

Economic

Credit Agencies

Moody's: Ba2

S&P: BB

Fitch: BB+

Nominal GDP (2006)

USD 36.9bn

Population (2006):

12.9 million

Total Trade / GDP:

36.2%

Currency:

Guatemalan quetzal

Exchange regime:

Managed floating

Merchandise Exports from Canada (2006):

CAD175.6mn

Main sources of Foreign Exchange (excl. FDI):

Remittance flows

Largest Merchandise Trading Partners:

United States

El Salvador

Mexico

Main imports:

M&E, Minerals

Risks to the Outlook:



Movement on structural reforms, and continued policy discipline.



Contagion of financial sector woes, and excess liquidity.

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Market Spotlight: Guatemala's prospects are underpinned by the expected benefits to exports and investment of CAFTA-DR. The trade deal, which came into effect in July 2006 for Guatemala, will contribute 1-1.5 percentage points per year to real GDP growth. Further, potential FTAs with Canada, the EU and Colombia could help improve prospects for efficiency gains.

Real economy: The country's policy backdrop has improved markedly, supporting growth of 4.6% last year. Strong exports, higher capital formation, and solid remittances have contributed to an improved macroeconomic environment. The construction (+29.6%), transport and communications (+12.9%), and mining (+9.5%) sectors all showed strong activity. We expect growth to remain broadly unchanged this year, at 4.5%, and slightly above-trend over the medium-term. Prospects are underpinned by expectations of continued remittance growth and the favorable effects on exports and investment of CAFTA-DR. On the supply side, construction will continue to be a key contributor, as a result of heavy investment in the wake of Tropical Storm Stan in 2005.

External: The country's current account deficit was 4.4% of GDP last year, as solid remittances and reduced non-oil imports offset its higher oil import bill and weaker net maquila exports. Inflows from Guatemalans living abroad are expected to have reached 10% of GDP in 2006. This year remittances are expected to grow by 11% and , together with an expected 11% rise in exports, should further reduce Guatemala's current account deficit. Indeed, overall surpluses in Guatemala's external balance have pushed foreign exchange reserves to approximately US\$3.8bn, or a stable 3.9 months of anticipated import cover. Meanwhile, FDI continues to disappoint, coming in at just under 1% of GDP in 2006. In the run-up to CAFTA-DR, the government has worked to enhanced competition in public procurement and telecommunications, strengthen intellectual property rights, and streamline customs procedures.

Monetary: Inflation ended 2006 at 5.8%, its lowest level since 2000, as a result of falling oil prices and the central bank's monetary tightening. Prices have since edged higher, with inflation reaching 7% in March. But the increase appears to be a temporary response to higher food prices, the oil price rebound, and central bank intervention to prevent the appreciation of the *quetzal* (which was only partly sterilized). The results are still below year-ago levels, and remain within the official target range of 5%-7%. Further, the central bank is confident that this year's inflation will stay close to the middle of the reduced 4%-6% target band. But poor monetary transmission and high liquidity levels (due to strong capital inflows) mean that domestic credit is growing at a rapid clip. This may complicate the 5% goal, given that the decline in oil prices may be masking underlying inflation.

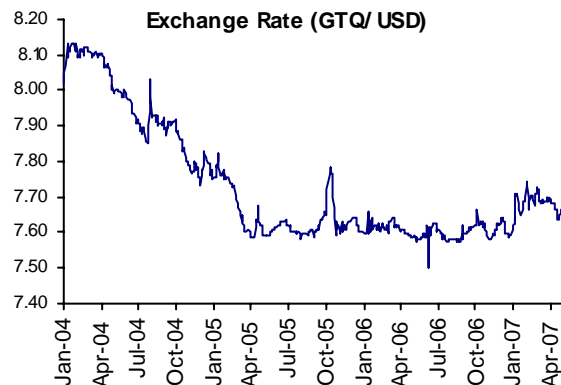
Fiscal: Fiscal austerity and stronger-than-anticipated revenue yielded an impressive combined public sector deficit of 1.5% last year. Going forward, enhancements to the tax administration should offset the elimination of some taxes and help make up for revenue losses associated with CAFTA-DR. As a result, the IMF estimates that this year's deficit will be around 1.4% of GDP, significantly lower than the budgeted 2.5% of GDP. Moderate fiscal deficits and shrewd debt management have improved both the size and composition of the public debt, steady at about 18% of GDP (very low by regional standards).

Outlook: Guatemala faces important challenges to consolidate recent gains and fully reap the benefits of economic integration, with the ultimate objective of sustaining high growth rates and reducing poverty. The key policy priorities are in strengthening the financial system, addressing social needs by raising the tax ratio, consolidating successes on the monetary side, and moving to a more flexible exchange rate regime. Downside risks include the fact that uncertainties in the banking sector could jeopardize Guatemala's ever-important capital inflows. Further, remittances and exports to the US provide current account inflows equivalent to 13.5% of GDP, and could also decline if the US economy were to slow sharply. In addition, rapid credit growth poses risks to the inflation outlook, and to the health of the banks' loan portfolios.

