Guatemala Viewpoint

Guatemala: Solid and stable market for our times

Initial Opinion - Credit

26 July 2022

GEM FI & FX Strategy
LatAm | Guatemala

Stable macro-economy and small government model

This Primer report introduces Guatemala, one the few positive macro stories in LatAm these days. Guatemala's historically conservative economic management has achieved very stable macroeconomic indicators. An exceptional mix of current account surplus, track-record of small fiscal deficits, and the lowest gross public debt ratio in the region. Low governance and social indicators are the main challenges for Guatemala.

Growth: Above LatAm median, with much lower volatility

Guatemala's average GDP growth of 3.2% over the past 15 years has been above the LatAm median, with much lower volatility than the regional average. Remittances and trade with the US are its main growth drivers. Guatemala avoided a sharp recession in 2020 (-1.8%) and rebounded strongly in '21 (8.0%). Growth is likely to moderate in '22 alongside a mild US recession, in our view. We expect growth of 3.7% in '22 and 3.0% in '23. Inflation is high (8% '22F), but it is milder than regional peers.

Fiscal discipline: Deficits back to pre-pandemic levels

Guatemala has a record of strong fiscal discipline. Its pandemic stimulus was relatively modest and it is one of the few EM countries where deficits have already returned to pre-pandemic levels. After posting an exceptionally small deficit of 1.2% in '21, we expect a deficit of 2.4% in '22 and 2.0% in '23 (vs. 2.2% in '19). Interest expense is relatively small (1.5% of GDP) and we expect a '22 primary balance of -0.9%.

Debt: Low ratio that is likely to remain low

Guatemala is generally averse to government indebtedness. Its debt ratio of 30% is among the lowest in LatAm and we expect the debt ratio to remain basically stable in the medium-term. About 43% of its debt is denominated in foreign currency, similar to Costa Rica (42%) but much lower than Dominican Republic (76%).

EXD Strategy: Initiate with Overweight recommendation

We initiate coverage of Guatemala's external bonds (EXD) with an Overweight recommendation ($5.6bn outstanding, 10y spreads of 375bp). Investors value macroeconomic stability, like that of Guatemala, when global uncertainty is elevated. We think Guatemala's bonds will remain attractive amidst a very uncertain global backdrop. Guatemala can also avoid issuing EXD in '22. Lower bond liquidity is a downside.

Macro risks: US, social discontent, climate, governance

Risks for Guatemala include (1) a deterioration in the bilateral relationship with the US (could impact migration or remittances and thus domestic activity), (2) social discontent due to high inflation and frustration with social services, (3) strong exposure to natural disasters, and (4) weak governance and institutional capacity, tainting the ESG image.

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Economic snapshot of Guatemala

Potential GDP growth: low-hanging fruit to increase it

Ninth largest economy in LatAm

Guatemala is the ninth largest economy in LatAm, with a nominal GDP of US$ 94bn ('22F). The population is 17.1 million, ranked eighth in LatAm. Roughly 40% of the population is indigenous, only surpassed by Bolivia (~60%), and descendants of the great Mayans and other Mesoamerican civilizations.

Demographic dividend: Much younger median age compared to LatAm

Guatemala's population has a low median age (22 years old vs. LatAm median of 30) and a relatively high population growth rate compared to LatAm (2.4% average since 1950). This demographic dividend is supportive of potential GDP growth, through a growing workforce. However, Guatemala has major challenges in improving the quality of its human capital. It ranks poorly on social indicators, such as stunting and malnutrition, comparable to Sub-Saharan African countries.

Very low female labor participation: Low-hanging-fruit to boost growth

Labor force participation in Guatemala is lower for women (38%) than for men (84%). An increase in the female labor participation rate would increase potential GDP growth (i.e., human capital grows faster in Solow Production Function). Therefore, we see ample room for gender parity policies with positive spillovers for economic growth.

Low urbanization provides opportunity to increase productivity

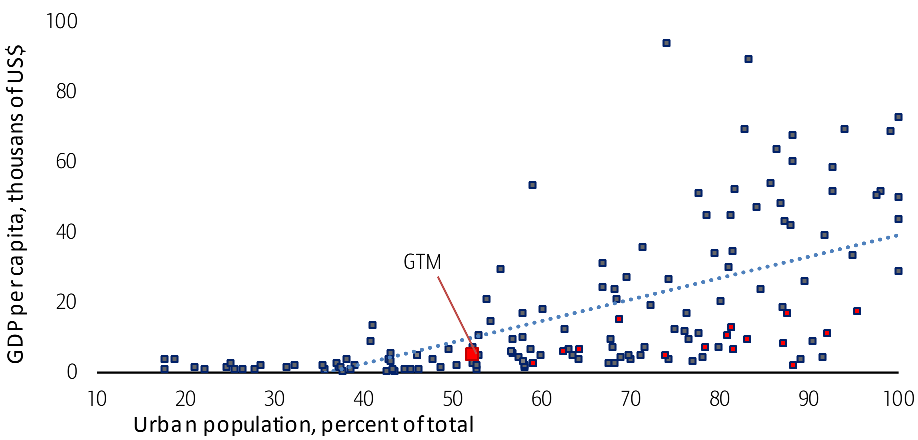
The economic development literature generally shows that countries reach the peak of their economic growth curve during waves of urbanization. It is when large amounts of people migrate from the rural to urban areas that GDP tends to grow at much higher rates. The productivity of urban households tends to be much higher than that of rural households. That is the story of China (excluding the Great Leap Forward period) and many other countries.

Guatemala has highest share of rural population in LatAm

Guatemala is the less urbanized country in LatAm, with only 52% of the population living in urban areas (vs. LatAm median of 77%). In our view, this may be a good reason to explain why Guatemala's GDP contraction in 2020 (-1.5%) was much smaller than the LatAm average (-8%) as the spread of COVID-19 was slower in rural areas than in the cities. We believe Guatemalan policymakers have a unique opportunity to boost potential

Exhibit 1: Urban population (% of total) and GDP per capita (US$ dollars) across the world

Empirical regularity indicates countries tend to accelerate their economic growth when urbanization takes place. Guatemala is the country in Latam (red dots) with the highest share of rural population



Source: BofA Global Research, UN, IMF

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growth by deepening the urbanization of the country, from such low levels. Productivity would definitely increase.

Lowest volatility of GDP growth across the LatAm region

Guatemala's GDP growth was 3.2% on average during the last 15 years, above the LatAm median (Exhibit 2). The volatility of the economic cycle – measured by the standard deviation of GDP growth – was the lowest in LatAm in the past two decades.

Consumption-driven economy

Private consumption accounts for the lion's share of GDP, hovering around 85%-90% in the past years. From a sector perspective, the economy is dominated by services. Though agriculture employs a large share of the population, it only represents 9% of GDP. This reflects the low productivity of the rural economy.

Investment to GDP is low, suffering from similar disease as El Salvador

Over the past decade, Guatemala's investment to GDP averaged 15%, substantially lower compared to the LatAm average (22%). We believe that the low investment rate is mainly explained by the combination of three factors: i) high crime rate, increasing transaction costs for firms (especially small firms, subject to extortion); ii) outward migration (mainly to the US), driven by insecurity, which lowers the marginal productivity of capital; and iii) weak governance and institutions, creating room for corruption, barriers of entry across industries, and poor conditions for innovation.

Weak governance and institutions can hold back private investment

Guatemala ranks poorly in the World Bank's governance indicators and Transparency International's corruption index. Its scores are among the lowest in LatAm. We believe poor governance conditions could be stifling private investment, for three main reasons.

i) Competition issues

Governance issues give way to competition problems at the industry level because of favoritism, barriers of entry and corruption that discriminate against firms which are not close to the circles of political power. Guatemala's foreign direct investment (FDI) inflows have been remarkably low, excluding 2021 (inflated by one-off investment in telecom industry), despite having strong macroeconomic conditions that should be a magnet of foreign investment.

ii) Disincentive to innovation

Weak governance tends to stifle innovation, by calling into question the independence of courts and thus the efficient defense of property rights. Predictability in arm's length contracts, civil liberties, and transparency in the administration of justice are key for creativity and innovation to flourish.

iii) Corruption diverts funds that could be used for infrastructure

Past studies by Accion Ciudadana (local civil society organization) estimated that ~20% of the nation's budget is lost to corruption. Funds that could be invested in upgrading human and capital stocks.

Growth: Likely to outperform LatAm

Broadly stable, but likely to be affected by US recession

We believe Guatemala's GDP growth will outperform LatAm region in 2022-24

We forecast Guatemala's GDP growth at 3.7% for 2022 and 3% for 2023, outperforming the LatAm region (2.4% and 1.3%, respectively, BofA scenario). Our Guatemala forecasts are broadly in line with the market consensus, as per the Consensus Economics survey.

