COUNTRY REVIEW

Guatemala

26 August 2010

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EULER HERMES COUNTRY RISK GRADE: B

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Strengths

- Functioning democratic process—four handovers of power since end of 36-year civil war in 1996.
- Conservative macroeconomic framework operating within an 18 month IMF stand-by programme.
- Managed float exchange rate policy.

Weaknesses

- History of political instability.
- Weak institutional framework (widespread corruption, weak judiciary).
- Poor long-term growth record, highly skewed income distribution and high poverty levels.
- Vulnerable to US economic cycle, particularly via workers remittances. Also commodity prices.
- Weak implementation of structural reforms.

Country Risk Assessment

Ratings	Guatemala Latest	Guatemala Previous	Median Grade B	Peers Honduras	Peers Colombia	Peers Thailand
Systemic Political Risk:	**P3+**	**P3+**	**P2-**	**P3-**	**P2-**	**P3+**
Systemic Economic Risk:	**E4**	**E5**	**E4**	**E5**	**E3**	**E3**
ME rating:	ME4	ME5	ME4	ME5	ME4	ME3
Structure	*4.0*	*4.0*	*5.0*	*5.0*	*4.0*	*5.0*
Policy	*4.5*	*3.9*	*4.2*	*4.6*	*4.3*	*3.2*
Solvency	*2.8*	*1.7*	*2.3*	*1.3*	*3.5*	*1.3*
External Liquidity	*2.8*	*5.2*	*3.7*	*4.8*	*2.2*	*2.8*
SBE rating:	SBE4	SBE4	SBE3	SBE5	SBE3	SBE3
COUNTRY GRADE:	**B**	**C**	**C**	**C**	**B**	**B**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Guatemala City
Population:	14.03 mn (2009)
GDP:	USD 37322 mn (2009)
Currency:	Quetzal (GTQ)
Form of state:	Republic
Head of government:	President Alvaro Colom
Next elections:	2011 September (Presidential & Legislative)

Major Industries (% of GDP 2009)	
Agriculture, forestry & fishing	11.0%
Mining & manufacturing	18.9%
Electricity & water	2.1%
Construction	4.1%
Services	63.9%

Global Assumptions	2010	2011
Real GDP grth (% yr/yr) *	3.3	2.9
Inflation (%, av) *	1.2	1.4
Dated brent (USD/b)	75	70

* World

Main Exports (% of total, 2009)	
Coffee	8.0%
Sugar	7.0%
Bananas	5.9%
Cardomom	4.2%
Oil	2.7%

Main Imports (% of total, 2009)	
Consumer goods	28.5%
Intermediate goods	34.1%
Fuels & lubricants	19.1%
Capital goods	18.3%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	34,128	39,139	37,322	40,891	43,270
Population (mn)	13.35	13.69	14.03	14.37	14.71
GDP per capita (USD)	2,556	2,859	2,660	2,846	2,942
Real GDP growth (% yr/yr)	6.3	3.3	0.6	2.7	2.0
Inflation (%, eop)	8.8	9.4	-0.3	5.5	5.0
Fiscal balance (% of GDP)	-1.4	-1.6	-3.2	-3.4	-3.0
Current account balance (% of GDP)	-5.4	-4.7	-0.7	-2.5	-3.7
External debt/GDP (%)	43	41	38	39	39
External debt/Exports of goods & services (%)	108	108	108	109	109
Interest paymetnts/Exports of goods & services (%)	6	5	5	4	5
Foreign exchange reserves (USD mn)	4,130	4,462	4,964	6,105	6,105
Import cover (months)	3.4	3.4	4.8	5.0	4.6
Exchange rate assumption:	7.67	7.56	8.16	8.06	8.15

f: CRU central forecast

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Elections at the end of 2003 marked an important stage in Guatemala's emergence from 36 years of civil war, which ended only ten years ago in 1996, as voters rejected decisively the candidature of former president and right-wing dictator Rios Montt (accused of various human rights offences, including genocide, during his previous term in office). Voters instead opted for the centre-right former mayor of Guatemala City Oscar Berger, of the conservative Gran Alianza Nacional (GANA) as president. The latest presidential elections in September (first round) and November (second round run-off) 2007 underscored the electorate's aversion to right-wing, hard-liners, when centre-left Unidad Nacional de la Esperanza (UNE) candidate, Alvaro Colom won comfortably with 52.8% of the vote, despite opinion polls immediately prior to the elections that had put his rival, former army general Otto Perez Molina (Partido Patriota, PP). The next elections are scheduled for September 2011 (presidential and legislative).

