Credit Analysis

Republic of Guatemala

Ratings

Foreign Currency
Long-Term IDR* .... BB+
Short-Term IDR* .... B
Rating Outlook .... Stable

Local Currency
Long-Term IDR* .... BB+
Rating Outlook .... Stable

Country Ceiling .... BB+

* IDR – Issuer Default Rating

Peer Group

BBB-	Croatia Namibia Romania
BB+	**Guatemala** Egypt El Salvador India Panama
BB	Azerbaijan Colombia Costa Rica Macedonia Peru Philippines

Ratings History

Date	LTFC	LTLC
22 Feb 2006	BB+	BB+

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Summary

Fitch Ratings recently assigned Guatemala sovereign ratings of 'BB+' (BB plus) with a Stable outlook. These ratings are supported by the country's low external and public debt burdens, the government's track record of fiscal discipline and moderate inflation, as well as a solid commercial debt repayment history.

Guatemala's track record of fiscal discipline, moderate inflation, low public debt, as well as a strengthening of the banking system, has provided a sufficient buffer to deal with adverse external shocks, such as the natural disasters experienced in recent years, and should continue to do so over our rating horizon. Fiscal prudence, combined with steady, though sluggish, GDP growth and a lack of access to credit during the 1980s, has resulted in one of the lowest debt/GDP ratios among peers. Fitch estimates that the country's debt/GDP ratio reached 16.6% last year. A recovery of investment and consumption has resulted in a gradual acceleration of GDP growth. A solid balance of payments performance, underpinned by remittance growth and increased private capital inflows, has been reflected in international reserve accumulation of US$250 mn in 2005. Reserve accumulation, combined with low debt service, will boost Guatemala's liquidity ratio to a projected 187% at the beginning of 2006, compared with a 'BB' median of 157%.

Credit Outlook

Although economic risks appear contained due to the government's favorable balance sheet, high levels of poverty and inequality, as well as the country's poor social indicators, will likely constrain Guatemala's ratings for some time. Maintaining a small government is prudent and has helped minimize the country's exposure to economic vulnerabilities, however, this policy makes tackling the poverty issue difficult due to a lack of resources. The government will have to implement a more comprehensive tax reform to increase the tax take if it is to address its social challenges. Yet political opposition to tax reform remains formidable.

Strengths

- Low external and public debt
- Solid repayment history
- Manageable debt service burden
- Macroeconomic stability

Weaknesses

- High income inequality and poverty
- Weak social indicators
- Poor infrastructure
- Political and social fragmentation
- High crime rates

February 9, 2006

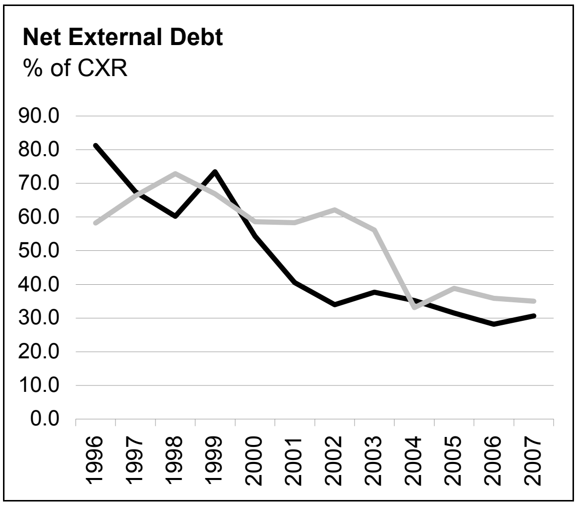
Key Indicators for Guatemala

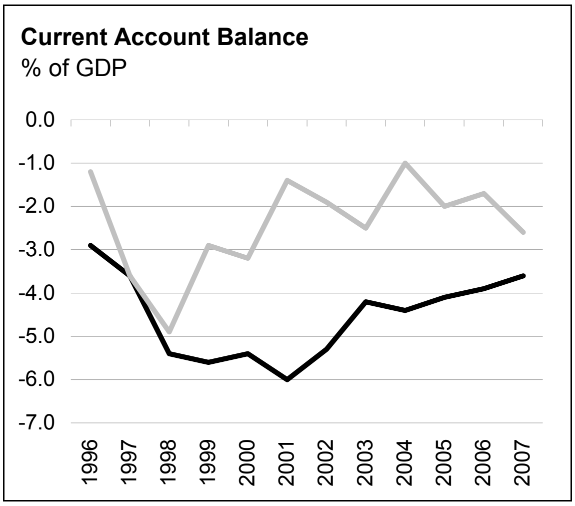
Population (2005): 12.6m **Population Growth Rate (2000-2005):** 2.4% p.a.
GDP (2005e): USD31.9bn **GDP per Head at Market Exchange Rates (2005e):** USD2,537
GNI Per Head at Purchasing Power Parity (2004): USD4,140 (= 10% of USA level)
Modern Sovereign Rescheduling History: 1993 Paris Club debt relief and rescheduling