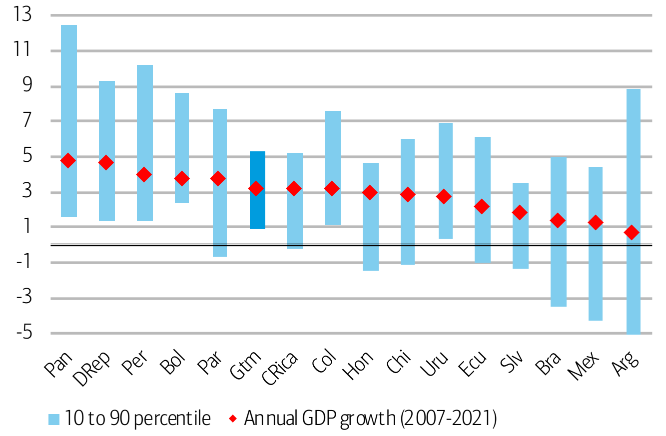
Activity has been robust in first five months of 2022

The monthly activity indicator (IMAE) increased by a strong 4.4% in the first five months of 2022. But a deceleration in the US will likely moderate worker remittances flows to

Guatemala and moderate exports. Also, high inflation is increasingly eating into real wages, posing risks for consumption in the second half of the year.

Exhibit 2: Annual GDP growth in LatAm, 2007-2021 period

Guatemala has a stable GDP growth rate, 3.2% in 2007-2021, above the median of 3% in the LatAm region



Source: BofA Global Research, Haver

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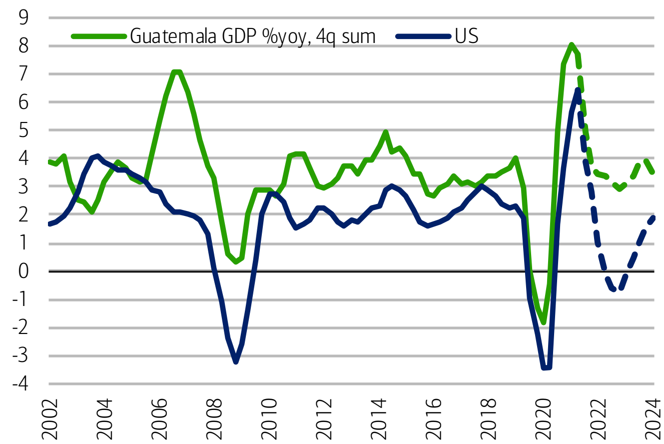
Exhibit 3: Guatemala growth is highly correlated with the US

Guatemala and the US linked by remittances and external trade



Source: BofA Global Research, Haver

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Sensitivity to US economic cycle is high

The links between the Guatemalan and the US economy are strong (Exhibit 3). Worker remittances inflows, mostly coming from the US, add up to 19% of GDP. Moreover, the US is Guatemala's top trading partner, accounting for over 30% of trade exchange (exports plus imports). Our US economics team forecasts a mild recession this year and expect 4Q/4Q GDP to decline by 1.4%, followed by a 1.0% increase in 2023 (see US Economic Viewpoint: 2022-23 US outlook: Mild recession supports a return to price stability 13 July 2022). The US slowdown will likely have a negative impact in Guatemala.

Exhibit 4: Selected financial and macroeconomic indicators

Guatemala GDP growth will decelerate to 3.7% in 2022 after an strong rebound in 2021

	2019	2020	2021	2022F	2023F
Real GDP growth (% yoy)	4.0	-1.8	8.0	3.7	3.0
CPI inflation (% yoy, eop)	3.4	4.8	3.1	8.1	5.0
Central bank policy rate (eop, %)	2.75	1.75	1.75	3.75	4.50
Nominal exchange rate (vs USD, eop)	7.7	7.8	7.7	7.8	7.9
Current account balance (% of GDP)	2.4	4.9	2.5	1.6	0.7
Central gov. primary budget balance (% of GDP)	-0.6	-3.2	0.6	-0.9	-0.5
Central gov. overall budget balance (% of GDP)	-2.2	-4.9	-1.2	-2.4	-2.0
Gross government debt (% of GDP)	26.5	31.6	30.8	30.0	30.1

Note: For other variables and forecasts see Exhibit 56. Source: BofA Global Research

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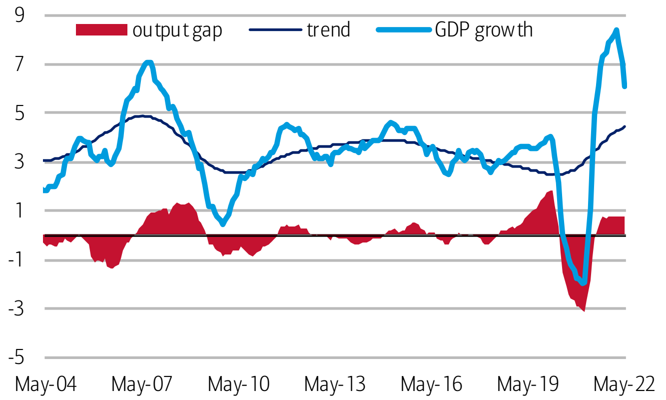
Exhibit 5: Output gap (deviation of seasonally-adjusted GDP from trend, using Hodrick Prescott filter, % percentage points)
We estimate Guatemala's output gap is fully closed



Source: BofA Global Research, BANGUAT

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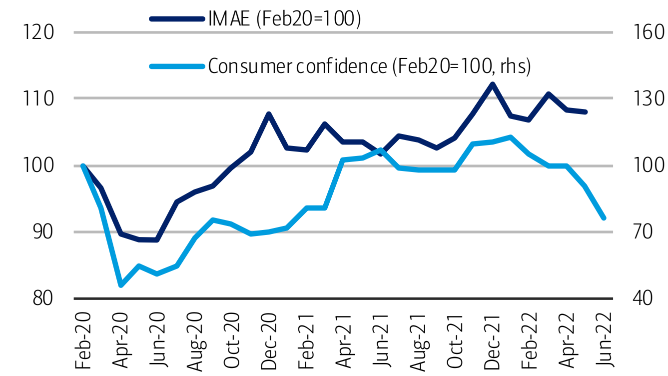
Exhibit 6: Monthly activity and consumer confidence
Consumer confidence has declined 32% ytd which signal that activity likely to moderate



Source: BofA Global Research, Haver, BANGUAT

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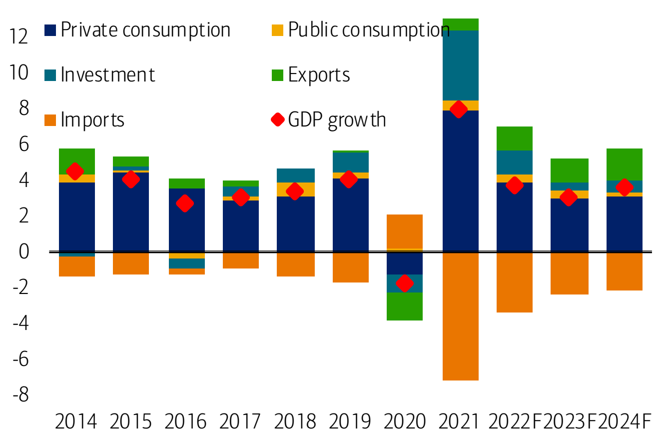
Terms of trade shock is net negative

As in the vast majority of Central American and Caribbean countries, perhaps with the exception of Guyana and Trinidad & Tobago, the movement of commodity prices observed in 2022 imply a negative terms of trade shock for Guatemala. For the simple reason that Guatemala is a net commodity importer. The main negative effect comes through oil prices.

Activity bolstered by remittances, exports, credit

During the pandemic, the Guatemalan economy declined by 1.8% in 2020, one of the smallest contractions in the LatAm region. The resilience of exports, remittances and the cash transfers implemented by the government to alleviate the effects of the pandemic helped to contain the shock to economic activity. Even so, transport and lodging services printed 2-digit declines.

Exhibit 7: Contributions to GDP growth (pp)
GDP growth driven by private consumption which represents 86% of GDP



Note: Percentage points (pp). Source: BofA Global Research, Haver

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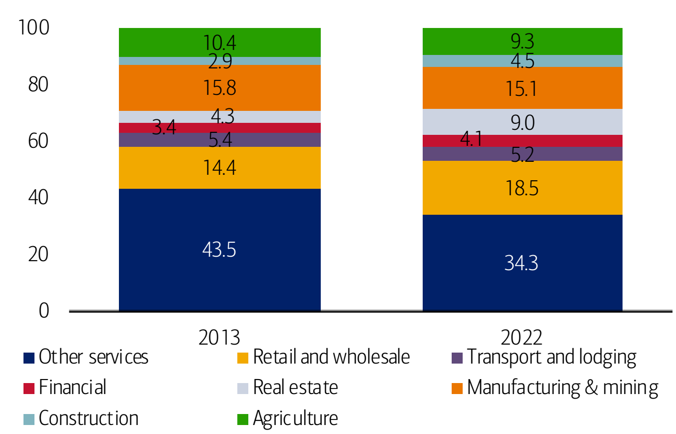
Exhibit 8: GDP by sector
Guatemala is a services oriented economy



Note: Other services includes utilities, science, communication, government, education, health and others. **Source:** BofA Global Research, Haver

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In 2021, the economy rebounded strongly to an historical record high growth of 8%, with record-high remittances fueling private consumption. Most of the sectors have now surpassed the pre-pandemic level with the exception of transport and lodging which lagged the recovery.

