12. THE IMPROVEMENT IN THE RESERVES POSITION OF THE BANK REFLECTS THE COMBINED IMPACT OF A TIGHTENING OF NET CREDIT AND AN INCREASE IN THE DEMAND FOR QUETZAL-DENOMINATED DEPOSITS AS PRIVATE SECTOR CONFIDENCE RETURNS. AFTER INCREASING BY 11.7 PERCENT DURING JANUARY-JUNE 1989, THE NET DOMESTIC ASSETS OF THE BANK ARE PROJECTED TO FALL BY 15.8 PERCENT IN THE SECOND HALF OF THE YEAR (TABLE 2). THE SHARP REDUCTION IN CREDIT DURING JULY-DECEMBER IS EXPLAINED BY A CONTRACTION IN NET CREDIT TO THE NON-FINANCIAL PUBLIC SECTOR (-12.2 PERCENT) AND A REDUCTION IN NET CREDIT TO COMMERCIAL BANKS (-8.8 PERCENT) AS COMMERCIAL BANK DEPOSITS ARE ACCUMULATED IN THE BANK OF GUATEMALA. THE INCREASE IN COMMERCIAL BANK DEPOSIT ARISES FROM THE GROWTH IN TIME AND SAVINGS DEPOSITS, AND REFLECTS THE IMPACT OF THE HIGHER INTEREST RATES PROJECTED IN THE FINANCIAL SYSTEM. OUR INDEPENDENT EVALUATION OF THE NEW OPEN MARKET OPERATION LIMIT AND

THE RECENT BEHAVIOR OF THE EXTERNAL ACCOUNTS SUGGESTS THAT THESE PROJECTIONS ARE ENTIRELY PLAUSIBLE.

TABLE 2 CHANGE IN BANK OF GUATEMALA OPERATIONS
(IN PERCENTAGE CHANGE

	1988 DECEMBER	1989 JUNE	1989 DECEMBER
NET INTERNATIONAL - RESERVES	-40.5	-15.1	-17.5
NET DOMESTIC - ASSETS	57.4	11.7	-16.8
PUBLIC - SECTOR	7.1	-11.5	-12.2
COMMERCIAL - BANKS	-12.8	3.6	-8.8
- CREDIT	3.8	-1.4	4.1
- DEPOSITS	-16.4	5.8	-12.1
OTHER	63.1	19.6	4.2
CURRENCY	16.9	-3.4	1.5

WITH RESPECT TO CURRENCY HOLDINGS AT THE BEGINNING OF THE PERIOD.

13. ONE LIMITATION OF THE PROJECTION IS THAT THE BANK OF GUATEMALA ASSUMES THAT THE WORLD BANK WILL DISBURSE US DOLS30 MILLION BEFORE THE END OF THE YEAR. GIVEN THE DELAYS THAT HAVE OCCURRED IN THE ELABORATION OF THIS PROGRAM, SUCH A DISBURSEMENT MAY BE DIFFICULT TO ACHIEVE. HOWEVER, EVEN IN THE ABSENCE OF THE WORLD

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FM AMEMBASSY GUATEMALA
TO SECSTATE WASHDC IMMEDIATE 4826
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA
AMEMBASSY SAN JOSE

UNCLAS SECTION 05 OF 06 GUATEMALA 09981

AIDAC

FOR LAC/DP:WWHEELER; LAC/DR:TBROWN; LAC/CEN:CCOSTELLO

E.O. 12356: N/A
SUBJECT: UPDATE INFORMATION FOR FY 1989 ESF PROGRAM

BANK DISBURSEMENT, TOTAL LIQUID RESERVES OF THE BANK OF GUATEMALA WILL INCREASE FROM THE PRESENT LEVEL OF LESS THAN ONE WEEK OF IMPORTS TO ALMOST FOUR WEEKS OF IMPORTS BY THE END OF THE YEAR, A DEFINITE AND IMPORTANT STEP TOWARD REBUILDING THE CRITCCAL RESERVE BASE.