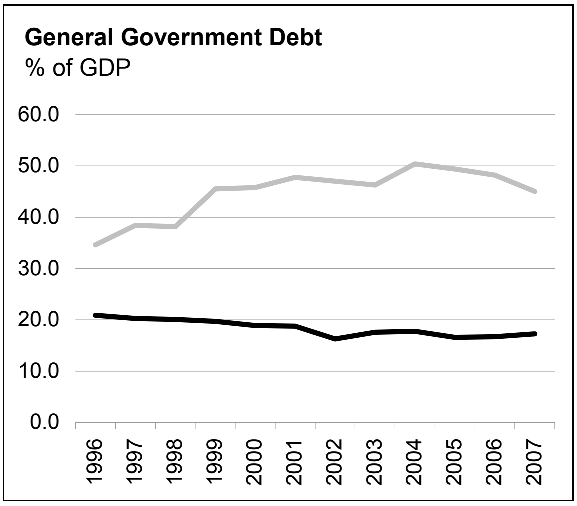
	2001	2002	2003	2004	2005e	2006f	2007f
Domestic Economy and Finance							
Real GDP Growth (%)	2.3	2.3	2.1	2.7	3.2	4.0	4.3
Unemployment (% of Labour Force)	3.6	3.6	3.3	3.1	3.0	3.0	3.0
Consumer Prices (Annual Average % Change)	7.6	8.0	5.5	7.4	9.1	7.6	6.3
Gross Domestic Savings (% of GDP)	7.6	6.8	5.3	3.8	3.7	3.2	3.0
Gross Domestic Investment (% of GDP)	17.8	19.1	18.1	17.8	18.0	18.6	18.9
Short-Term Interest Rate (%)(1)	10.6	9.1	6.6	6.2	6.5	6.0	6.0
Broad Money (% Change Dec to Dec)	18.1	11.8	15.0	9.4	9.3	10.0	10.0
GTQ per USD (Annual Average)	7.86	7.82	7.94	7.95	7.64	7.85	8.20
REER (CPI, 2000=100)	126.7	135.5	137.7	142.8	-	-	-
REER: % Change (+ = Appreciation)	2.5	6.9	1.6	3.7	-	-	-
Public Finances							
General Government Balance (% of GDP)	-1.9	-1.0	-2.3	-1.0	-1.5	-1.6	-1.2
General Government Debt (% of GDP)	18.8	16.3	17.6	17.8	16.6	16.7	17.3
General Government Debt/Revenue (%)	169.9	142.8	158.7	161.4	162.9	162.2	169.8
Interest Payments/Revenue (%)	12.6	10.9	10.4	11.1	11.7	13.1	14.3
Balance of Payments							
Current Account Balance (USDm)	-1,253	-1,235	-1,039	-1,188	-1,301	-1,369	-1,336
Current Account Balance (% of GDP)	-6.0	-5.3	-4.2	-4.4	-4.1	-3.9	-3.6
Current Account Balance plus Net FDI (USDm)	-797	-1124	-908	-1034	-1103	-1169	-1136
Current Account Balance plus Net FDI (% of GDP)	-3.8	-4.8	-3.7	-3.9	-3.5	-3.4	-3.1
Gross Financing Requirement (% of Official Reserves)(2)	81.6	61.9	60.0	57.8	52.9	53.0	53.2
Current External Receipts CXR (USDm)	5,246	6,203	6,857	7,830	8,791	9,330	9,836
Current External 0Receipts CXR (Annual % Change)	5.2	18.2	10.5	14.2	12.3	6.1	5.4
Current External Payments CXP (USDm)	6,499	7,438	7,896	9,018	10,092	10,699	11,172
Current External Payments CXP (Annual % Change)	7.7	14.4	6.2	14.2	11.9	6.0	4.4
External Assets and Liabilities							
Gross External Debt (USDm)	4,687	4,752	5,837	6,619	6,912	6,854	7,337
Gross External Debt (% of GDP)	22.3	20.4	23.6	24.7	21.6	19.7	19.9
Gross External Debt (% of CXR)	89.3	76.6	85.1	84.5	78.6	73.5	74.6
Net External Debt (USDm)	2,126	2,110	2,588	2,755	2,772	2,634	3,006
Net External Debt (% of GDP)	10.1	9.1	10.4	10.3	8.7	7.6	8.2
Net External Debt (% of CXR)	40.5	34.0	37.7	35.2	31.5	28.2	30.6
Public External Debt (USDm)	3,617	3,718	4,046	4,347	4,286	3,840	3,939
Public External Debt (% of GDP)	17.2	16.0	16.3	16.2	13.4	11.1	10.7
Net Public External Debt (% of CXR)	24.1	21.7	16.4	10.5	5.6	0.0	0.1
Public FC Denominated & FC Indexed Debt (USDm)	3,961	3,972	4,552	4,774	4,646	4,282	4,534
Short-Term External Debt (% of Gross External Debt)	20.2	19.6	21.5	19.2	18.6	18.9	17.8
External Debt Service (% of CXR)	8.3	7.5	9.0	9.7	9.6	10.0	10.3
External Interest Service (% of CXR)	4.1	4.0	3.4	3.2	3.2	3.1	3.1
Liquidity Ratio (%)(3)	140.0	180.8	170.7	161.3	183.1	187.1	183.2
Official International Reserves Including Gold (USDm)	2,352	2,373	2,925	3,522	3,790	3,840	3,931
Official International Reserves in Months of CXP Cover	4.3	3.8	4.4	4.7	4.5	4.3	4.2
Official International Reserves (% of Broad Money)	37.7	33.2	36.7	38.9	37.6	36.9	35.2

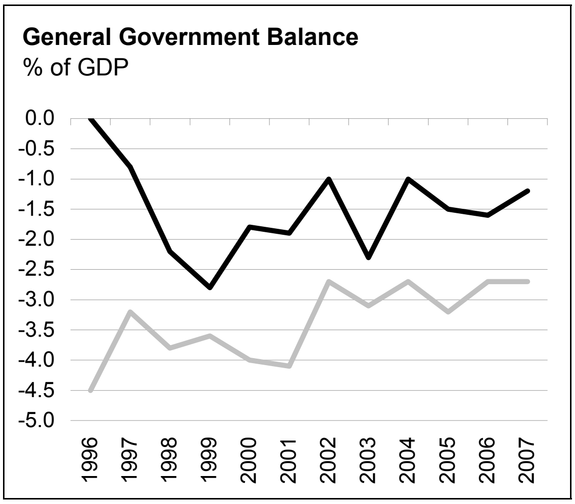
(1) Money market interest rate (annual average).
(2) Current account balance plus amortization of medium and long-term debt, over official international reserves.
(3) Official reserves incl. gold plus banks' foreign assets/ Debt service plus liquid external liabilities.

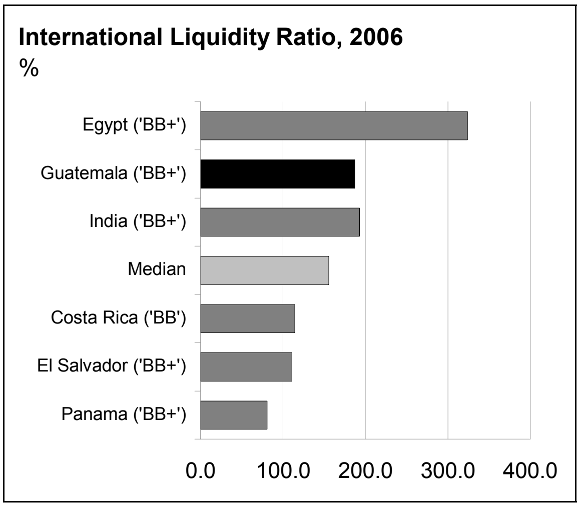
Peer Comparison

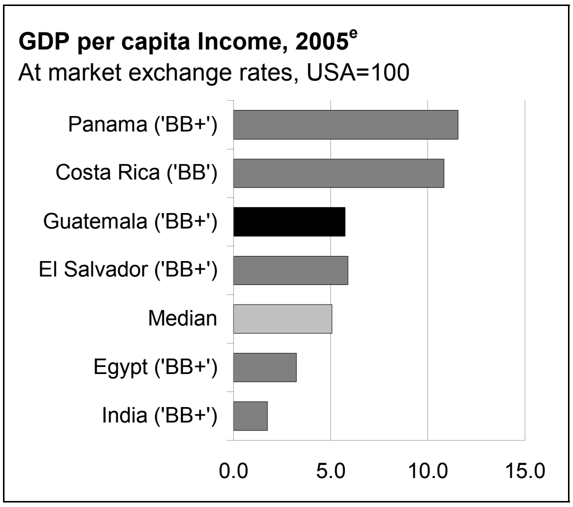












Guatemala — 'BB' Median

Source: Fitch Sovereign Comparator

Rationale

Fitch Ratings recently assigned Guatemala sovereign ratings of 'BB+' (BB plus) with a Stable outlook. These ratings are supported by the country's low external and public debt burdens, the government's track record of fiscal discipline and moderate inflation, as well as a solid commercial debt repayment history. Fitch has also assigned a short-term rating of 'B' and a country ceiling of 'BB+'.