In 1Q22, real GDP increased by 0.6% qoq saar (quarter over quarter, seasonally adjusted annual rate), down from 1.6% in 4Q21. In annual terms, GDP rose 4.5% driven by a 4.9% increase in private consumption and a 9.4% increase in exports. Imports of goods and services rose by 11.8% yoy in 1Q22.

While remittances, exports, tourism arrivals and credit indicators continued to increase in the first months of 2022, consumer confidence has declined steadily since January and fell 32% ytd in June (Exhibit 6) likely due to the Ukraine-Russia conflict and high domestic inflation.

Labor market: Tight with low unemployment

Low unemployment rate, 2.2% in last reading

Guatemala's unemployment rate has been historically low and currently stands at 2.2% in the latest employment report (from 2021). Unemployment is particularly low in the rural areas (1.1% in 2021).

Employment already fully recovered from covid shock

Formal employment data from the social security institute (IGSS) revealed 6k jobs were destroyed in 2020, which represented 4.4% of the formal jobs in Guatemala. Nevertheless, employment rebounded strongly in 2021. The IGSS data show formal employment is now at a record high of 1.46mn.

Labor informality is quite high

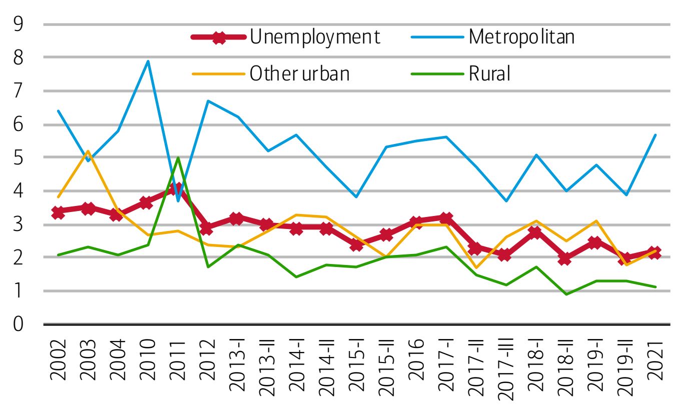
As previously highlighted, contrary to the stable macroeconomic indicators, Guatemala's social indicators have a low ranking compared to regional peers. The employment informality rate in Guatemala is high, at 71% in 2021.

Tight labor market conditions are a risk for inflation

With a fully closed output gap – given the small contraction of GDP in 2020 followed by a fast recovery – and apparently little slack in the labor market, it is possible that demand pressures are contributing to push inflation up to some extent.

Exhibit 9: Low unemployment rate

Rural area has maintained a low unemployment rate though the years



Source: BofA Global Research, BANGUAT, INE

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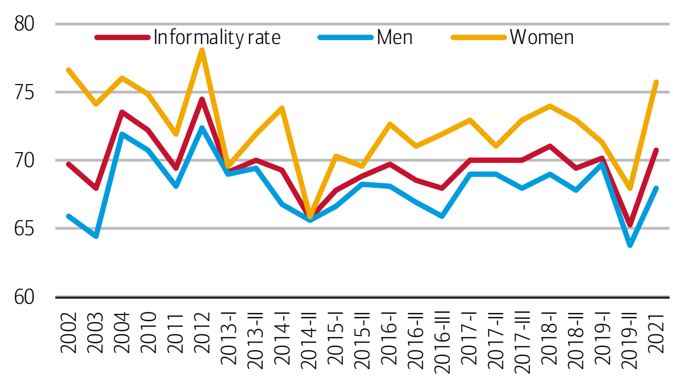
Exhibit 10: Informality rate reflects the lack of access to social security networks

Informality is specially high in the women's employment



Source: BofA Global Research, BANGUAT, INE

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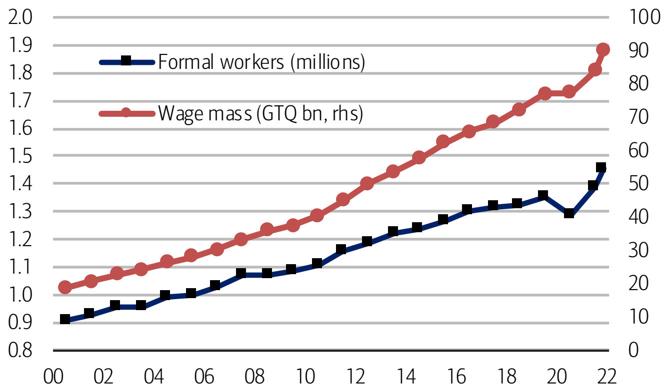
Exhibit 11: Formal workers are increasing but still represents low percentage of total employment

An increase in the wage mass is positive for consumption



Note: 2022 data as of April. **Source:** BofA Global Research, BANGUAT, INE

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Exhibit 12: Characteristics of the Guatemalan working force

Unemployment at 2.2% in 2021

	mn	%
Total population	17.20	
Working age population	11.80	68.6
Economically active population	7.40	62.7
Total employment	7.24	97.8
Total unemployment	0.16	2.2

Source: BofA Global Research, BANGUAT, INE

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Exhibit 13: Average income from the employment survey (GTQ)

Wages didn't recover in 2021 despite high GDP growth

	Total	Men	Women
2018	2,260	2,351	2,076
2019	2,429	2,521	2,252
2021	2,207	2,434	1,788

Source: BofA Global Research, BANGUAT, INE

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Inflation: Trending up

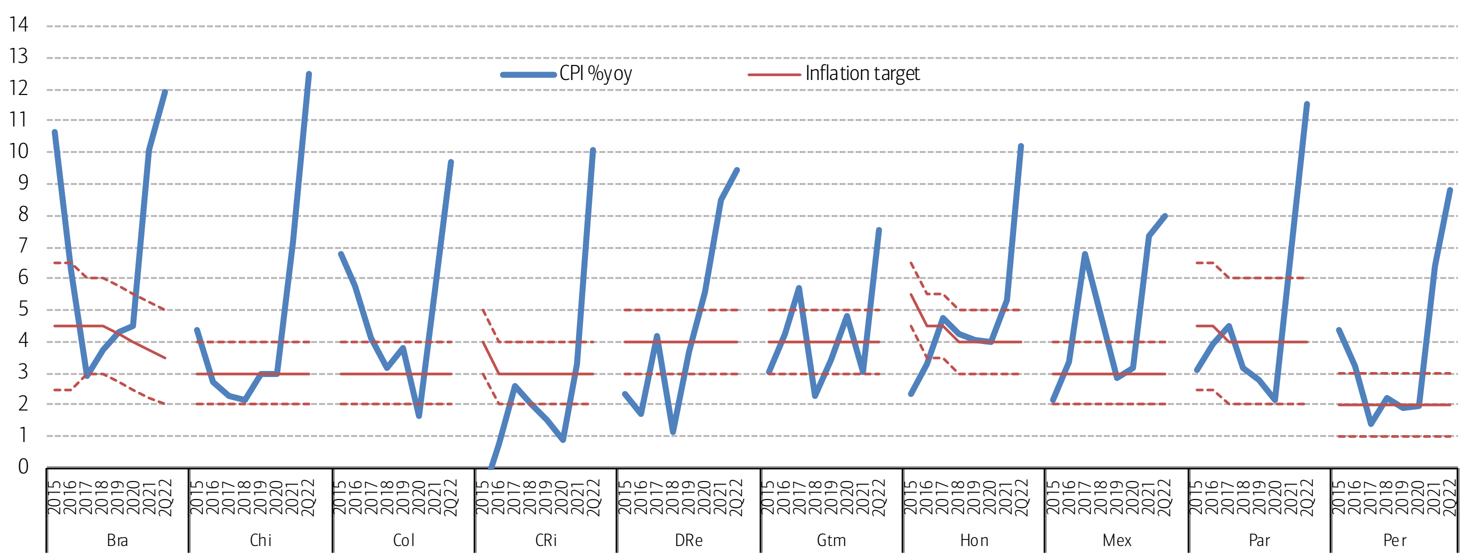
Inflation to peak in 1Q23, and fall to 5% by year-end '23

We expect inflation to return tolerance range of Central Bank in 2023

We expect headline inflation to peak at 8.3% yoy in 1Q2023, up from the current level of 7.6% yoy (June), and then decrease to 5% by the end of 2023. That is the upper bound of the 1 percentage point tolerance range around the Central Bank's (BANGUAT) 4% target. We believe inflation will be in line with the 4% target in 2024.

