

Edgar Barquín: Recent economic trends and policy issues

Presentation by Mr Edgar Barquín, President of the Central Bank of Guatemala, at the JP Morgan Investor Seminar, Central America Panel, on the occasion of the IADB Annual Meetings, Montevideo, Uruguay, 17 March 2012.

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I would like to thank JP Morgan for the opportunity to share my views on this panel.

In addressing the recent economic trends in Guatemala and the main policy issues, I would first like to highlight some specific features of the current international context that directly affect Guatemala's economy. Then I will give you a quick overview of recent trends and prospects of Guatemala's main economic variables, and finally I will share with you the main policy challenges we are or will be facing in the near future.

Regarding the current international context, I would like to highlight six elements:

First, the deterioration of global economic prospects, which is already being reflected in the weakening of global trade. Lower economic prospects are also on the horizon for most Latin American countries as well as some key emerging economies such as China and India.

Second, high frequency indicators suggest a recovery of economic activity in the United States of America, though the sustainability of this recovery is still uncertain due to high levels of unemployment, problems in some key markets such as the housing market, potential risks due to the problems in the Euro Area and fiscal consolidation issues, among others.

Third, uncertainty arising from the Euro Area debt crisis with potential spillover effects to other regions and financial markets.

Fourth, declining commodity prices that have contributed to easing of headline inflation in most developing countries. However, prices are still high, particularly oil prices.

Fifth, high levels of unemployment remain in most advanced economies including the United States and the Euro Area as a whole.

And **sixth**, insufficient progress in developing medium term fiscal consolidation in advanced economies that could deepen global imbalances.

Regarding recent trends and prospects of Guatemala's main economic variables, first of all I would like to highlight that the recovery of economic activity continued in 2011; in that year, GDP increased by 3.8 percent, though still below the pre-crisis levels.

For 2012 we are expecting a growth rate between 2.9 percent and 3.3 percent, mainly due to the impact of the international environment I just mentioned.

As regards exports, after experiencing negative growth rates in 2009 due to the crisis, the growth rate in 2011 was the highest of the last 13 years or more, at 23.6 percent. This performance was mainly due both to higher prices and higher export volume of Guatemala's main traditional products. For 2012, prospects we are expecting slightly lower growth rates, though still positive, due to the deterioration in global economic prospects.

In the case of imports, the growth rate was quite significant at 20 percent during 2010 and 2011, reflecting a higher domestic demand of goods and services particularly capital goods, fuel and other inputs for the industry. For 2012, a lower growth rate is expected as we are estimating a lower demand for consumption goods and inputs for the industry.

Remittances inflows are recovering at a slow pace. In 2011 the amount was a little bit higher, 63.3 million dollars, than the one of 2008 previous the hit of the crisis in Guatemala. For 2012, even though we are expecting a recovery in the amount of inflows, the growth rate is

not significant, 5.7 percent, as the Hispanic unemployment rate in the United States, from which about 99 percent of remittances come, is still high.

As the Guatemalan economy is more integrated with the global economy and as new investment opportunities arise due to a greater diversification of its production of goods and services, we have experienced an increase of capital flows from Foreign Direct Investment. We expect these flows to keep growing as specific actions are being taken to promote investments in the country on the basis of a public-private strategic alliance which also includes efforts to improve Guatemala's investment climate.

As of today, about 55 percent of Foreign Direct Investment comes from the United States and Mexico.

Here it is important to mention that short term capital inflows to the economy have not been significant. Therefore, we have not experienced the problems of other Latin American countries which had to deal with relatively high capital inflows as well as with significant appreciations of their nominal currencies and increases of credit to the private sector that fueled economic activity over its potential levels.

International Monetary Reserves have reached highest historical levels, at over USD 6 bn (and expected to reach close to USD 7 bn in 2012), which represents an important liquidity cushion for the Guatemalan economy as well as a good signal to the international markets and credit rating agencies.

The banking credit to the private sector has increased, mainly the credit in foreign currency due to lower international interest rates as well as the higher Guatemalan industrial activity experienced in 2011. The main funding of the credit in foreign currency has been commercial lines of credit from American banks.

The Economic Activity Confidence Index is improving, particularly in the most recent months. This performance is highly related with positive expectations about the new government that took office in mid January. So far, the government has given clear signals of being a pro-private sector government. In its first month in office the government has launched a competitiveness agenda and an integrated policy for foreign trade, competitiveness and investments. These and other specific actions have contributed positively to expectations about economic growth despite the uncertainty on the global economic prospects.

Declining commodity prices have contributed to easing of headline inflation since mid 2011, reaching 6.20 percent by the end of the year, slightly above the top limit of the Monetary Board's target of 5.0 percent plus minus 1 percentage point.