Fiscal prudence, combined with steady, though sluggish, GDP growth and a lack of access to credit during the 1980s, has resulted in one of the lowest debt/GDP ratios among peers. Fitch recognizes the government's efforts to manage its fiscal accounts in a prudent manner through various external shocks. Fitch estimates that the country's debt/GDP ratio reached 16.6% last year, substantially below the 'BB' median of 48.3%. However, GDP measures of public debt understate Guatemala's debt burden due to the narrowness of the country's tax base. Guatemala's debt/revenues ratio approached 160.0% last year, compared with the 'BB' median of 198.4%. Only Azerbaijan, with a ratio debt/GDP ratio of 15.4% and a debt/revenue ratio of 58.4% was lower than Guatemala in the 'BB' category. Limited public debt and a manageable fiscal deficit also drive the sovereign's low financing requirement, which is expected to approach 4% of GDP this year if the budget is fully executed.

Although economic risks appear contained due to the above mentioned credit strengths, high levels of poverty and inequality, as well as the country's poor social indicators, will constrain Guatemala's ratings to sub-investment grade levels for some time. Fitch believes the current policy framework could be vulnerable to the erosion of public support if progress on these fronts is not forthcoming. Additionally, Guatemala's vulnerability is underscored by a persistent current account deficit, about half of which is financed by short-term capital inflows. Though the newly approved free trade agreement with the US (DR-CAFTA) should reduce this vulnerability over the medium-term.

Guatemala's track record of fiscal discipline, low inflation, low public debt, as well as a strengthening of the banking system, has provided a sufficient buffer to deal with adverse external shocks, such as the natural disasters experienced in recent years, and should continue to do so over our rating horizon. A recovery of investment and consumption has resulted in a gradual acceleration of GDP growth. A solid balance of payments performance, underpinned by remittance growth and increased private capital inflows, has been reflected in international reserve accumulation of US$250 mn in 2005. Reserve accumulation, combined with low debt service, will boost Guatemala's liquidity ratio to a projected 187% at the beginning of 2006. Even when adjusting the liquidity ratio to exclude banks' foreign assets and include banks' resident foreign currency deposits, the ratio remains above 100%.

Guatemala's external debt ratios are on a par with similarly rated peers. Net external debt as a proportion of export receipts (CXR) and GDP declined slightly in 2005 to an estimated 31.5% and 8.7%, respectively, due to export and GDP growth. This compares to the 'BB' median for the NXD/CXR and NXD/GDP ratios of 32.5% and 16.3%, respectively. However, net public external debt/CXR was 4.9% last year, significantly below the 'BB' median of 17.4%. Guatemala's low level of external debt drives its external debt service ratio of 9.6%, which is lower than the 'BB' median of 11.6%.

Although most of Guatemala's macroeconomic indicators compare favorably to other 'BB' rated sovereigns, the country's high level of poverty and poor social indicators stand in stark contrast to many of its rating peers. Guatemala's per capita income is on a par with similarly rated peers, however this masks the country's high level of inequality and poverty. The proportion of the population living in poverty was 59.9% in 2002, a rate that is significantly higher than that in poorer countries such as Nicaragua (50.3%) and Honduras (53.0%) and approaching that of Bolivia (63%), which Fitch assigns a 'B-' Foreign Currency Issuer Default Rating. Other comparative social indicators, such as infant mortality, life expectancy, access to healthcare, literacy rates and school enrollment rates also do not compare favorably to the average in Latin America and the Caribbean, similarly rated sovereigns, or to poorer countries.

Unlike low income countries, Guatemala does not have the same access to concessional lending and/or grants from international institutions or donors, requiring the government to raise its own revenues and provide its own resources to improve social conditions. At around 10%, Guatemala has one of the lowest tax/GDP ratios of its peers and the government has encountered significant obstacles to increasing its tax take. While maintaining a small government is prudent and has helped minimize the country's exposure to economic vulnerabilities, this policy makes tackling the poverty issue difficult due to a lack of resources. The government is looking into private/public partnerships as one way of dealing with this situation. However, ultimately the government will have to implement a more comprehensive tax reform to increase the tax take if it is to address its pressing social challenges.

Political & Social Situation

Guatemala's political risk is high relative to other sovereigns rated by Fitch, which is a rating constraint. The country is characterized by emerging democratic institutions, high levels of poverty and inequality, problems with personal security, as well as other social pressures emanating from ethnic divisions, a young population and above average population growth. As a result, Fitch believes there is a higher probability of event risk in Guatemala relative to other rated sovereigns. Nevertheless, it is important to highlight that the current administration has begun to take steps to address some of the underlying causes of these weaknesses with its renewed commitment to the peace accords, further reductions of the military, and efforts to reduce the perception of corruption.

Political institutions in Guatemala have been developing in a democratic direction only recently and the effectiveness of these institutions needs improvement. Corruption is a problem, undermining the credibility of institutions, including the judiciary. According to the Transparency International Corruption Perceptions Index, Guatemala ranked 120th out of 159 nations surveyed in 2005, putting it among the more corrupt countries according to this measure. In Latin America, the perception of corruption was higher only in Guyana (121) and Paraguay (147). Furthermore, Guatemala's multi-party system is fragmented and can create obstacles to governability, requiring the executive to negotiate with all parties to secure passage of legislative initiatives as many types of legislation require a 2/3s vote.

The current president, Oscar Berger Perdomo, of the center-right Gran Alianza Nacional (Gana), assumed the presidency in January 2004 for a four year term. Prior to the presidency, Berger served two terms as the mayor of the capital and has had the support of the business community throughout his political career. However, President Berger's coalition of parties, including the Movimiento Reformador (MR), Solidaridad Nacional (SN) and some of the president's followers from Partido de Avanzada Nacional (PAN), currently control only 45 out of 158 seats in Guatemala's unicameral legislature.

Upon assuming office, the Berger Administration indicted numerous high ranking officials from the outgoing Portillo administration including the ex-president and the military on charges of corruption. Progress on these cases has been slow, and after the Constitutional Court stripped Mr. Portillo of his political immunity as a deputy of the Parlamento Centroamericano, he fled to Mexico. Legal procedures are underway to extradite Mr. Portillo to Guatemala to face charges. Other measures implemented by the president during his first year of office included the reduction of the armed forces by 12,000 troops and the establishment of military spending limits. In addition, the president was able to secure support in a fragmented Congress for a tax reform in June 2004 (see public finances below for more detail), which contained slippage of the tax/GDP ratio.