Exhibit 14: Headline inflation across all the inflation-targeting countries of LatAm

In the recent years, Guatemala's inflation has been more stable than in the inflation-targeting peer countries



Source: BofA Global Research, Haver

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Inflation gained significant traction in the last months

After a muted start of the year, annual headline inflation accelerated in recent months and reached 7.6% in June, which is the highest rate since 2011. Food and transport prices are the main contributors to the annual inflation rate (Exhibit 15 and Exhibit 16).

Fuel subsidies repressing inflation

The acceleration of inflation has happened notwithstanding the fact that the government is currently subsidizing gasoline and diesel. The subsidy to gasoline will end on the first days of August. That will exert upward pressure on transport inflation. The subsidy for diesel, however, will likely remain in place, according to the latest guidance from the government. Food, transport and utilities have the largest weights in the CPI index (Exhibit 18).

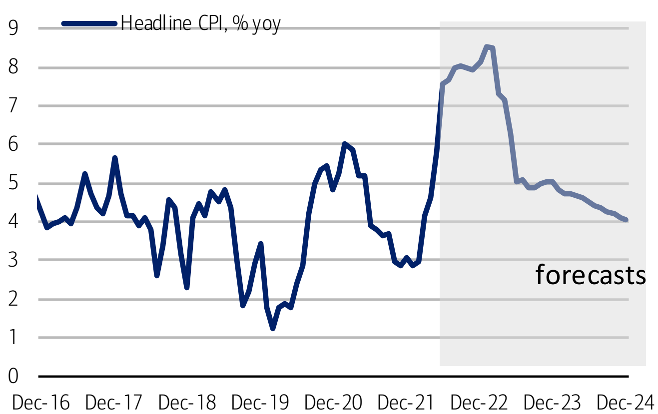
Risks to the inflation outlook: mainly commodity prices

The main risks for Guatemala's inflation outlook are further increases in oil and food prices. Our Global Commodity Research team expects WTI oil prices to average US$ 100/bbl in 2022 and then decline a bit to US$ 95/bbl in 2023 (see the most recent Global Energy Weekly).

Exchange rate volatility is usually very low; no pressure from pass-through

Exchange rate volatility in Guatemala is remarkably low, even though the Quetzal floats, because of Central Bank interventions in the FX market.

Exhibit 15: Headline CPI, % yoy
We expect inflation to accelerate to 8.1% in 2022 and then moderate in 2023 and 2024.



Source: BofA Global Research, BANGUAT, Haver

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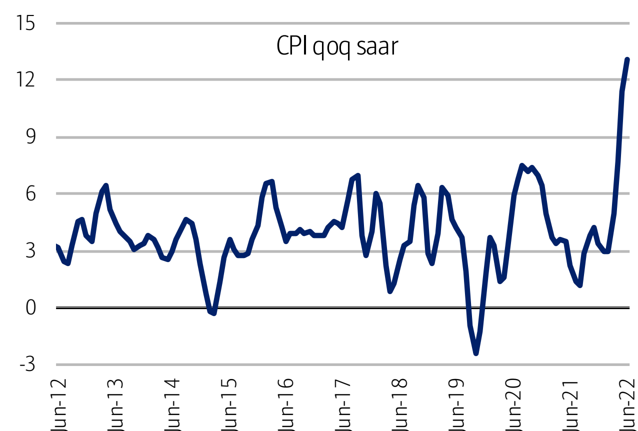
Exhibit 16: Headline CPI, % qoq saar
Sequential inflation well above historical prints



Source: BofA Global Research, BANGUAT, Haver

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Base-effects held down yoy inflation in 1H22, but that effect is fading

Until April, Guatemala's headline inflation was relatively low (below 5% yoy) and within the Central Bank's tolerance range. This contrasts with the majority of LatAm countries where yoy inflation increased a lot in 2H21 and drifted above the target of several central banks. Base-effects explain why Guatemala's yoy inflation took longer to rise.

Hurricanes Eta and Iota, followed by transport union price hikes

In late 2020 and early 2021, food prices spiked because hurricanes Eta and Iota disrupted agricultural supply and the transportation of food. Then, in the first half of 2021, transportation prices increased by a whopping 20% because public transportation companies decided to charge higher prices.

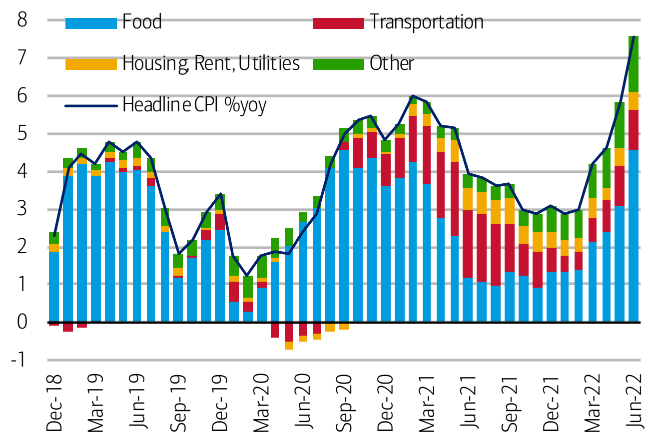
The increase in transportation fares was motivated by the fact that the government reduced transportation capacity by 50% – as a health measure (to reduce to spread of COVID-19) – between 2020 and 2021. Transportation companies were catching up, in an attempt to compensate for foregone revenues.

Inflation persistence in Guatemala seems relatively low

We ran an econometric analysis and found evidence that inflation persistence in Guatemala is low. Our analysis (see insert below) suggests that the persistence of inflationary shocks in Guatemala has declined over the past 10 years and currently is among the lowest in the CAC region (Exhibit 19). Moreover, we also found that Guatemala's inflation variance is explained more by idiosyncratic factors instead of global factors (Exhibit 20).

Having said that, a relatively short-lived persistence of inflation shocks and the predominance of idiosyncratic vs. global factors in the inflation variance should help BANGUAT to implement a less restrictive monetary tightening compared to regional peers.

Exhibit 17: CPI inflation at 7.55% in May
Food and transport are the main contributors to annual inflation (bp)



Source: BofA Global Research, BANGUAT, Haver

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Exhibit 18: Weights of main CPI components
Gasoline, electricity and other fuels have a weight of

Weights of CPI main components /100			Weights of fuel and electricity/100	
Food and Nonalcoholic Beverages	28.75		Electricity	3.30
Alcoholic Beverages & Tobacco	0.28		Gas	1.20
Clothing and Footwear	7.41		Other home fuels	2.16
Housing, Rent, Utilities	12.61		Gasoline and diesel	2.90
Furnishing & Equipment	5.43			
Health	4.22			
Transportation	10.43			
Communications	5.15			
Recreation & Culture	5.62			
Restaurants and Hotels	3.72			
Education	9.24			
Other Goods and Services	7.16			

Source: BofA Global Research, BANGUAT

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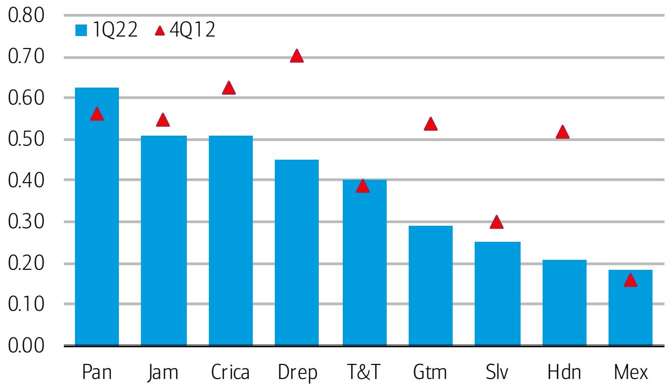
Inflation persistence and global vs. idiosyncratic factors

In order to calculate the inflation persistence and analyze how that persistence has evolved over time, we calculate the persistence of inflation using the same methodology for all of the CAC countries and also included Mexico due to its strong trade links with Guatemala.

We estimate inflation persistence using the coefficient of an AR(1) regression on quarterly data using 12 year samples, controlling for seasonality. The higher the coefficient, the higher the persistence of shocks on inflation.

For the global vs idiosyncratic factors, we calculate a global (or common) inflation factor using the first principal component of the panel of quarterly inflation since 2000 for the 9 LatAm countries under analysis. Exhibit 20 shows a simple decomposition of inflation in Guatemala broken down into global and idiosyncratic factors by projecting inflation on the global factor.