The UNE is well short of a working majority in congress and the need to maintain shifting working alliances among the fragmented and fractious parties represented there constrains the effective implementation of the government's legislative programme. This includes tax reforms, which are necessary to increase the relatively low tax revenue-GDP ratio. As elections approach it is likely to become increasingly difficult to pass structural reform legislation.

The 1996 Peace Accords that ended the civil war set out a broad national consensus on social, economic and security reform priorities as the basis for policy objectives and, though much of the agenda remains incomplete, broad macroeconomic stability has been maintained. The decisive issue in the most recent presidential elections was not economic policy, but the approach to the deteriorating security situation in the country, which brought the worst pre-election violence since the end of the civil war. Colom won the presidential elections on a platform of increased welfare spending and curbing civil violence and crime by inclusion rather than force (as proposed his by his right-wing rival). Guatemala has one of the highest violent crime records in the region.

Social tensions remain deep-rooted. The majority indigenous population are marginalised and political institutions are weak. Corruption is widespread, respect for the rule of law is weak—reform of the judiciary has been slow—and political parties are fragmented and polarised. The military, historically dominant, have had a reduced role since 1996, but as reforms in this area are incomplete they remain a powerful force.

In the wake of the global financial crisis the Colom government entered an 18-month IMF stand-by arrangement (SBA). The Third review of the programme to end-March was completed and approved in July 2010. The SBA continues to be treated as precautionary (undrawn).

Internationally, Guatemala is a member of the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) with the US, which came into effect for Guatemala in 2006 and made permanent preferential access for Guatemalan exports, replacing the previous Caribbean Initiative

Economic Stability

Guatemala is a lower-middle income economy with an estimated per capita GDP of almost USD2,500 in 2009. Coffee, sugar and bananas remain important exports. Manufacturing exports—particularly garments and the maquila sector (offshore assembly for re-export)—and workers remittances, however, have both grown strongly and the latter accounts for 25-30% of all current account foreign exchange earnings. The economy is vulnerable to both commodity price fluctuations and the US economic cycle. Annual average growth of real GDP per capita has been low over the past ten years at just 0.3%.

Growth remained positive in 2009 at 0.6% and better than many emerging economies, despite the global recession, though it was well down on the 4.3% annual average of 2004-08. Moderately expansionary fiscal and monetary policy helped cushion some of the worst effects of lower remittances and falling investment. A moderate recovery is evident in 2010—the monthly activity indicator registered 3.3% yr/yr average growth in H1—but tropical storm Agatha will have some short term impact on agricultural production this year. Nonetheless, we expect real GDP to increase by 2.7% in 2010 and 2% in 2011.

Inflation accelerated rapidly through much of 2008 but decelerated just as rapidly in 2009, as domestic demand fell away and energy prices reversed, and by December 2009 consumer prices had fallen by 0.3% yr/yr, with the underlying measure at 0.9% yr/yr. Inflation has picked up in 2010 and was 4.1%

yr/yr in July, though core inflation was lower at 2.4%. We expect end-2010 inflation of around 5.5% yr/yr and end-2011 of 5%yr/yr, which would be within the central banks 4-6% target range, though above the mid-point.

Policy interest rates were reduced by 275bps (7.25% to 4.5%) in 2009 and have remained at the lower level so far in 2010, though not much of this has been passed on in commercial rates. With credit expansion low but inflation trending upwards into the upper bound of the central bank's target range the next interest rate move is likely to be up (probably before year-end). The real effective exchange rate was overly strong exchange rate but a correction in 2009 eliminated this effect. The exchange rate is a managed float.