Congress, 2005

	Seats	% Total
Gran Alianza Nacional (GANA)	33	20.9%
Frente Republicano Guatelmateco (FRG)	27	17.1%
Unidad Nacional de la Esperanza (UNE)	26	16.5%
Integracionistas	13	8.2%
Partido de Avanzada Nacional (PAN)	12	7.6%
Partido Patriota (PP)	10	6.3%
Solidaridad Nacional (PSN)	8	5.1%
Parties with less than 5 seats	29	18.4%
	158	**100.0%**

Source: Guatemalan Congress

Although Guatemala's Constitution prohibits discrimination against indigenous people, ethnic divisions persist. The government is required to consult indigenous people before making any decisions that could affect their interests; however, vehicles to channel their demands through the political system remain limited. In addition, rural indigenous people, many of whom do not speak Spanish, have very few educational and economic opportunities. While social pressures from this group appear manageable at this time, in part due to emigration to and remittances from the United States, all of these factors led many to support guerilla groups in the 1970s and 1980s and could potentially have a volatile impact on politics going forward if advances for this group are not achieved. Nevertheless, outbreaks of social unrest, with demonstrators blocking roads, public buildings and airports, are infrequent.

Political violence has been largely eliminated since the 36-year internal armed conflict ended with the signing of an Accord for the Firm and Lasting Peace on December 29, 1996, between the government and the guerillas under the auspices of the UN. While the early stages of the implementation of the peace process succeeded in demobilizing the guerillas, reducing the armed forces and setting up a civilian police force, implementation in other areas, particularly with respect to the social conditions stipulated in the peace agreements, has been slow. Rejection of the peace process reforms in the May 1999 referendum, which would have translated the peace accords into law, has detracted from the implementation of the peace accords as well. The government has yet to increase the tax take to 12%

of GDP (increasing only to 10% of GDP from 8% of GDP at the time of the accords) and social spending as proportion of GDP has declined since 2001 (from 3.2% of GDP at time of accords to 5.5% of GDP in 2001 and 5.2% of GDP in 2005). In addition, the legacy of violence remains and personal security from crime, as well as allegations of human rights abuses, continue to be an issue.

On the international front, Guatemala has yet to resolve its territorial border dispute with Belize or its maritime border disputes with Belize and Honduras. While attempts to resolve these disputes through diplomatic means are ongoing, talks with Belize under the auspices of the Organization of American States (OAS) have stalled. However, bilateral relations with the US have improved under the Berger Administration thanks to the government's greater willingness to address money laundering, illegal drug trafficking and to collaborate in the Bush administration's war against terrorism.

DR-CAFTA is expected to come into effect on April 1, 2006. Additionally, Guatemala is a member of numerous international organizations, including the UN and related agencies, the IMF, the World Bank and the World Trade Organization. Regionally, it is a member of the Organization of American States, the Inter-American Development Bank and the Central American Common Market.

■ Short-Term Prospects

Economic growth has been accelerating, underpinned by tourism, remittances and growth of non-traditional exports. After reaching an estimated 3.2% in 2005, real GDP growth is expected to increase to around 4.0% this year and to average around this level over the medium-term. In spite of GDP growth averaging only 3.1% in the five years ending in 2005, Fitch expects GDP growth to accelerate to the 3.5% to 4.0% range, driven by reconstruction efforts in 2006 and higher investment associated with DR-CAFTA. A recovery of public consumption (+5.3%) and investment growth (+6.4%) combined with accelerating private consumption, underpinned growth last year. Easier access to credit and strong remittance growth contributed to consumption growth. All economic sectors, with the exception of mining, experienced growth in excess of 2%. In particular, growth in the transport, storage and communications (+8.4%) and electricity and water sectors (+3.5%) remained robust, while the construction sector expanded by 3% following a contraction of almost 20% in 2004 that was driven by a decline in public investment characteristic Guatemalan governments' first administrative year. These same sectors are likely to drive growth over our forecast horizon as well due to reconstruction following Hurricane Stan.

Although the human toll and material destruction of Hurricane Stan was considerable, the damages and losses associated with the storm approached a manageable GTQ7.4bn (3% of GDP) by the government's estimates and the impact on growth was limited as the principal sectors of agriculture, industry, commerce and tourism did not experience great losses. Infrastructure suffered the most damage, evidenced by a reduction in capital stock, which likely has been a constraint on output growth. On the other hand, reconstruction costs will be reflected as an increase in gross fixed capital formation, boosting growth especially in 2006 and perhaps 2007.

Inflation reached 8.6% by year-end 2005. If not for the effect of the hurricane on prices of domestic foodstuffs and high international oil prices, inflation would have been closer to the upper end of the targeted range of 4% to 6%. Inflation is expected to decline gradually in 2006 with a tightening of monetary policy and lower oil prices.

The performance of the external accounts is expected to strengthen, particularly within the context of the approval of DR-CAFTA. Anecdotal evidence points to an increase in foreign direct investment in export related sectors such as tourism and textiles, which should contribute to favorable export trends. In addition, Guatemala is expected to maintain an overall positive balance of payments position, contributing to gradual foreign reserve growth in the medium-term.

Economic performance and outlook

	2004	2005e	2006f
Real GDP (%)	2.7	3.2	4.0
CPI inflation (%, annual avg.)	7.4	9.1	7.6
Budget balance (% GDP)	-1.0	-1.5	-1.6
Current account (% GDP)	-4.4	-4.1	-3.9

Source: Fitch Ratings (e) estimates and (f) forecasts.

■ Economic Fundamentals

Since the implementation of the 1996 Peace Accords, Guatemala has achieved macroeconomic stability and has implemented important structural reforms. Nevertheless, progress in achieving the economic and social goals of the Peace Accords stalled during the last administration. The Berger government has a renewed commitment in the implementation of the Peace Accords, making these an important part of its policy agenda. Under the government's structural reform plan, *Vamos Guatemala*, the government is focusing on reforms to promote growth, competitiveness and social progress. The main emphasis is on raising tax revenues, implementing financial sector reforms and improving governance. Guatemala's track record of fiscal discipline and low public debt, combined with a strengthening of the banking system and international reserve growth, minimizes the country's economic vulnerabilities relative to peers. However, Guatemala's policy framework could be prone to an erosion of public support, particularly if the government is not able to increase its low revenue base to improve its capacity to address poverty and infrastructure bottlenecks.

Along with other Central American countries, Guatemala began negotiations with the US on a free trade agreement in 2004, with the expectation that it could be ratified in 2005 and take effect on January 1, 2006. Like other countries in the region, Guatemala has experienced delays with the implementation of DR-CAFTA and currently expects the agreement to take effect on April 1, 2006. The DR-CAFTA is important for Guatemala as it secures broad and stable market access to the US, its main trading partner, as previously provided under the Caribbean Basin Initiative. The free trade agreement should provide an anchor for the implementation of growth oriented reforms and attract new investment, an important factor given the country's comparatively low investment rate of 18% of GDP. Additionally, the agreement is expected to strengthen the position of Guatemala's traded goods, especially within the context of the expiration of quotas on world trade in textiles. These factors should contribute to more dynamic export and GDP growth. The sectors that are likely to benefit most include agriculture and textiles.