Exhibit 19: Inflation persistence in CAC region
Guatemala has a relative low inflation persistence in the region



Source: BofA Global Research

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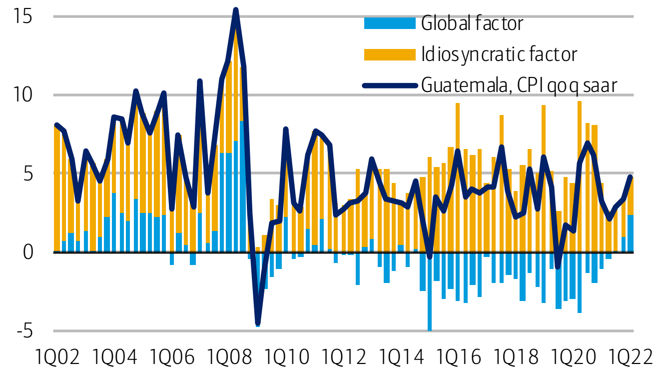
Exhibit 20: Inflation dynamics in Guatemala not driven global factors
The idiosyncratic factor explains most of the inflation variance



Source: BofA Global Research

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Fiscal policy: Strongest pillar of economy

Policy ethos: Discipline

Fiscal discipline is a distinctive feature of current and past Guatemalan governments, despite the lack of an explicit mechanism to anchor fiscal policy. Moreover, policymakers seem very adamant to not hike taxes. These features of the fiscal policy framework are consistent with the development model of the country which is based on conservative economic policy management and a small government.

Expect fiscal deficits in vicinity of ~2% of GDP

We expect the fiscal deficit to widen to 2.4% of GDP in 2022 from an exceptionally small 1.2% deficit in 2021. We believe the primary balance will come in at a small deficit of 0.9% of GDP in 2022, from a 0.6% surplus in 2021. The government's interest expenditures are relatively small (1.5% of GDP for 2022 in our scenario); in stark contrast with CAC peers such as Costa Rica, El Salvador and DomRep where debt service absorbs a large share of the government budget.

The fiscal balance improved during the first months of the year (trailing 12-month fiscal balance stands at -1.0% of GDP in May, with a primary surplus of 0.7% of GDP, see Exhibit 22). But we expect this trend to reverse towards year-end. The deficit will widen due to fuel subsidies, transfers, dropping out of 2021 one-off revenues (tax paid over the sale of a large telecom company), and moderating tax revenue growth.

Fuel subsidies as social relief measure, amid high inflation

We expect a relief package to alleviate households from the cost of soaring inflation to increase spending by around 0.8% of GDP in 2022. The package includes energy subsidies and infrastructure expenditures. As a matter of fact, total expenditure rose 15.5% yoy in the January-June period, while transfers (including subsidies) were up 49.4% yoy.

Revenues outperforming 2022 budget

Tax revenues continue to outperform compared to budget estimates. Imports' VAT and tariff collections are posting particularly strong numbers. The Ministry of Finance highlights that the improvements in customs enforcement are supporting higher tax revenues. Total revenues increased 16.8% yoy in 1H22, 20% above the 2022 budgeted amounts.

Revenue growth will likely moderate in coming quarters

Revenues will probably be affected by the moderation of GDP growth. Also, we note that the government received extraordinary revenues in late 2021 (taxes paid over the sale of a large telecom company's assets, about 0.2% of GDP) that is unlikely to be repeated.

Exhibit 21: Guatemala 's fiscal position has track-record of small deficits and disciplined policies
We forecast the fiscal deficit at 2.4% of GDP in 2022

	2014	2015	2016	2017	2018	2019	2020	2021	2022F	2023F	2024F
Overall Balance (%GDP)	**-1.9**	**-1.5**	**-1.1**	**-1.4**	**-1.9**	**-2.2**	**-4.9**	**-1.2**	**-2.4**	**-2.0**	**-1.8**
Primary Balance	**-0.4**	**0.1**	**0.4**	**0.1**	**-0.4**	**-0.6**	**-3.2**	**0.6**	**-0.9**	**-0.5**	**-0.4**
Revenues	**11.7**	**11.1**	**11.5**	**11.4**	**11.3**	**11.2**	**10.7**	**12.4**	**12.1**	**11.9**	**11.9**
Tax Revenues	11.0	10.4	10.8	10.8	10.7	10.5	10.1	11.7	11.5	11.3	11.3
Non Tax	0.7	0.6	0.7	0.6	0.6	0.7	0.6	0.6	0.6	0.6	0.6
Expenditure	**13.6**	**12.6**	**12.6**	**12.8**	**13.2**	**13.4**	**15.6**	**13.5**	**14.5**	**13.9**	**13.7**
Goods and services	6.3	5.9	5.7	1.4	1.6	1.5	1.7	2.1	2.1	2.1	2.1
Compensation	4.1	4.2	4.1	4.2	4.2	4.4	4.6	4.3	4.2	4.2	4.2
Interests	1.5	1.6	1.5	1.5	1.5	1.6	1.7	1.7	1.5	1.5	1.4
Subsidies and transfers	2.9	2.8	3.2	3.3	3.3	3.2	4.6	3.0	3.7	3.5	3.4
Capital	3.0	2.2	2.2	2.3	2.6	2.7	3.0	2.4	2.9	2.6	2.5

Note: Government published a deficit estimate of 2.4% of GDP in the public finances report for May 2022. **Source:** BofA Global Research, Haver, MoF

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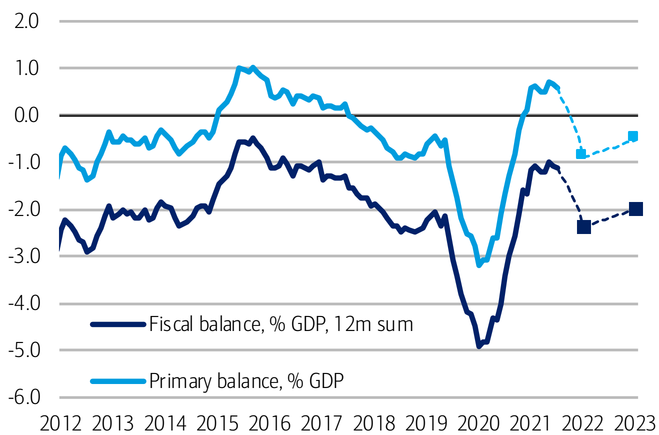
Fiscal support against fuels shock: 0.8%-of-GDP package

The commodity prices shock, exacerbated by the Ukraine war, led the government to implement an economic support program, consisting of fuel subsidies and infrastructure expenditures, totaling 0.8% of GDP for 2022.

In March, Congress approved some modifications to the budget and increased the expenditure by GTQ 4.5bn (0.6% of GDP) to include the gasoline subsidies. The government also included more funds for infrastructure projects, with most of the resources going to roads maintenance. Support for propane gas (used for cooking) and electricity consumption was also included.

At the end of May, the fuel subsidies were extended until August and Congress approved another modification to the 2022 budget. We expect the fuel subsidies to total 0.4% of GDP between March and August, and around 0.6pp of GDP for the full year.

Exhibit 22: Trailing 12 months government balance
Public finances to over perform budget estimates on higher than expected tax revenues



Source: BofA Global Research, Haver, MoF,

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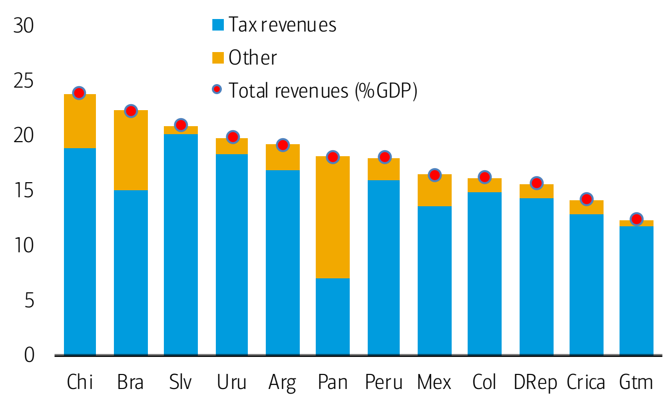
Exhibit 23: Fiscal revenues as % of GDP in 2021
Guatemala with one of the lowest government revenues in the LatAm region



Source: BofA Global Research, Haver

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The government has not adjusted its debt issuance forecasts because they expect to cover the increased funding needs with the deposits generated past year (Treasury deposits increased by GTQ11.9bn in 2021).

In 2021, government revenues came in well above the budget estimates, reducing the budget deficit, but the government still captured the budgeted amount of financing (with the exception of the central bank financing). For this reason, the government accumulated 1.8% of GDP in the cash balances despite the primary surplus was only 0.6% of GDP.

Fiscal flexibility: withdrawal of pandemic expenditures

Government has withdrawn bulk of pandemic-related expenditures

Guatemala spent about 3.3% of GDP in pandemic-related expenditures, which as of now have been largely withdrawn (except for some spending in health and vaccines, 0.4% of GDP). The appendix, at the end of the report, has the details of the main fiscal measures implemented by the government to face the COVID-19 shock.