For 2012, inflation estimates are within the range target of 4.5 percent plus minus 1 percentage point, though inflationary expectations are still above this range.

Guatemala's Central Bank main goal is to pursue price stability which is reflected in an inflation range target set out by the Monetary Board, the one I have mentioned. In this context, if inflationary pressures arise or inflationary expectations continue above the target, specific actions will be taken by the Monetary Board in the near future to achieve the 2012 and the midterm inflation targets.

In the meantime, the central bank is monitoring the performance and prospects of key external and internal economic variables that may impact headline inflation and inflationary expectations. In addition, coordination with fiscal policy continues to be strengthening as well as the transmission mechanism of monetary policy.

Guatemala is known by international organisations and credit rating agencies for its good record of prudent fiscal and monetary management as well as for its low levels of public debt and tax burden.

Fiscal revenues were significantly hit during the crisis 2008/2009 so fiscal deficit almost doubled, reaching 3.3 percent of GDP in 2010. To keep public debt at sustainable levels in

the midterm, fiscal deficit should be equal or lower than 2 percent of GDP. In this regard, even though further reductions are needed, we can say that the consolidation is underway as the fiscal deficit reached 2.9 percent of GDP in 2011 and is expected to be at 2.6 percent of GDP in 2012.

It is worth mentioning that during the first month of the new government Congress has passed two legal provisions aim at strengthening fiscal revenues on a sustainable path. The legal provisions included not just modifications to some taxes but also specific provisions to strengthen the Tax Administration powers to fight against tax evasion and smuggling.

Despite the increase in public debt in recent years, total debt to GDP ratio is still below critical values. We expect that the actions that are being taken to strengthen fiscal revenues on a sustainable way will contribute to stabilize this ratio at sustainable levels.

Given the uncertainty that remains about the global economic prospects I would say that there are three main policy challenges we are currently facing as policy makers:

The first one is to anchor inflation expectations to the midterm target. This means that the Central Bank has to stand ready to take any necessary measures to address inflationary pressures, even in a context of potential deterioration of economic growth at the national level. This is important because if the downside risks to growth materialize and inflation expectations are still above the midterm target, the Central Bank has no room to ease monetary policy and support economic growth.

The second main policy challenge is to secure fiscal sustainability in the medium term through the strengthening of tax revenues and the implementation of prudent fiscal policies reflected in the stabilization of the rising debt-to-GDP ratio and the reduction of the fiscal deficit to levels below 2 percent of GDP. This is particularly crucial as we need to restore fiscal maneuver in the short term in order to be able to address a more severe global economic downturn or the impact of a natural disaster which in fact is very likely to happen as Guatemala is among the world's most vulnerable countries to experience natural disasters. Securing fiscal sustainability is not just an issue of reducing public expenditure as besides high fiscal rigidities; Guatemala has important infrastructure and social needs that need to be addressed in order to foster sustainable economic growth.

This drives me to the **third main policy challenge** which is to foster sustainable economic growth in an uncertain international environment.

To address this challenge commitment is needed not just from the government but mainly from the private sector as well as civil society. As I already mentioned, some work has been done to build these strategic alliances through the competitiveness agenda and the integrated policy agenda for foreign trade, competitiveness and investments as both have been endorsed by the private sector. In addition, efforts initiated by the previous government regarding specific programs to address poverty and creation of opportunities for the most vulnerable groups are being taken by the new administration as well as specific actions to address the high levels of crime and violence that also affect sustainable economic growth.

Some of these actions will render benefits in the medium term, so in the mean time the main contribution of monetary and fiscal policies would be to preserve macroeconomic stability while maintaining the soundness of the financial system as this has been key to address adverse shocks in the past as well as to create a solid basis to achieve a sustainable economic growth.

As a conclusion, allow me to summarise with the following points:

- As we have and will be discussing these days in different forums, our economies are, again, vulnerable to external shocks arising from other regions.
- Even though we have made significant improvements, particularly regarding the strengthening of the economic fundamentals of our economies, which is reflected in a lower volatility of the main macroeconomic prices including lower inflation rates,

strengthened financial systems, more sound fiscal balances, improvements in productivity and so on, we are not exempt, now and in the future, from experiencing these kind of shocks that at the end affect not just economic and financial variables but most important the well being of our populations.

- As policy makers, we have the responsibility to preserve those economic fundamentals and to come up with policy actions that may reduce their negative impact, or even better that could make our economies less vulnerable to their effects.
- In this context, I am glad to be here and looking forward to the discussion of our challenges as we may come up with specific policy actions that may be needed now or in the future to address these challenges.

Thank you very much for your attention.