At 34% of GDP Guatemala's trade openness, as measured by the average of a country's exports and imports of goods (in US$) as a proportion of GDP, is on a par with similarly rated peers and other Central American countries. Guatemala is a relatively open economy with respect to its trade and investment regime. Nevertheless, there are some key factors that continue to hinder the country's underlying growth potential, some of which may be addressed with implementation of DR-CAFTA. In particular, the investment climate needs further improvements. On average, foreign direct investment has covered only 17% of the current account deficit for the five years ending in 2005. Areas that need to be addressed include improving infrastructure, strengthening the rule of law and lowering the cost of doing business in general. Additionally, fostering transparency in governance and fighting corruption should continue to be high priorities.

Although per capita income is on a par with many of Guatemala's similarly rated peers, this masks the high level of inequality and poverty, as well as poor social indicators. According to the World Bank, Guatemala has one of the highest levels of inequality in the world.[1] Furthermore, the proportion of the population living in poverty was 59.9% in 2002, a rate that is significantly higher than that in poorer countries such as Nicaragua (50.3%) and Honduras (53.0%) and approaching that of Bolivia (63%). Other comparative social indicators, such as infant mortality, life expectancy, access to healthcare, literacy rates and school enrollment rates also do not compare favorably to the average in Latin America and the Caribbean, or to poorer countries. Out of 174 countries, Guatemala ranks 120 in the UNDP Human Development index, lower than Nicaragua (118) and Honduras (116). The severity of poverty and poor income distribution underpins the need to raise additional fiscal revenues to fund higher social spending.

■ Financial Sector

While not a rating strength, Guatemala's financial sector appears not to pose a systemic financial risk or contain significant contingent liabilities for the public sector given its small size. Fitch has assigned an individual rating of 'D' to Banco Industrial, one of the larger banks in the system accounting for about 20% of system assets.[2] In addition to the system's small size, risk concerns are also mitigated by a low level of dollarization (28% of loans, 13% of deposits), albeit increasing, relative to similarly rated and regional peers. Foreign participation is also low in Guatemala, but more consolidation is expected and could lead to a larger foreign presence from regional banks. The main risks to the banking system include its concentrated nature (top three banks account for 45% of system assets), still high levels of related party lending and limited information with respect to off-shore banks.

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[1] The World Bank's Gini coefficient, an indicator of wealth distribution, is 0.58 for Guatemala. This measure is between 0 and 1, with a higher number representing greater income inequality.

[2] Individual Ratings are assigned only to banks on a scale from A to E, with graduations between rating levels (i.e. C/D). These ratings, which are internationally comparable, attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. These ratings are designed to assess a bank's exposure to, appetite for, and management of risk, and thus represent our view on the likelihood that it would run into significant difficulties such that it would require support. Banks in emerging markets are necessarily faced with a greater number of potential deficiencies of external origin and are typically rated in the 'C' category and below.

Nevertheless, the authorities have made advances in modernizing financial sector legislation and implementing tighter prudential norms, including a strengthening of on-site supervision since 2002. These actions have improved solvency, asset quality and liquidity. Additionally, off-shore banks are now required to be a part of a licensed financial conglomerate, a process which is expected to be completed by mid-2006. However access to consolidated financial information remains limited. Currently, both off-shore and on-shore banks report risk-weighted capital adequacy ratios above the 10% regulatory minimum.

Key Facts: Banking system

	2005
M2 (% GDP)	31.4
NPL ratio	3.0
Capital adequacy ratio	13.9
Public Ownership, % of Assets	3.3
Foreign Ownership, % of Assets	1.2

Source: Fitch Ratings.

■ Public Finance

Since the return of democracy in 1986, the Guatemalan government has had a history of maintaining a sustainable fiscal position. Unlike other Latin American countries, Guatemala did not build up a high level of external debt during the 1980's. In contrast to many 'BB' rated sovereigns, debt sustainability is not a rating constraint. While the maintenance of a low fiscal deficit and a low level of public sector debt help reduce Guatemala's economic vulnerabilities, Fitch views Guatemala's low tax/GDP ratio as a structural problem given the country's high levels of poverty and poor social indicators and vulnerability to natural disasters. If progress with addressing poverty and social indicators remains slow, domestic support for the current economic model could unravel.

Although recent governments in Guatemala have been successful at maintaining a manageable fiscal position, attempts to increase the tax take have had mixed results. The 1996 Peace Accords, required the government to raise the tax/GDP ratio to 12% by 2000 to fund increases in social spending, restructure the security forces and the judicial system, compensate the victims of the conflict and finance a land purchase program. Under international pressure to comply with the Peace Accords, the Portillo administration passed a package of tax measures in 2000 and 2001, but these fell short of increasing the tax take as a proportion of GDP on a permanent basis. Key measures included an increase in the value-added tax to 12% from 10% and an increase in the agricultural and mercantile business tax (IEMA). While these measures succeeded at increasing the tax/GDP ratio to 10.6% in 2002 from 10% in 2000 and 8% in 1996, the private sector launched subsequent legal challenges in the Constitutional Court, which reversed some of the measures, including IEMA, in early 2003, causing tax revenues as a proportion of GDP to decline.

The key aspects of the tax package approved in June 2004 included the reintroduction of excise taxes on alcoholic beverages; introduction of a turnover tax as an option under the corporate income tax regime; establishment of a presumptive minimum corporate income tax (Extraordinary and temporary tax in support of the Peace Agreements or IETAAP) with a lower rate and different structure than the one revoked in 2003; and a provision for a small minimum corporate tax that will take effect after the IETAAP is phased out in 2007. In addition, a comprehensive plan to strengthen tax administration was implemented. It was initially anticipated that these measures would increase the tax/GDP ratio to 10.5% in 2005 and 11.0% in 2006. While tax revenues increased by 6.0% in nominal terms last year, the tax/GDP ratio fell to 9.6% from 10.3% in 2004, highlighting the importance of mobilizing support for a new revenue package and full implementation of a tax administration plan.

The 2005 budget targeted a deficit of 2.0% of GDP, however, the actual deficit of 1.5% of GDP was better than anticipated, even with the costs associated with Hurricane Stan, due to the under-execution of the budget during the first three quarters of the year. Immediate reconstruction expenses were covered by re-directing already budgeted resources to distressed areas. The authorities were targeting a larger fiscal deficit in 2005, following a drastic reduction in expenditures in 2004, reflecting efforts to raise public investment and social spending. Execution of public investment projects and capital transfers to municipalities has been improving (though still significantly below budget), contributing to an increase of 11.6% of total expenditures. Capital expenditures increased by 18% reflecting capital transfers to various government entities to cover expenses related to the Hurricane Stan reconstruction program.

Fiscal rigidity is high in Guatemala as salaries and local government transfers account for 63% of total expenditures. Meeting the Peace Accords objectives and Millennium Development Goals will require better execution of expenditures for social spending and public investment, indicating that fiscal rigidity will remain high for some time. Given Guatemala's level of development and the social pressures that could arise from not meeting poverty reduction goals and improving social indicators, Fitch does not view fiscal rigidity as a rating constraint for Guatemala at this time. Expenditure growth is expected to remain buoyant in 2006, in part due to increased social expenditures and the reconstruction effort, with the government targeting a deficit of 1.9% of GDP. The fiscal deficit is budgeted to gradually decline over the medium-term as the government mobilizes support for a new revenue package and a pickup in economic activity supports increased tax collections. Guatemala's multi-annual budget projects a central government deficit of 1.5% by 2008, while the primary deficit should be balanced by this time.