To be sure, very few countries in LatAm have managed to withdraw the bulk of the pandemic-expenditures. To us, this reflects the flexibility that the Guatemalan government has to manage fiscal policy.

Fiscal austerity has a social trade-off

Low social spending is inhibiting the development of human capital

The trade-off that the Guatemalan government has faced for implementing fiscal austerity is that social and infrastructure expenditures have been low throughout the years, inhibiting the development of human capital. The social contract in Guatemala seems to be one in which the government does not interfere much with the private sector, but its people cannot expect much from the quality of public services.

Looking at the Human Development Index (HDI), published by the United Nations Development Programme (UNDP) (a summary measure of average achievement in a long and healthy life, being knowledgeable and have a decent standard of living), Guatemala ranks among the lowest in the LatAm region, only above Nicaragua, Honduras and Haiti (Exhibit 25).

In addition, stunting prevalence for children under 5 is at 42.8% according to the World Bank, the highest in LatAm, followed by Ecuador and Haiti. The prevalence of stunting is the percentage of boys under age 5 whose height for age is more than two standard deviations below the median for the international reference population (Exhibit 24).

Guatemala has the potential to solve the historical social and infrastructure gaps as it has space to increase debt and public investment, in our view, though an agreement is needed between the government and the strong private sector if the country wants to change its development model. Structural reforms to increase tax revenues, reduce informality, improve governability, accountability and transparency are also needed. If implemented, they could also help attract foreign direct investment (FDI).

Guatemala may be the counterfactual of Costa Rica

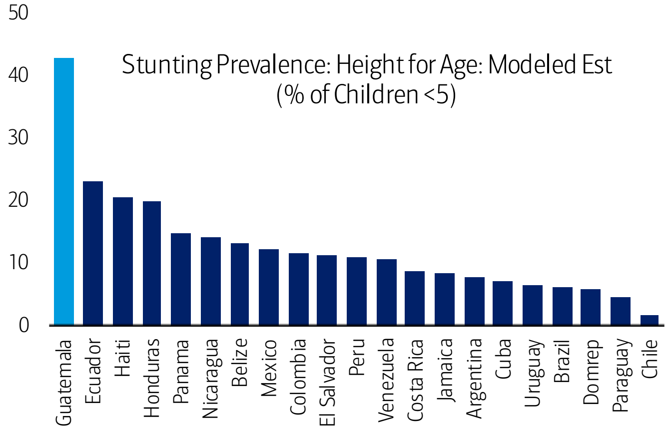
Costa Rica's experiment: sacrificed fiscal stability for the sake of human capital

Perhaps one can think of Guatemala as the counter-factual of Costa Rica, where the government sacrificed the fiscal position for the sake of upgrading its human capital.

Costa Rica's public debt ratio doubled, lost IG, and ended up asking IMF for help

In 2011 Costa Rica approved a constitutional amendment whereby the government was mandated to spend 8% of GDP on education every year. Also, spending in government workers' compensation increased substantially, with the objective of educating a better-trained cadre of public servants. Since then, however, the public debt ratio more than doubled, reaching almost 70% of GDP. Costa Rica lost investment-grade status, and later had to seek an IMF program in 2021 to avoid a sovereign debt default.

Exhibit 24: Stunting prevalence in children under 5 years
Stunting prevalence in Guatemala is well above the rest of the LatAm region



Source: BofA Global Research, World Bank

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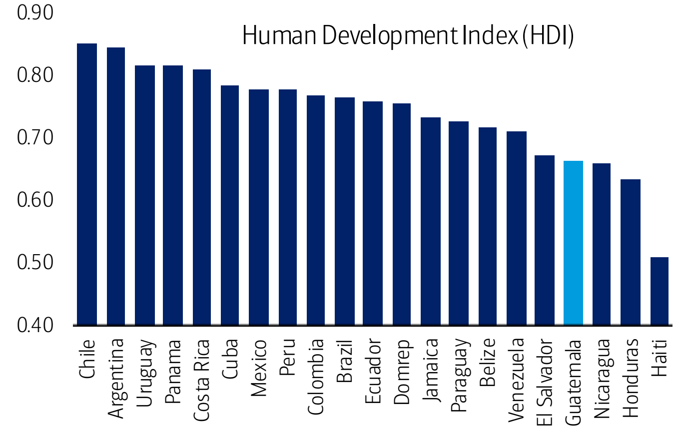
Exhibit 25: Human Development Index (HDI)
Guatemala has a low HDI compared to regional peers in LatAm



Source: BofA Global Research, UNDP

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Optimal policy mix must ensure strong macro conditions

Without macroeconomic discipline, an EM country faces the risk of an economic crisis. Latin America offers many examples. Costa Rica – one of the countries with the highest living standards in the region, the oldest democracy, above average education, low crime – is a case in point. But its government neglected fiscal discipline for a decade and is now under IMF emergency assistance. Guatemala has the opposite challenge. It has to build on its strong macro conditions to gradually improve the quality of public services and social development.

Debt: Lowest gross debt ratio in LatAm

Low public debt ratio reflects tradition of fiscal discipline

Guatemala has the lowest gross public debt ratio in the LatAm region (Exhibit 28), which is a testament of the fiscal discipline that characterizes Guatemalan policymakers. Its gross public debt stands at 30.3% of GDP, in the latest reading.

Caveats: government financial assets, low revenue base, other liabilities

If we focus on net debt – not gross – Guatemala's ratio is no longer the lowest

One important caveat is that if one considers government financial assets and subtracts them from gross debt – to calculate net debt – then Chile and Peru (both rated investment-grade) are in a better position than Guatemala. Guatemala does not have the lowest net debt in LatAm.

Public debt relative to tax revenues is not low

In the same spirit, Guatemala's gross public debt doesn't seem so low anymore if we compare it to tax revenues (250%). The narrow revenue base has often been pinpointed by rating agencies as one of the weaknesses of Guatemala.

Including other liabilities, public debt increases by more than 10pp of GDP

The government has liabilities to the central bank (pending capitalization contributions) and the pay-as-you-go social security institute (IGSS) in the form of contribution arrears to health services and pensions (Exhibit 34). If we add up these liabilities the gross public debt ratio jumps to 43.7% of GDP (from 30.3%). Notably, these liabilities are not accounted as part of public debt in the statistics published by the Ministry of Finance and the Central Bank (BANGUAT). See the Appendix for more details on contingent liabilities.

Rating agencies have constructive views on Guatemala: Closer to IG status

Guatemala is getting closer to investment grade status, though Guatemala's governance and low revenue base remain important challenges. Moody's rates Guatemala at Ba1, with a stable outlook (only one notch away from investment-grade). Fitch and S&P, in contrast, have Guatemala at BB-, two notches below Moody's, but with a positive outlook.

Public debt dynamics seem sustainable and stable

We expect public debt ratio to hover between 30%-31% of GDP in 2022-24

We expect the gross public debt ratio to fall slightly in 2022, to 30% of GDP (from 30.8% in the previous year). The improvement would come despite a deterioration in the primary fiscal deficit (by 1.3pp of GDP). In addition to abnormally high nominal GDP growth, which inflates debt away, we believe that the drawdown of cash balances will reduce the need for debt issuance. In our scenario, the government will use 0.6% of GDP of its cash balances to cover its 2022 funding needs.

Very low funding needs compared to LatAm peers

We estimate funding needs of 3.4% of GDP for 2022, and below 3% for 2023-24

We estimate funding needs for 2022 at 3.4% of GDP (exhibit 19). On the sources side, we believe the government will get 0.5% of GDP in external financing (largely multilaterals), 1.7% of GDP in domestic financing, and 1.2% of GDP from the drawdown of cash balances. The government accumulated 1.8% of GDP in cash in 2021, given that the fiscal balance outperformed the budget and the Treasury ended up over-financing.

Pipeline of multilateral loans

U$$ 500mn (0.5% of GDP) from World Bank in the offing

The government received Congress approval for a US$ 500mn loan from the World Bank. This disbursement should come soon. Another US$ 250mn loan from the World Bank still needs to be voted on by Congress. As well as a US$ 250mn loan from CABEI (Central American Bank for Economic integration).

US$ 400mn contingent credit line with IDB, in negotiation process

Moreover, the government is planning to sign a US$ 400mn contingent credit line with the IADB (Inter-American Development Bank), specifically to hedge against natural disasters.

