“The monetary policy stance remains broadly appropriate. It is important that the authorities remain vigilant and ready to tighten the stance if inflationary pressures emerge. Exchange rate flexibility continues to be essential to absorb shocks and enhance the inflation-targeting framework.

“Progress continues with the financial sector reform agenda, including on regulations on liquidity and foreign-currency credit risk management, provisioning of nonperforming loans, and the approval of the law governing the insurance sector. Congressional passage of the amendments to the banking law and the development of a banking resolution plan would further efforts to increase the resilience of the financial system,” Mr. Portugal said.

Statement by Ramón Guzmán, Executive Director for Guatemala
September 27, 2010

We thank the staff for a concise and well-balanced report. Our authorities broadly agree with the staff's appraisal and recommendations. We would also like to thank management and staff for the continued engagement and willingness to carry out a productive policy dialogue with our authorities throughout the program, and Directors for their constant support.

Our authorities would like to reiterate that Fund's support played a crucial role in maintaining confidence and macro-financial stability during the recent global crisis.

Performance under the Stand-By Arrangement has been strong. All the end-June quantitative performance criteria were met; particularly, our authorities complied with the targets on net international reserves and the overall balance of the central government. Government deposits at the Central Bank were well above the indicative target and annual inflation remained within the inner consultation band set in the program.

Recent Developments

The natural disasters that hit the country recently caused human loses and had a negative impact on the economy; however, they did not deviate the economic recovery path. The monthly index of economic activity (IMAE) increased 3.1 percent (y/y) in June in line with the expected economic growth for the whole year of more than 2 percent. Headline inflation was 4.1 percent as of end-August, and we expect it will remain within the target of 5 percent +/- 1 percentage points established by the Monetary Board. Currently, growth in exports and imports is accelerating, remittances are recovering, and international reserves are well above end-2009 levels. The fiscal outturn in the first semester of 2010 was better than envisaged, with the deficit of the central government reaching 0.9 percent of GDP, 0.6 percent lower than programmed. The banking system remains liquid and well capitalized and credit to the private sector in domestic currency has begun to gradually recover.

Fiscal Policy

Although challenges on the revenue front persist, our fiscal authorities remain committed to maintaining prudent policies. Key priorities in the short-term are to accommodate relief and reconstruction spending related to the recent natural disasters, seek congressional approval of the already submitted 2011 budget, avoid domestic arrears by the government, control non-priority spending, and seek congressional support to the anti-evasion law.

In that context, our authorities raised their 2010 target for central government deficit to 3.4 percent of GDP (3.1 percent previously) to face demand for relief and reconstruction spending. For 2011 the budget draft envisages the start of fiscal consolidation, with a central government deficit of 3.1 percent of GDP (2.7 percent of GDP excluding reconstruction expenditures). Although we see merit in staff's recommendation of having a more ambitious pace of consolidation, we believe it is not feasible in the short-term (at least not without

reducing social and capital expenditure significantly) having in mind the ongoing spending pressures related to the natural disasters.
From a medium-term perspective, our fiscal authorities are of the view that fiscal consolidation should be fostered by further structural changes. In that context, given that political resistance to a comprehensive tax reform prevails, as a first step our authorities intend to work with Congress to build support for some measures included in the draft law submitted in November 2009, including increases in income and stamp tax rates. Authorities will also seek congressional approval of measures to strengthen tax administration .Those measures are aimed at avoiding a contraction in social and capital expenditures during fiscal consolidation.

The authorities are aware of the importance of implementing measures to avoid new arrears and regularize the outstanding debt stock. In that sense, they intend to undertake several actions recommended by the recent Fund's technical assistance mission on domestic arrears.

Monetary and Exchange Rate Policies

The monetary policy rate has been kept at 4.5 percent since September 2009, given that inflation expectations have broadly converged to the upper limit of the target set by the Monetary Board (6 percent). Moreover, the authorities consider that inflation expectations around the target, a sluggish credit growth, and a negative output gap are reasonable indicators that the current monetary policy stance is broadly adequate. However, they stand ready to adjust their policy stance if conditions change.

The Central Bank has been improving its monetary operations and plans to implement a framework based on an overnight interest rate. A transitional framework may come into place in October, bearing in mind that the upgraded framework will begin to function when the Central Bank and markets are confident that procedures and systems work efficiently. We believe that these changes will contribute to enhance the inflation targeting regime and the monetary transmission mechanism.

Our authorities remain committed to maintaining the exchange rate flexibility, which has proved effective to help absorb external shocks. In that sense, the Central Bank's intervention in the foreign exchange market is aimed at moderating exchange rate volatility using a rules-based scheme.

Financial Policy

The banking system remains liquid and well capitalized. The authorities have recently adopted regulations on liquidity and foreign currency credit risk management and have made further progress towards full provisioning of non-performing loans. In addition, in July Congress approved a law governing the insurance sector activity, which enhances the legal capacity of the Superintendency of Banks to effectively supervise insurance intermediaries.

The authorities have also been working in preparing regulations to further strengthen information technology risk, banks risk governance and comprehensive risk management;