Two banks were intervened in late 2006 and early 2007. There have been mergers and a re-organisation since then and the third review of the SBA in June 2010 noted that "the banking sector remains resilient. Banks remain well capitalised and liquid". In 2009 net foreign assets moved from negative to positive where they have remained so far in 2010. Dollarization is relatively low.

Fiscal policy has been conservative with deficits (non-financial public sector) below 2% of GDP a year in 2004-08. In 2009, however, the deficit widened to 3.2% of GDP as revenues have fallen, while expenditure was maintained, though this was within the agreed IMF target. The deficit is targeted at 3.1% in 2010 and 2.5% in 2011, as the stimulus is withdrawn. However, there was some slippage in H1, in part the result of spending associated with tropical storm Agatha. The targeted 3.1% is now expected to be met if emergency and reconstruction spending related to the tropical storm is excluded, though the actual deficit will probably be 3.4% of GDP. The public debt-GDP ratio increased from 20.1% of GDP in 2008 to 23.2% at end-2009 and will probably rise to 25-27% in 2010-11 and with a low revenue-GDP ratio (around 11-12%) it will be necessary not to allow the debt ratio to rise rapidly in the medium-term, absent a comprehensive tax reform.

The external current account deficit was an annual average 5.1% of GDP in 2004-08. In 2009, however, the deficit narrowed to less than 1% of GDP. Exports of goods and workers remittances fell sharply, but imports decreased even more in value terms. With stronger domestic demand growth expected we expect the deficit to widen to around 2.5% of GDP in 2010 and 3.7% in 2011. FDI flows weakened in 2009 and in 2010-11 may cover only around 40% of the deficit. FX reserves have increased 2009 and current levels cover 4.6 months of projected 2011 imports of goods and services, and 170% of external debt (ST and medium-term principal) falling due in 2011.

External debt ratios are moderate. External debt is relatively high as a proportion of GDP at 39% but is a moderate 110% of exports of goods and services, while interest payments are also a moderate 5% of exports of goods and services.

Structural Business Environment

The Structural Business Environment is adequate**,** but below average (121 out of 210 countries assessed).

Based on data and definitions from the World Bank's 2010 Doing Business Survey, of ten areas surveyed eight—Starting a Business, Dealing with Construction Permits, Protecting Investors, Paying Taxes, Trading Across Borders, Enforcing Contracts, Closing a Business, Employing Workers—were weaker areas, ranking below average but none were very weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality about average, but Rule of Law and Control of Corruption below average for the Latin American region, with Regulatory Quality above average and Rule of Law and Control of Corruption below average for the lower middle income group of countries. Transparency International's Corruption Perception Index, 2009, assigns Guatemala a score of 3.4—on a scale of 1 (bad) to 10 (good)—and a ranking of 84= out of 179 (the same as Gabon and Jamaica, among others). As a broad measure of the pro-business environment The Heritage Foundation 2009 Index of Economic Freedom ranks Guatemala 87 out of 179.