Exhibit 26: Funding needs and sources

Funding for 2022 mostly comes external loans, domestic bonds and use of cash balances

	GTQ bn				% of GDP			
	2021	2022F	2023F	2024F	2021	2022F	2023F	2024F
Funding needs	**16.1**	**24.4**	**20.0**	**19.8**	**2.4**	**3.4**	**2.5**	**2.3**
Fiscal Deficit	7.8	17.1	15.6	15.3	1.2	2.4	2.0	1.8
Amortizations	8.4	7.3	4.4	4.5	1.3	1.0	0.6	0.5
External	2.9	6.9	4.4	4.5	0.4	1.0	0.6	0.5
Bonds	0.0	5.5	0.0	0.0	0.0	0.8	0.0	0.0
Loans	2.9	1.4	4.4	4.5	0.4	0.2	0.6	0.5
Domestic	5.4	0.4	0.0	0.0	0.8	0.1	0.0	0.0
Funding sources	**16.1**	**24.4**	**20.0**	**19.8**	**2.4**	**3.4**	**2.5**	**2.3**
External	8.2	3.9	7.7	2.1	1.2	0.5	1.0	0.2
Bonds	7.7	0.0	7.7	0.0	1.2	0.0	1.0	0.0
Loans	0.4	3.9	0.0	2.1	0.1	0.5	0.0	0.2
Domestic	19.9	12.1	12.3	17.7	3.0	1.7	1.5	2.1
Use of cash balances (+ = drawdown)	-11.9	8.4	0.0	0.0	-1.8	1.2	0.0	0.0

Source: BofA Global Research, Haver, MoF,

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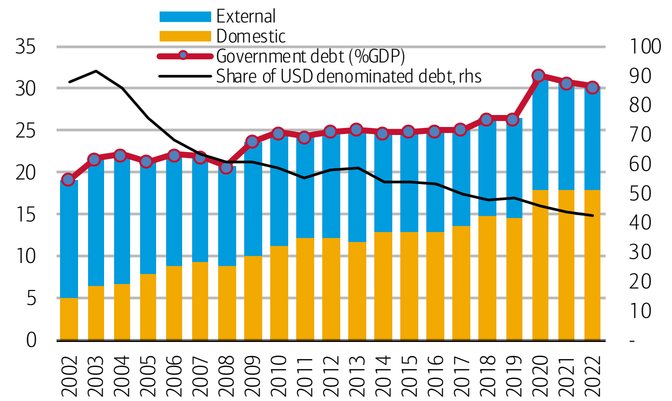
Exhibit 27: Debt composition shifted to domestic from external
Government debt at 30.3% of GDP in April 2022



Note: 2022 data as of April. **Source:** BofA Global Research, BANGUAT, MoF

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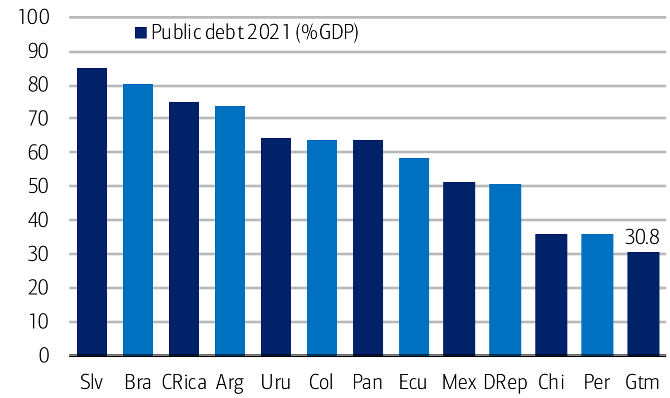
Exhibit 28: Gross public debt in LatAm region
Guatemala with one of the lowest debt-to-GDP ratio in LatAm



Source: BofA Global Research, Haver

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No Eurobond issuance in 2022; we expect US$ 1bn for 2023

We do not expect Guatemala to issue Eurobonds in 2022. We believe the Ministry of Finance was considering a US$ 1bn issuance in its initial financing plan, but will not come out to the markets under currently stressed condition for high-yield countries.

Debt is mostly domestic, dominated by local banks

Dollarization of public debt has fallen a lot, reducing vulnerability to FX shocks

Over the past 20 years, Guatemala's government has dramatically reduced the exposure of public debt to exchange rate fluctuations. Back in 2003, 70% of government debt was external, and 90% was denominated in US dollars. But that has changed a lot. Currently, the foreign currency share of debt is only 42.6%, and external debt represents 41%.

Almost half of public debt is held by local commercial banks

46% of government debt is held by local banks. They are, not doubt, the largest institutional investors in the local market. The pension system is run by the government, through the Social Security Institute (IGSS) which manages a pay-as-you-go fund.

Exhibit 29: Main holders of the government debt
Domestic banks play a very important role for government financing

	GTQ bn	USD bn	% of GDP	% total debt
Total govt debt	**206.2**	**26.9**	**30.3**	**-**
Domestic banks	94.8	12.4	13.9	46.0
Foreign bondholders	35.6	4.7	5.2	17.3
Multilaterals	35.5	4.6	5.2	17.2
Central Bank BANGUAT	15.3	2.0	2.2	7.4
Deposits insurance fund	5.3	0.7	0.8	2.6
Pension fund IGSS	14.9	1.9	2.2	7.2
Domestic insurance co	4.7	0.6	0.7	2.3

Source: BofA Global Research, MoF, Banguat, IGSS, Superintedencia Financiera

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Exhibit 30: Gross public debt dynamics for Guatemala
We foresee debt hovering between 30%-31% of GDP in coming years

	2021	2022F	2023F	2024F
Gross public debt (% of GDP)	30.8	30.0	30.1	30.4
Change in public debt (= -I + II + III)		-0.8	0.1	0.2
I) Primary balance (% of GDP)		-0.9	-0.5	-0.4
II) Automatic debt dynamics (a + b + c)		-0.8	-0.4	-0.1
a) Real interest rate		0.2	0.2	0.6
b) GDP growth		-1.0	-0.8	-1.0
c) Exchange rate		0.1	0.2	0.2
III) Other debt creating flows (= d)		-0.9	0.0	0.0
d) Use of cash balances		-0.9	0.0	0.0
Parameters				
Effective interest rate (%)		6.0	6.0	6.0
GDP growth (%)		3.7	3.0	3.4
Deflator (%)		5.1	5.1	3.6
Share of foreign currency debt (t - 1)		43.8	43.0	44.0
Exchange rate		0.5	1.8	1.4

Source: BofA Global Research, MoF

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Exhibit 31: External debt composition as of April 2022
Multilaterals play an important role in foreign financing

	US$ bn	% GDP
External debt	**10.9**	**12.4**
Eurobonds	6.3	7.2
2022*	0.7	0.8
2026	0.7	0.8
2027	0.5	0.6
2028	0.7	0.8
2030	0.5	0.6
2032	0.5	0.6
2033	0.5	0.6
2034	0.3	0.4
2041	0.5	0.6
2050	1.4	1.6
Multilateral	4.3	4.8
CABEI	0.7	0.8
IADB	1.9	2.2
IBRD-WB	1.7	1.9
Bilateral	0.3	0.4

Note: the 2022 Eurobond matured in June and the country got a 0.5bn loan from the IBRD-WB in May. **Source:** BofA Global Research, MoF

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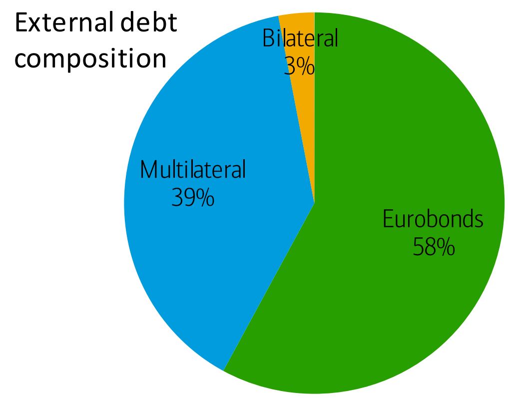
Exhibit 32: External debt composition as of April 2022
Multilaterals plays an important role in foreign financing



Source: BofA Global Research, MoF

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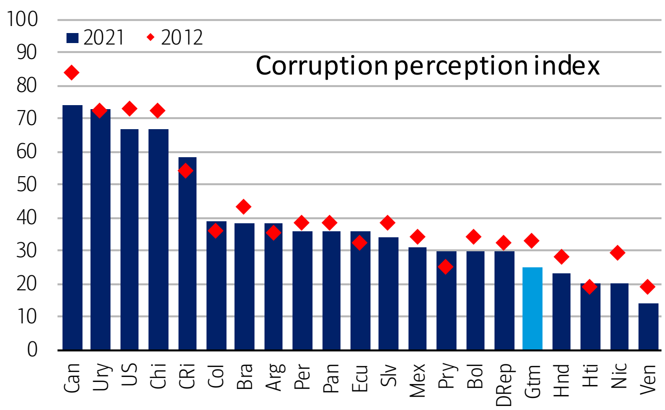
Exhibit 33: Guatemala's score in Transparency International's Corruption perception index worsened in the past 10 years
Corruption perception has made the population reluctant to any increase in the government size