14. AS A RESULT OF THESE MEASURES THE OVERALL INFLATION RATE IS PROJECTED TO REMAIN ABOUT 10 PERCENT AND REAL GDP IS PROJECTED TO GROW BY 3.5 PERCENT, THE SAME PACE AS IN 1988.

AGRICULTURAL POLICY

15. WHILE THE AGRICULTURAL STRATEGY DESCRIBED IN THE PAAD REMAINS UNCHANGED, ADDITIONAL DETAILS HAVE BEEN DEVELOPED DURING THE COURSE OF THE YEAR. THE PROGRAM FOR 1989 EMBRANCES THE FOLLOWING OBJECTIVES:

A. SEVENTY PERCENT OF THE INVESTMENT BUDGET OF THE MINISTRY OF AGRICULTURE (MAGA) WILL BE EXECUTED DURING THE CALENDER YEAR AND THE REMAINING 30 PERCENT WILL BE EXECUTED DURING THE FIRST QUARTER OF 1990.

B. MAGA HAS PRESENTED, BEFORE THE APRIL 30 DEADLINE AND FOR THE FIRST TIME, A UNIFIED BUDGET INCORPORATING THE DIVERSE ENTITIES OPERATING IN THE AGRICULTURAL SECTOR. THIS UNIFIED BUDGET PERMITS IMPROVED MONITORING AND EVALUATION OF DIVERSE ACTIVITIES CARRIED OUT IN GUATEMALA.
C. MAGA WILL PREPARE A MASTER IRRIGATION PLAN. THE FIRST STEP IN THE DEVELOPMENT OF THE PLAN, THE ANALYSIS OF IRRIGATION NEEDS, IS UNDERWAY AND THE WRITING OF A LAW OF WATER AND SOIL CONSERVATION WILL BE COMPLETED THIS CALENDAR YEAR.

D. THE STRENGTHENING AND DECENTRALIZATION PROCESS FOR BANDESA HAS BEGUN IN ERNEST. AS PART OF THE EFFORTS TO STRENGTHEN THE ADMINISTRATIVE CAPABILITIES OF THE INSTITUTION, A NEW PRESIDENT HAS BEEN APPOINTED ALONG WITH TWO NEW DEPUTY DIRECTORS. A SIGNIFICANT REASSIGNMENT OF BANDESA'S PERSONNEL WAS ALSO BEGUN AT MID-YEAR.

E. IN THE AREA OF NATURAL RESOURCES, DEVELOPMENT OF A TROPICAL FOREST ACTION PLAN BEGAN EARLY THIS YEAR. A WORKING GROUP HAS BEEN FORMED AND THE VICE-PRESIDENT

OF THE REPUBLIC IS ACTIVELY INVOLVED IN THE GROUP'S ACTIVITIES. A FORESTRY LAW, DEVELOPED WITH AID TECHNICAL ASSISTANCE, HAS BEEN SUBMITTED TO CONGRESS AND CONGRESS IS EXPECTED TO APPROVE THE LAW WITHIN 60 DAYS.

F. MAGA IS UNDERTAKING AN AGRICULTURAL DEVELOPMENT AND FOOD SECURITY STUDY. A TEAM IS AT WORK AND THE FINAL REPORT IS DUE BY SEPTEMBER 30.

TIMING OF DISBURSEMENT OF ESF DOLLARS

16. THE US COUNTRY TEAM IN GUATEMALA STRONGLY BELIEVES THAT ONLY A SINGLE DISBURSEMENT OF THE ESF FUNDS MAKES SENSE GIVEN THE COMPREHENSIVENESS OF AND THE SERIOUSNESS OF PURPOSE REFLECTED IN THE NEW ECONOMIC PROGRAM. MOREOVER, THE LOSS OF RESERVES THAT HAS BEEN EXPERIENCED SO FAR THIS YEAR REFLECTS THE GOG'S BEST EFFORT TO SUSTAIN THE GROWTH MOMENTUM FROM LAST YEAR PENDING POLICY DECISIONS REQUIRED TO TRIGGER ANTICIPATED EXTERNAL ASSISTANCE.