The government's improved access to the domestic capital markets has strongly benefited public financial flexibility and represents a good source of financing going forward. Guatemala has been increasing its reliance on bond debt; however, longer maturities and a move toward local currency debt issuance help minimize refinancing risk. Guatemala's government financing requirement reached 3.0% of GDP last year and is expected to increase to around 4% of GDP this year if the budget is fully executed. The government's financing needs are low relative to peers given its prudent fiscal stance and low levels of public debt. Like last year, the government expects to meet its financing needs with local debt issuance and multilateral disbursements.

Public Finances: Sources and Uses

GTQbn

	2005e	2006f
Uses	**7.2**	**10.7**
Budget balance	3.6	4.3
Amortisation	3.6	6.5
Domestic	2.7	4.6
External	0.9	1.9
Sources	**7.2**	**10.7**
Gross borrowing	5.4	10.6
Domestic	4.3	6.0
External	1.1	4.6
Official	1.1	4.6
Market	0.0	0.0
Change in cash position	1.8	0.1

Source : MoF, IMF, Fitch Ratings (e) estimates and (f) forecasts.

Guatemala's government debt/GDP ratio declined to 16.6% last year, substantially below the 'BB' median of 48.3%. Only Azerbaijan, with a ratio of 15.4%, has a lower level of public debt in terms of GDP. However, GDP measures of public debt understate Guatemala's debt burden relative to a country like Azerbaijan with a similarly low level of public debt due to the narrowness of the country's tax base. Guatemala's debt/revenues ratio approached 160.0% last year, compared with 58.4% for Azerbaijan. Nevertheless, Guatemala's debt/revenues ratio was still substantially below the 'BB' median of 198.4%.

Unlike many sovereigns in the 'BB' category, debt sustainability is not a rating constraint for Guatemala. Even if the country's key economic variables such as economic growth, inflation, interest rates and the primary balance, were to remain at historical averages over the past decade, Guatemala's debt to GDP ratio would increase only slightly, reaching 17.2% by the end of 2010. Stressing the key variables of real GDP growth, interest rates and the primary balance by two standard deviations in a negative direction in both 2006 and 2007 does not materially affect debt sustainability, as according to Fitch's model, debt would only increase to around 24% of GDP. Clearly, given the high proportion of foreign currency debt, the variable that could have a significant impact on debt sustainability is the exchange rate. If a devaluation of two standard deviations in both 2006 and 2007 were added to the previous downside scenario, debt/GDP could increase to around 27% by the end of 2010. While debt levels would increase under these stress scenarios, the debt/GDP ratio would still be significantly lower than peers. Nevertheless, these stress scenarios do not appear likely and Fitch is not anticipating significant devaluation over our forecast horizon.

About 30% of Guatemala's non-financial public sector debt is domestic. The central government issues domestic bonds in local and foreign currency.[3] The proportion of US$ denominated domestically issued debt has fallen to 23% in 2005 from 39% in 2004 as the government did not issue any US$ denominated debt in 2005. The remaining US$ denominated securities had a weighted average interest rate of 9.22% and maturity of 5.75 years. By comparison, GTQ denominated debt had a weighted average interest rate of 9.13% and maturity of 8.5 years. The central bank holds about 8% of the domestically issued debt. Holders of domestic debt include the private sector (46%) and the banking sector (23%). Non-resident holders hold close to 6% of Guatemala's domestically issued debt.

■ Monetary & Exchange Rate Policy

Guatemala's monetary policy is complicated by the sensitivity of capital inflows to the policy interest rate and the government's sometimes conflicting

[3] Fitch nets out debt held by non-financial public sector entities, but not by the central bank for its debt calculations. The central government's total domestic debt outstanding reached GTQ16.9 bn as of November 30, 2005, of which 5.8% was held by Banco de Guatemala and 29.8% was held by Social Security and other non-financial public entities.

objectives of price stability and containing excessive exchange rate appreciation. Banco de Guatemala operates as an autonomous and decentralized institution of the government. However, independence is somewhat limited as the Ministries of Public Finance, Economy and Agriculture, as well as a representative of Congress, are all members of the board of directors of the central bank.

Banco de Guatemala's main policy goal is to maintain the stability of prices and it is in the process of adapting an inflation targeting framework to achieve this goal. The central bank's target is to maintain inflation between the range of 4% and 6%. In spite of the implementation of relatively prudent monetary policy, which included an increase in the benchmark 7-day deposit interest rate from 2.6% in early 2005 to 4.25% at the end of the year, external shocks from high oil prices and Hurricane Stan caused the central bank to miss its targeted range for a second year in a row, with inflation reaching 8.6% by year-end 2005, only a slight improvement from the previous year. Although this target has not been met consistently, the central bank has gained credibility in its efforts to reduce inflation and maintain economic stability, and conducts monetary policy in a relatively transparent manner, factors which support the current credit rating.

Banco de Guatemala relies on indirect instruments, mainly open market operations in the secondary market to conduct monetary policy. The central bank issues its own Certificates of Deposit which are auctioned in the money market. It can also issue its own monetary stabilization bonds with prior approval from Congress, or negotiate public sector debt instruments in the secondary market. Other instruments include the use of deposit reserve requirements, setting of a 7-day deposit policy interest rate and a discount window which financial institutions can use to deal with temporary liquidity problems.

However, the central bank's ability to aggressively raise its benchmark 7-day deposit interest rate was somewhat limited by the real appreciation of the quetzal due to strong remittance and private capital inflows as well as depreciation of the US dollar. Higher interest rates run the risk of attracting additional capital inflows, which in turn could strengthen the quetzal. Guatemala has a flexible exchange rate regime within the context of a managed float; however, it does not predetermine a path for the exchange rate and intervenes in the market only to curb volatility. The central bank has been trying to contain currency appreciation by purchasing US dollars in the open market, operations which have not been fully sterilized. As a result, there has been an increase in the money supply which has contributed to inflationary pressures as well. Furthermore, real interest rates for lending remain low, while real interest rates for deposits as well as the central bank's benchmark 7-day deposit rate are negative, suggesting lax monetary conditions.

Banco de Guatemala's growing reliance on open market operations has resulted in a higher stock of open market instruments and an increase in the cost of servicing this stock. As a result, the central bank's quasi-fiscal deficit has averaged about 0.4% of GDP since 2000. Nevertheless, Banco de Guatemala is still sufficiently capitalized as a revision to the central bank law in 2002 requires the government to cover this quasi-fiscal cost from its own budget with the authorization of the issuance of treasury bonds or other financial instruments on a lagged basis. The 2006 budget includes a payment to the Banco de Guatemala of GTQ1,160 mn to cover the quasi-fiscal costs for 2004.