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	2.5	4.6	4.5	4.4
Inflation (% change avg)	7.5	6.6	6.0	5.0
Fiscal Balance (% of GDP)	-1.4	-1.7	-1.5	-2.0
Exports (% growth)	3.7	13.3	5.0	10.0
Imports (% growth)	11.2	13.6	10.0	5.0
Current Account (% of GDP)	-4.8	-4.4	-5.7	-5.1
Reserves (month of imports)	4.2	4.1	3.9	3.9
External Debt (% of GDP)	19.4	14.0	13.9	13.4
Debt Service ratio (% of Exports)	7.5	6.7	7.0	6.9
Exchange rate (end-period USD)	7.8	7.6	7.9	7.9

Source: EIU, EDC Economics



Source: Bloomberg

Political

Political Structure
Presidential Republic

President
Oscar Berger (GANA)

Vice President
Eduardo Stein

National Legislative Bodies
Unicameral Congress – 158 members

Major Parties (number of seats)

- *Gran Alianza Nacional (GANA)* – 34
- *Frente Republicano Guatemalteco (FRG)* – 27
- *Union de la Esperanza (UNE)* – 27
- *Partido de Avanzada Nacional (PAN)* - 13

Last Elections
November/ December 2003

Next Elections
November 2007

Press Freedom Survey:
• 2006 Score: 58 Partly Free (0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:
• 2005 Score: -0.98 (-2.5: Worst; +2.5: Best)
worldbank.org

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General Political Environment:

President Oscar Berger of the centre-right *Gran Alianza Nacional (GANA)* was inaugurated on January 14, 2004 after winning the country's second post-Civil War democratic elections. A former mayor of Guatemala City, Berger continues to be strongly supported by the business community, and his victory came with expectations that he would foster democracy in Guatemala. Berger promised to improve socio-economic conditions and the security environment, both of which need attention due to the ineffectiveness and corrupt practices of the previous administration of President Alfonso Portillo of the *Frente Republicano Guatemalteco (FRG)*.

President Berger faces numerous governance challenges. A minimum of 80 votes are required to pass legislation, and GANA holds but 34 of 158 seats and controls only 10 more. The fact that most parties do not have a strong tradition of party discipline further complicates Berger's task. Despite having to muster support in a painstaking way in most cases, Berger has passed some important legislation, including the ratification and July 2006 implementation of the free trade agreement with its neighbours and the United States (CAFTA-DR). Other improvements led to a ratings upgrade for Guatemala which will assist in securing financing on more favourable terms.

Berger has made some progress in improving the civil rights climate. In its 2005 Press Freedom report, Freedom House acknowledged a decrease in the intimidation of journalists by changing Guatemala's status from "Not Free" to "Partly Free". He has also addressed the culture of impunity by bringing some corrupt public officials to justice, but Guatemala's ranking as one of the region's most corrupt countries means that a long-term effort is in order.

Containing violent crime is one of Berger's most pressing concerns. The increase in criminality is blamed on local gangs, but there is increasing evidence of support from trafficking and criminal organizations in Mexico and the United States. These links, plus the extent to which drug traffickers have infiltrated parts of government and key security forces are particularly worrying. Guatemala has spearheaded efforts to counter crime in the region, but it is also dealing with the economic repercussions of hurricanes Stan and Wilma, and does not have sufficient resources available to mount an effective campaign against gangs, traffickers, and organized crime.

Investment Environment:

The 1998 Law on Foreign Investment provides for equal treatment for foreign investors, and the current administration remains committed to improving the attractiveness of the investment environment, increasing predictability in the application of regulations and transparency in the processes for awarding public contracts. There are no foreign exchange controls.

The country operates with a large bureaucracy that can cause long delays. There is widespread corruption at all levels and in the judiciary. Frequent administrative problems are due to the lack of clarity in regulations, especially with respect to customs.

Efforts to implement new legislation for the mining sector have been weighed down by opposition from several sectors of society, and the ongoing uncertainty has not helped Guatemala's efforts to convince investors that development of the country's mineral resources is an attractive proposition.

Investors need to be aware of Guatemala's deficient infrastructure in order to assess the potential impact on their operations. Transportation is particularly difficult, with both roads and rail lines in poor shape, a situation exacerbated by hurricanes in 2005. Efficiency at Guatemala's ports suffers from outdated facilities and processes.

Political Violence:

A legacy of the country's 36-year Civil War is the persistence of violent crime and political violence, although the latter has decreased significantly. Violent crime is a major issue, but a portion of that is limited to inter-gang warfare. Paramilitaries who were notorious for human rights abuses during the civil war are seeking compensation for the period they served in the army. Former president Portillo committed to a compensation package and the ex-servicemen have launched violent protests when payments have not been made. The situation has not been fully resolved under Berger.

Outlook

Despite the fractured nature of Guatemalan politics, President Berger continues to seek consensus where possible and is promoting a long-term national plan to address the country's most urgent social needs. Improvements in the macro-economic environment are positive, but the need for greater fiscal discipline and better tax collection, among other issues, will not likely provide a level of economic growth that will give the President political breathing space. Crises in areas such as the health sector and high crime levels also serve to reduce the probability that development progress will gain the kind of momentum needed to effect substantive change in the country over the short term.