Guatemala Macro-Political Update

- After going through a modest slowdown in 2016 (3.0% growth), Guatemala is expected to bounce back to a 3.6% or so expansion in 2017 (The Central Bank of Guatemala predicts 3.0% - 3.8% growth for 2017, and 3.0% - 4.0% for 2018). According to IMF estimates, the country's potential growth rate has been somewhere in a 3.3% - 4.0% range for the past 8 years, meaning that even with the rebound, the country is still growing roughly at potential (see chart to the right).

- On the inflation front, the country has had relatively stable inflation around 4% over the past 6 months or so, leading the Central Bank of Guatemala to hold rates unchanged at 3.0% in its May 31st meeting. Even though inflation is expected to hover in the top-half of the central bank's 4% +/- 1 percentage point range for the next 1.5 years (until the end of 2018, expectations surveys put inflation hovering around 4.5%), the central bank seems comfortable holding rates at the current level. The biggest source of risk on the inflation front appears to be: 1) fading benefits from lower energy prices, 2) second order effects related to higher food prices, which partly result from the income effect to rural households that derives from continued strong growth in remittances. However, this is not a base case among private players (the Central Bank's survey's show inflation above the mid point of the target, but within the target range). In terms of monetary policy, current real rates of about –1.0% are on the lose side, with "neutral real interest rates" falling somewhere in the 0.4% - 1.6% according to IMF estimates.

- The country's relatively high growth rate is achieved despite poor total factor productivity (TFP), which is explained by issues ranging from migration of skilled workers out of the country, a very large informal economy that diverts resources into less productive activities, inadequate infrastructure, etc. Part of the reason for the flight of skilled workers is the violence epidemic caused by organized crime, with which the country's government is battling, alongside civil society (see "Central America's Violent Northern Triangle" D. Renwick" CFR, 2016). As elsewhere in LATAM, one factor linking macroeconomic challenges to security is a relatively weak justice system.

- The IMF's Article IV consultation "Selected Issues" for Guatemala points lack of legal / judicial stability, poor protection for investors, high insecurity and quality of infrastructure as some of the factors behind low TFP (total factor productivity). Similarly, according to the World Bank ("*Doing Business 2017: Equal Opportunity for All*"), the country ranks 88th globally in terms of the friendliness of its business environment (about halfway in the rankings), with some of the greatest challenges being the protection of minority investors (173rd out of 190), difficulty enforcing contracts (173rd out of 190), and the difficulty in starting businesses (119th out of 190).

- Its probably no coincidence that the country faces some challenges in both contract enforcement and violence. Thankfully, there are efforts being made to address the issues of the relatively weak justice system, including through reforms seeking to improve transparency and independence of judges, and depoliticizing judge nominations. Alongside these steps being taken to tackle judicial system deficiencies, the government is also pushing through efforts to

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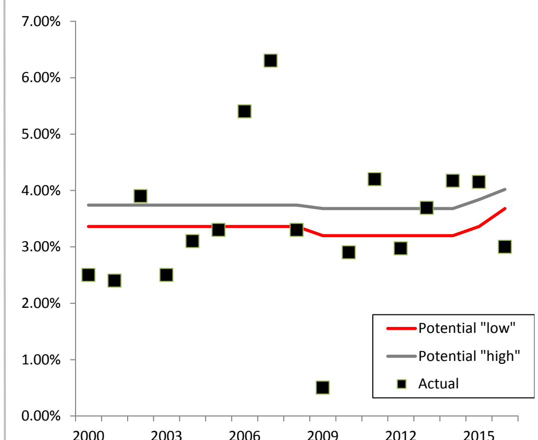
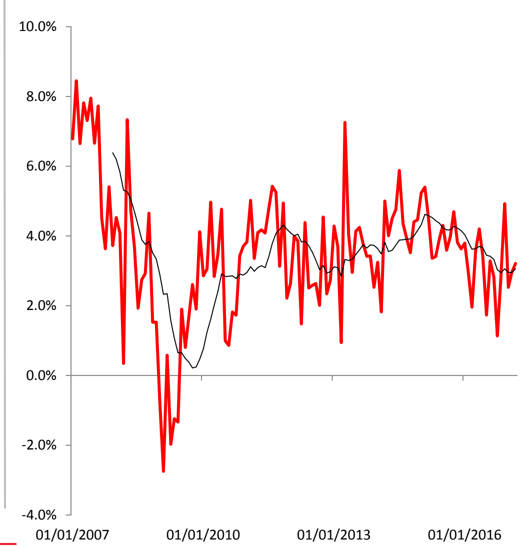
Growth remains robust, and is expected to get back to potential in 2017, after a moderate slowdown in 2016

Guatemala: growth vs potential
Source: IMF, Scotiabank.