■ External Finance

The need to finance sizeable trade deficits, characterizes the country's balance of payment vulnerability. However, thus far this has not been an issue and a surge in remittances has underpinned a steady improvement in Guatemala's current account balance, from a deficit of 6.0% in 2001 to 4.1% last year. Furthermore, remittances have covered about 70% of the trade deficit since 2003. It is also important to note that although Guatemala rescheduled debt with the Paris Club in 1992, it has never restructured external debt with private creditors, a credit strength in the 'BB' category.

Relative to peers, export concentration is not as high, which minimizes the instability in the level of income provided by Guatemala's export receipts. Guatemala's main agricultural exports include coffee, bananas, sugar and cardamom, but account for only about 20% of exports. Although traditional export growth has lagged in recent years, non-traditional exports such as textiles, light manufactures and specialty agriculture have shown robust growth. The three largest foreign currency sources in the current account are now workers' remittances, exports of textiles and tourism receipts. Guatemala's main trading partners are the US and other countries in Central America.

The trade balance deteriorated in 2005 as import growth exceeded export growth, mostly due to high international oil prices as imports of petroleum increased by 44% last year. Although Guatemala also exports petroleum products, the country is a net oil importer and production has been declining in recent years. Nevertheless, the value of petroleum exports increased by 26% last year to US$226 mn, due entirely to higher prices. The increases in factor services, underpinned by tourism receipts, and workers remittances were not sufficient to offset the deterioration in the trade balance and higher interest payments on external debt, causing the current account deficit to increase slightly to US$1.3 bn from US$1.2 bn. However, as a proportion of GDP, the current account deficit was reduced to 4.1% in 2005 from 4.4% in 2004.

Since 2000, the most significant component of Guatemala's capital and financial account has been private sector capital inflows, however, only a small portion of this has been non-debt creating flows. According to the central bank, foreign direct investment reached an estimated US$198 mn, while medium and long-term flows reached US$592 mn and short-term flows reached US$686 mn in 2005. Currently, there are few restrictions on the capital account. Capital inflows contributed to a US$250 mn increase in reserves last year, sustaining a healthy liquidity ratio of 187% at the beginning of 2006. This compares to a median of 157% for 'BB' rated peers. Even when adjusting the liquidity ratio to exclude banks' foreign assets and include banks' resident foreign currency deposits, the ratio remains above 100%. Guatemala's external financing needs as a proportion of reserves are forecast to reach 52% this year, above the 'BB' median of 33%, reflecting its moderate current account deficit. Although this ratio is on a par with many of Guatemala's peers, it appears high given the country's substantially lower level of external debt, underpinning the importance of reducing trade imbalances.

Guatemala's external debt indicators are similar to 'BB' rated sovereigns and do not present a credit concern. Net external debt as a proportion of export receipts (CXR) and GDP declined slightly in 2005 to an estimated 31.5% and 8.7%, respectively, due export and GDP growth as external debt remained at similar levels to 2004. This compares to the 'BB' median for the NXD/CXR and NXD/GDP ratios of 32.5% and 16.3%, respectively. However, net public external debt/CXR was 4.9% last year, considerably below the 'BB' median of 17.4%. Furthermore, all of these debt measures will improve significantly this year due to an agreement between Corfina (state-owned financial institution), Banco Bilbao Vizcaya Argentaria (BBVA) and the Compañía Española de Seguro de Crédito de Exportación (CESCE) in January 2006. Corfina will pay US$10.5 mn, with the remaining balance of unpaid principal and interest amounting to US$538 mn to be forgiven by BBVA and CESCE. As a result, Fitch projects that the public sector will report a slight external creditor position this year. Guatemala's low level of external debt drives its external debt service ratio of 9.6%, which is significantly lower than the median for similarly rated peers of 11.6%.

As relatively few Guatemalan corporates access international capital markets, the public sector still accounts for close to two-thirds of external debt.[4] Global bond issuances in 2003 and 2004 increased the bonded proportion of public external debt to 27%. Of the remaining debt, 48% is owed to multilateral creditors and 25% to bilateral creditors. Debt owed to bilateral creditors will be halved in 2006 due to the debt forgiveness mentioned above.

Fitch expects Guatemala's external debt service ratio to increase to 10.0% in 2006 from 9.6% in 2005 due to an increase in private sector debt. However, public sector external debt service is expected to gradually decline as the government pursues its strategy of limiting market debt to domestic sources and relying on multilateral and bilateral debt for external financing. Guatemala's debt service ratio remains below the 'BB' peer median of 11.6%. Given the still low portion of market debt, Guatemala's external interest service ratio is forecast to remain flat in 2006 at about 3.1% of CXR (versus the 4.4% 'BB' median).

[4] Comprehensive data is not available on the private sector's level of external indebtedness; however, Fitch estimates that private sector external debt reached 8% of GDP in 2005, not inconsistent with external debt data reported by BIS and World Bank.

Fiscal accounts summary*

% of GDP

	2001	2002	2003	2004	2005e	2006f	2007f
Revenue & grants (excl. priv'n)	**11.1**	**11.4**	**11.1**	**11.0**	**10.2**	**10.3**	**10.2**
o/w tax revenues	**9.7**	**10.6**	**10.3**	**10.3**	**9.6**	**9.5**	**9.5**
Expenditure & net lending	**12.9**	**12.4**	**13.4**	**12.0**	**11.7**	**11.8**	**11.4**
o/w social expenditure	**5.5**	**5.1**	**5.3**	**5.0**	**5.2**	**n.a.**	**n.a.**
Primary balance (excl. interest)	**-0.5**	**0.3**	**-1.2**	**0.2**	**-0.3**	**-0.2**	**0.2**
Overall balance	**-1.9**	**-1.0**	**-2.3**	**-1.0**	**-1.5**	**-1.6**	**-1.2**
Financing:							
Sale of assets	**1.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Domestic, net	**0.4**	**-0.6**	**1.5**	**0.8**	**1.1**	**0.8**	**1.8**
External, net	**2.0**	**0.9**	**1.4**	**1.6**	**-0.1**	**0.7**	**-0.6**
Change in cash position	**-1.9**	**0.7**	**-0.5**	**-1.4**	**0.6**	**0.0**	**0.0**
Public debt**	**18.8**	**16.3**	**17.6**	**17.8**	**16.6**	**16.7**	**17.3**
Domestic	**14.7**	**13.4**	**14.1**	**13.8**	**11.6**	**11.4**	**10.8**
External	**4.1**	**2.9**	**3.5**	**3.9**	**5.0**	**5.3**	**6.5**
Public debt (% of revenue)	*169.9*	*142.8*	*158.7*	*161.4*	*162.9*	*162.2*	*169.8*
memo:							
interest service (% of revenue)	*12.6*	*10.9*	*10.4*	*11.1*	*11.7*	*13.1*	*14.3*
Non-financial public sector	*-1.4*	*-0.3*	*-1.5*	*0.1*	n.a.	n.a.	n.a.
Banco de Guatemala	*-0.8*	*-0.6*	*-0.5*	*-0.6*	n.a.	n.a.	n.a.