17. NOTWITHSTANDING EXTREMELY DIFFICULT POLITICAL AND SOCIAL CONDITIONS IN THE COUNTRY, THE GOG HAS ADOPTED A WIDE-RANGING AND COMPREHENSIVE ECONOMIC PROGRAM. THE SHORT-TERM CONSTRAINTS ARE DEALT WITH EFFECTIVELY WITHIN THE CONTEXT OF A MAJOR ECONOMIC REFORM OVER THE MEDIUM TERM. THE MONETARY BOARD HAS SHIFTED THE METHOD FOR ESTABLISHING THE EXCHANGE RATE, REDUCING DISCRETIONAL CONTROL AND REPLACING THE FIXED EXCHANGE RATE SYSTEM WITH ONE THAT MAINTAINS THE COMPETITIVENESS OF THE QUETZAL OVER THE MEDIUM TERM. NOTWITHSTANDING VOCAL AND STRIDENT OPPOSITION FROM

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FM AMEMBASSY GUATEMALA
TO SECSTATE WASHDC IMMEDIATE 4027
AMEMBASSY SAN SALVADOR
AMEMBASSY TEGUCIGALPA
AMEMBASSY SAN JOSE

UNCLAS SECTION 06 OF 06 GUATEMALA 09981

AIDAC

FOR LAC/DP: WWHEELER; LAC/DP TBROWN; LAC/CEN: CCOSTELLO.

E. O. 12356: N/A
SUBJECT: UPDATE INFORMATION FOR FY 1989 ESF PROGRAM

SOME ELEMENTS OF THE FINANCIAL COMMUNITY, THE GOG HAS ADOPTED A COMPLETELY FLEXIBLE INTEREST RATE SYSTEM.

18. THIS POLICY PROGRAM IS PRECISELY THE KIND THAT US POLICY HAS SOUGHT TO ENCOURAGE THROUGHOUT CENTRAL AMERICA. THE BREADTH AND COMPREHENSIVENESS OF THE PROGRAM DESERVES OUR COMPLETE SUPPORT, AND THE TECHNICAL ECONOMIC REQUIREMENTS DICTATE A SINGLE DISBURSEMENT.

NEXT STEPS

19. THIS NEW ECONOMIC POLICY FRAMEWORK WILL NEED CONTINUAL INTERNATIONAL SUPPORT TO ENSURE ITS SUCCESS OVER THE NEXT YEARS. INSTITUTIONALIZATION OF SUCH RADICALLY NEW APPROACHES TO POLICY MAKING IS FRAUGHT WITH DIFFICULTIES. USAID/GUATEMALA IS NOW IN THE PROCESS OF EXAMINING KEY INTERVENTIONS TO HELP THE GOG CONSOLIDATE PROGRESS MADE THUS FAR. AMONG POSSIBLE ISSUES TO BE EXAMINED ARE EFFORTS TO STRENGTHEN THE FINANCIAL SYSTEM AND MAKE IT MORE RESPONSIVE TO MARKET SIGNALS, ELIMINATION OF MARKET DISTORTIONS AND RESTRICTIONS TO THE FREE MOVEMENT OF FACTORS OF PRODUCTION, AND THE DEEPENING OF THE DOMESTIC CAPITAL MARKETS. PROGRESS IN THESE AREAS MUST BE MADE WITHIN THE CONTEXT OF A FURTHER STRENGTHENING OF THE COUNTRY'S INTERNATIONAL RESERVE POSITION, STABLE PRICE LEVELS AND ECONOMIC GROWTH. EFFORTS TO CONFRONT THESE CHALLENGES CAN PROVIDE THE BASIS OF FURTHER US SUPPORT TO GUATEMALA. MICHEL