Monthly economic activity (and 12 month moving average)
Source: Bloomberg, Scotiabank.

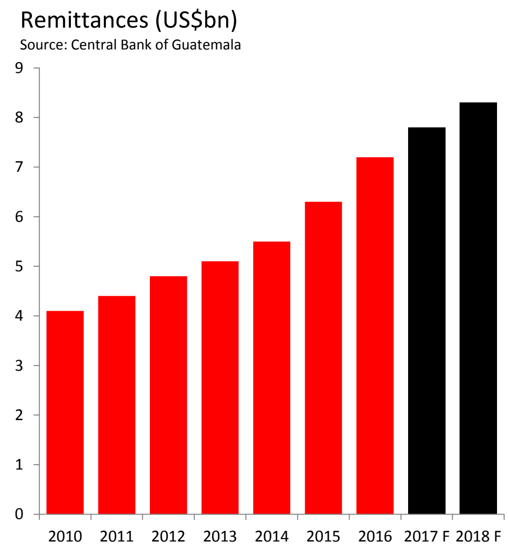


fight corruption, including: cleaning up tax authorities, making procurement processes more transparent, efforts to clean up political parties and the judicial and legislative powers.

- So why has growth in Guatemala held up relatively well despite the challenges? In the 2000—2010 period, a strong jump in capital accumulation (from 4.5% in the mid 2000s to 5.5% in 2007) accounted for some of the stronger growth, but in the 2007—2014 period, that capital accumulation boom faded (it dropped to about 2.5%). What propped up growth since? To a large degree, the answer appears to be significant increase in the working age population, as a result of the country having among the highest fertility rates in the region. This dependence on population growth and above trend capital accumulation makes reforms critical—not only in rule of law to boost investment, but also in other fronts, such as education.

- On the fiscal front, Guatemala's debt trajectory looks steady at about 25% of GDP according to IMF projections. The country's credit ratings remain sub-investment grade (BB with both S&Ps and Fitch, and Ba1 with Moody's), with the latest action being a downgrade from BB+ to BBB by Fitch in June 2014. Although the trajectory of debt is stable, an issue that likely constrains the country's ratings is relatively high debt to revenues (revenues are only about 12% of GDP, putting gross debt to fiscal revenues around 200% according to IMF data). This is another sector where reform is necessary, as higher fiscal revenues are likely necessary to improve infrastructure and education.

Remittances are a key source of foreign currency—and continue to grow healthily



- On the external account / financial front, remittances are a major source of foreign currency income in Guatemala, representing about 2-3 times receipts from exports. The country's current account deficit is modest, printing under 1% of GDP for 2016, and is expected to remain near that level for the next couple of years (between -0.5% of GDP and –1.0% of GDP). One of the potential sources of risk, is the relatively high dollarization of the banking system. About 35% of credit in Guatemala is dollarized, with dollar loan-to-deposit ratios sitting around 180% - with credit lines from abroad funding most of these dollar loans.

- Although the Quetzal (GTQ) is classified as a floating currency (rather than free floating) its float is managed by the central bank (the intervention band is 0.75% of the 5-day moving average). So far in 2017, the central bank has been a net buyer of USD—about US$900bn. There does not appear to be a strong reason to be concerned over the CB's capacity to act, given reserves, at US$9.3bn are adequate. The current stock of reserves covers anywhere from 1.5X to 2.0X times the adequacy metrics suggested by the IMF (Broad money, months of imports covered, short term debt, and the EM Reserve Adequacy Metric).

- In terms of credit, Guatemala trades relatively wide for a LATAM BB credit, but there are some structural reasons. If we compare it to similarly rated Brazil, some reasons for the spread include: 1) Guatemala does not have a domestic funding base proportional to Brazil's, 2) size of market, 3) importance in global benchmarks (it helps to have captive investor bases), 3) Guatemala is much less liquid than Brazil, and tends to demand a higher liquidity premium.

Guatemalan credit is trading wide relative to similarly rated Brazil