*All figures refer to the consolidated central government. ** All figures refer to the non-financial public sector. Source: Ministry of Public Finance,

Amortization schedule on medium- and long-term debt

USDmn

	2006	2007	2008	2009	2010
Public sector	**242.0**	**396.7**	**286.6**	**321.2**	**n.a.**
IMF	0.0	0.0	0.0	0.0	0.0
Other multilateral creditors	190.8	198.4	243.3	274.2	
Bilateral creditors	51.2	48.3	43.3	47.0	
Bonds	0.0	150.0	0.0	0.0	
Other	0.0	0.0	0.0	0.0	
Private sector	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Banks					
Corporates					
Total					

Source: Ministry of Public Finance.

Balance of payments

USDmn

	2001	2002	2003	2004	2005e	2006f	2007f
Current account balance	**-1,253**	**-1,235**	**-1,039**	**-1,188**	**-1,301**	**-1,369**	**-1,336**
% of GDP	*-6.0*	*-5.3*	*-4.2*	*-4.4*	*-4.1*	*-3.9*	*-3.6*
% of CXR	*-23.9*	*-19.9*	*-15.2*	*-15.2*	*-14.8*	*-14.7*	*-13.6*
Trade balance	**-2,282**	**-2,972**	**-3,116**	**-3,760**	**-4,311**	**-4,608**	**-4,752**
Exports, fob	2,860	2,819	3,060	3,430	3,856	4,049	4251
(annual % change)	*-7.3*	*-1.4*	*8.5*	*12.1*	*12.4*	*5.0*	*5.0*
Imports, fob	5,142	5,791	6,176	7,189	8,167	8,657	9,003
(annual % change)	*8.4*	*12.6*	*6.6*	*16.4*	*13.6*	*6.0*	*4.0*
Services, net	**117**	**79**	**-67**	**-116**	**-112**	**-131**	**-151**
Services, credit	1,045	1,145	1,059	1,178	1,208	1,268	1,331
Services, debit	928	1,066	1,126	1,294	1,320	1,399	1,483
Income, net	**-84**	**-318**	**-318**	**-319**	**-371**	**-393**	**-416**
Income, credit	317	161	179	173	170	170	170
Income, debit	402	479	497	492	541	563	586
o/w: interest payments	218	246	231	254	279	291	302
Current transfers, net	**997**	**1,976**	**2,462**	**3,006**	**3,494**	**3,763**	**3,983**
Non-debt creating flows, net	**456**	**111**	**131**	**155**	**198**	**200**	**200**
Equity Direct investment, net	456	111	131	155	198	200	200
Portfolio equity investment, net	0	0	0	0	0	0	0
External borrowing, net	**979**	**928**	**1194**	**1080**	**966**	**824**	**830**
General government	43	173	308	79	-61	100	100
Monetary authorities	-11	-11	-12	-68	-1	-1	0
Commercial banks	22	0	0	0	0	0	0
Other private sector	926	766	898	1069	1027	725	730
Net lending abroad	**112**	**158**	**192**	**363**	**250**	**250**	**250**
Capital nes, net	**93**	**124**	**134**	**135**	**139**	**150**	**150**
Net errors and omissions	**87**	**-65**	**-61**	**63**	**0**	**0**	**0**
Overall balance = chg in reserves (-=increase)	**-474**	**-21**	**-550**	**-608**	**-252**	**-55**	**-94**
memo:							
Gross borrowing (incl. short-term)	1,195	1,148	1,489	1,399	1,274	1,134	1,286
Gross external financing requirement	1,469	1,455	1,334	1,507	1,609	1,679	1,792
Stock of International reserves, excl. gold	2,292	2,299	2,833	3,426	3,678	3,733	3,827

Source: IMF, Banco de Guatemala, Fitch Ratings (e) estimates and (f) forecasts.

External debt & liquidity

USDmn

	2001	2002	2003	2004	2005e	2006f	2007f
Gross external debt	**4,687**	**4,752**	**5,837**	**6,619**	**6,912**	**6,854**	**7,337**
% of GDP	*22.3*	*20.4*	*23.6*	*24.7*	*21.6*	*19.7*	*19.9*
% of CXR	*89.3*	*76.6*	*85.1*	*84.5*	*78.6*	*73.5*	*74.6*
By maturity:							
Medium- and long-term	3,738	3,820	4,580	5,350	5,630	5,559	6,029
Short -term	949	932	1,257	1,270	1,282	1,295	1,308
% total debt	20.2	19.6	21.5	19.2	18.6	18.9	*17.8*
By debtor:							
Public sector	3,617	3,718	4,046	4,347	4,286	3,840	3,937
Non-bank private sector	0	0	448	916	1,258	1,633	2,003
Banks	121	102	86	86	86	86	86
Unidentified (short-term)	949	932	1,257	1,270	1,282	1,295	1,308
By creditor:							
Multilateral	1,695	1,915	1,977	2,092	n.a.	n.a.	n.a.
Bilateral	613	588	575	515	n.a.	n.a.	n.a.
Commercial banks	525	526	538	545	n.a.	n.a.	n.a.
Debt securities	782	686	953	1,194	n.a.	n.a.	n.a.
Other	1,072	1,037	1,794	2,273	n.a.	n.a.	n.a.
Gross external assets*							
International reserves, incl. gold	2,352	2,373	2,925	3,522	3,790	3,848	3,937
Deposit money banks' foreign assets	209	268	324	342	350	380	*400*
Net external debt	**2,126**	**2,110**	**2,588**	**2,755**	**2,772**	**2,626**	**3,000**
% of GDP	*10.1*	*9.1*	*10.4*	*10.3*	*8.7*	*7.6*	*8.2*
% of CXR	*40.5*	*34.0*	*37.7*	*35.2*	*31.5*	*28.2*	*30.6*
Debt service (principal & interest)	**434**	**466**	**526**	**573**	**587**	**601**	***758***
Debt service (% of CXR)	*8.3*	*7.5*	*7.7*	*7.3*	*6.7*	*6.4*	*7.7*
Interest service (% of CXR)	*4.1*	*4.0*	*3.4*	*3.2*	*3.2*	*3.1*	*3.1*
Liquidity ratio (%)	***140.5***	***181.0***	***181.2***	***177.5***	***208.1***	***219.9***	***205.9***
excl. banks' foreign assets	*131.3*	*166.2*	*162.8*	*159.8*	*189.7*	*201.3*	*187.4*
excl. banks' foreign assets & incl.banks' resident FCDs	*105.3*	*130.2*	*118.2*	*119.9*	*135.8*	*126.6*	*121.8*
memo:							
Public Foreign Currency & FC indexed debt	*3,961*	*3,972*	*4,552*	*4,774*	*4,646*	*4,282*	*4,534*
Non-resident holdings of domestic debt	307	211	178	89	n.a.	n.a.	n.a.

* non-bank private sector external assets are not taken into account. Source: Ministry of Public Finance, Global Development Finance, IMF, Fitch Ratings (e) estimates and (f) forecasts.