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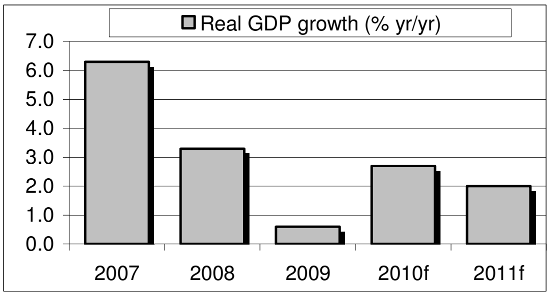
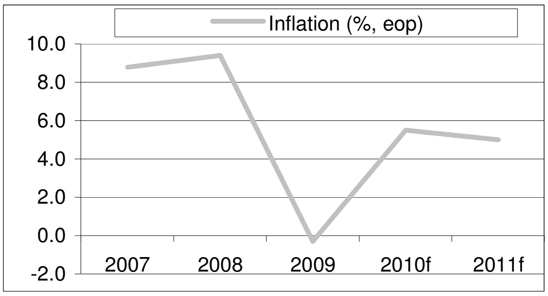
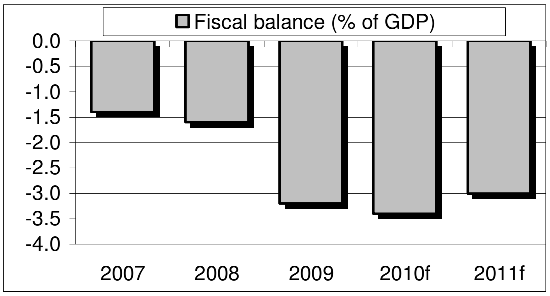
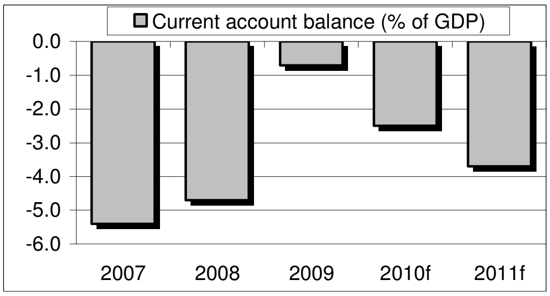
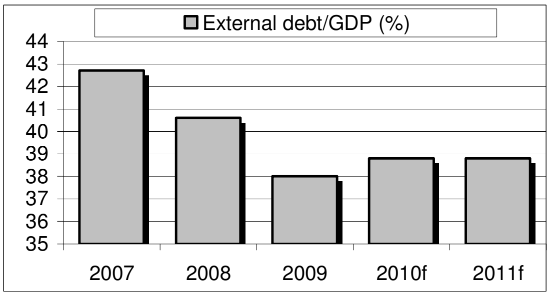
Charts

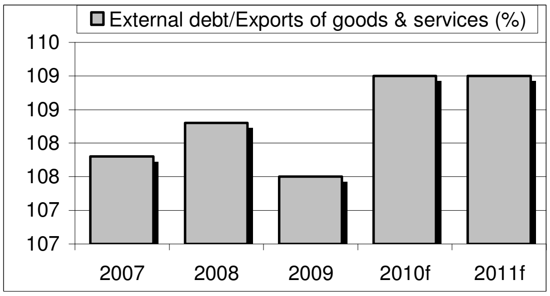

Real GDP growth (% yr/yr)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f

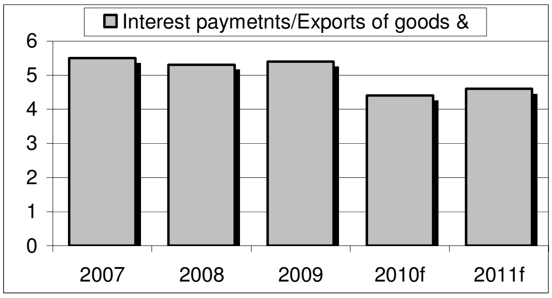

Inflation (%, eop)
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
2007
2008
2009
2010f
2011f

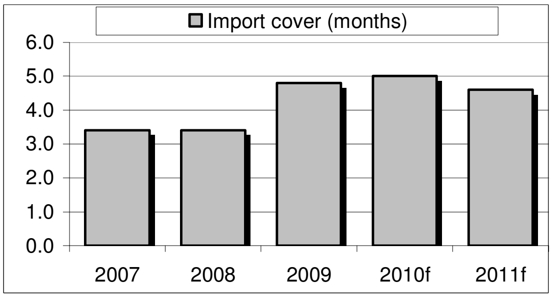

Fiscal balance (% of GDP)
0.0
-0.5
-1.0
-1.5
-2.0
-2.5
-3.0
-3.5
-4.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
-6.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
44
43
42
41
40
39
38
37
36
35
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
110
109
109
108
108
107
107
2007
2008
2009
2010f
2011f


Interest paymetnts/Exports of goods &
6
5
4
3
2
1
0
2007
2008
2009
2010f
2011f


Import cover (months)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f