Source: Transparency International

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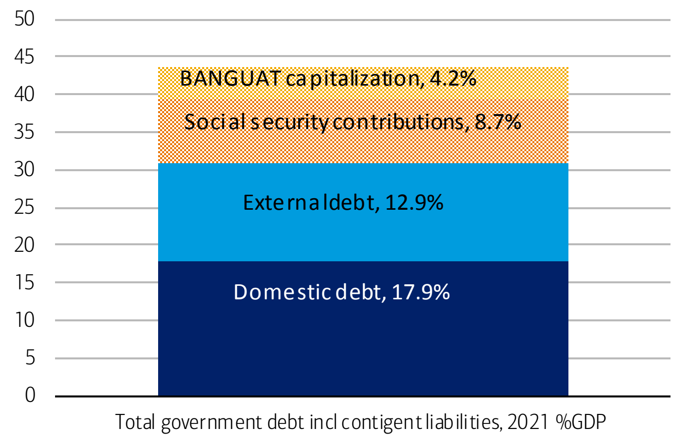
Exhibit 34: Guatemala's government debt including contingent liabilities
Total government debt jumps to 43.7% of GDP after including the debt with the BANGUAT and the IGSS



Source: BofA Global Research, BANGUAT; IGSS, MoF

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Monetary policy: In a tightening cycle

We expect BANGUAT to deliver 225bp of additional hikes

Board will probably step up the pace at next meeting

In our view, the Central Bank (BANGUAT) will hike the policy to 3.75% by the end of 2022, from the current level of 2.25%, at a pace of 50bp per meeting. This would imply stepping up the pace, as the board has only delivered two 25bp hikes so far (in May and June).

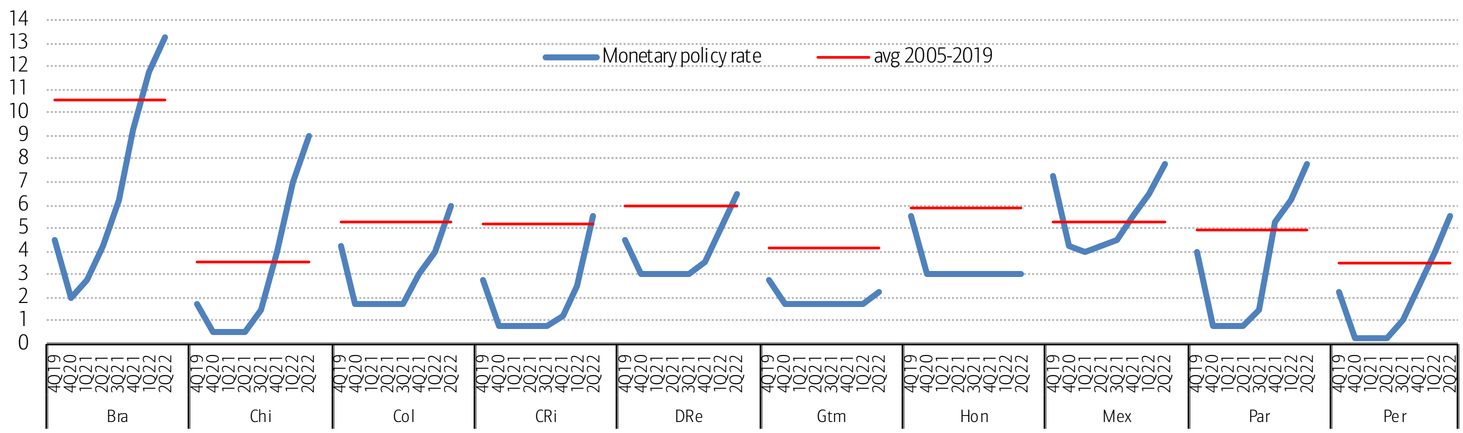
Spike in inflation is pushing the board to act

BANGUAT began the tightening cycle much later compared to the other LatAm inflation-targeting central banks. But inflation has recently spiked to the highest level since 2011 (7.6% yoy in June), putting pressure on the board to take action. BANGUAT's inflation targeting is 4%, with a 1pp tolerance range.

In the statement from the June 30 monetary policy meeting, the monetary board highlighted that the external shocks to fuel and food prices continue to generate increases in both inflation forecasts and inflation expectations for '22 and '23.

Exhibit 35: Monetary policy rates across the inflation-targeting countries of LatAm

Guatemala and Honduras are lagging the tightening cycle of the other inflation-targeting central banks



Source: BofA Global Research, Haver

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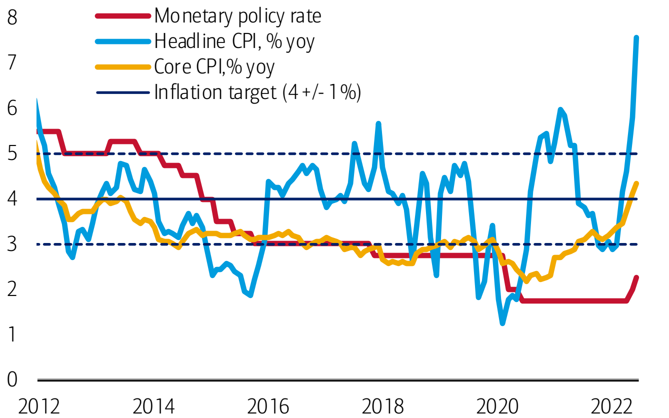
BANGUAT estimates real neutral rate around 0.5%

We foresee 75bp of additional hikes in 2023, in Q1, reaching a terminal rate of 4.50%. The policy rate would remain stable at 4.50% in 2024, according to our scenario, which we think would imply a neutral monetary policy stance.

Insulated by segmentation of rates and FX markets

We believe BANGUAT has more wiggle room to manage the tightening cycle than other LatAm inflation-targeting central banks because of the segmentation between the rates and FX market. Portfolio flows to Guatemala have little sensitivity to foreign interest rates, given that foreign ownership of local bonds is very low. Therefore, the Guatemalan Quetzal (GTQ) doesn't suffer much depreciation pressure from the monetary tightening in advanced economies. In fact, the GTQ is barely traded by foreign investors. And the Central Bank actively intervenes in the FX market, to smooth out the volatility of the exchange rate, which deepens the segmentation of the rates and FX markets even more.

Exhibit 36: Central bank began to hike on the back of high inflation
Inflation continues to accelerate despite fuel subsidies



Source: BofA Global Research, BANGUAT, Haver

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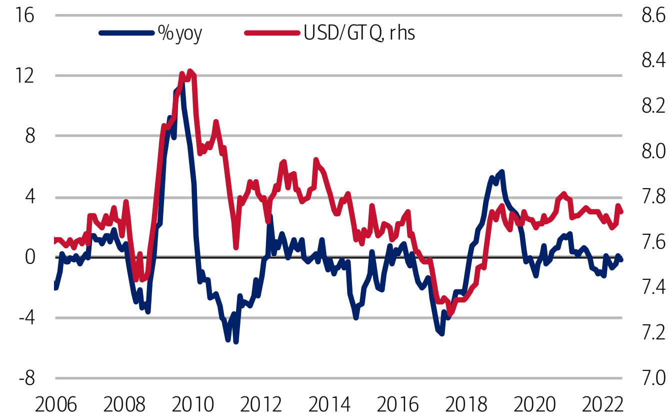
Exhibit 37: Exchange rate has been stable since 2018
FX stability is driven by stable fx flows and the intervention of the BANGUAT



Source: BofA Global Research, BANGUAT, Haver

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BANGUAT's FX policies: Reduce volatility, accumulate reserves

Rule-based and discretional interventions

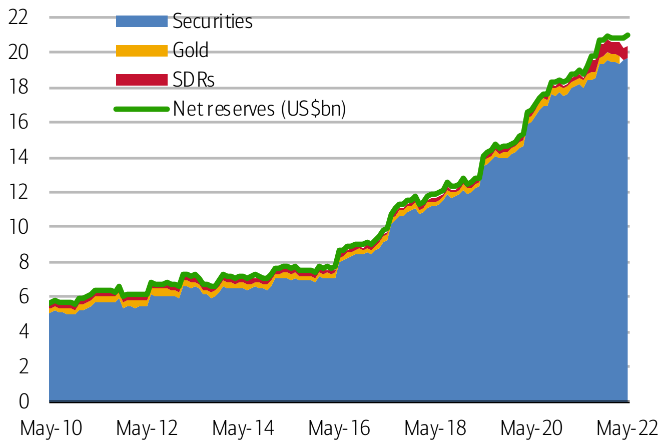
BANGUAT mainly intervenes in the foreign exchange market based on a rule-based framework that counteracts short-term volatility. They buy (or sell) up to US$ 10mn when the daily average USD/GTQ is below (above) 0.9% the average of the last five trading days. The threshold for the intervention rule was increased to 0.9% for 2022 from 0.85% in 2021 with the objective to give more flexibility to the exchange rate movements.

Of course, the central bank can also intervene in the FX market when they consider volatility to be unusual. They keep their options open and intervene discretionally when they consider it appropriate.

In addition, BANGUAT intervenes for reserve accumulation purposes. For example, in 2021 the central bank bought US$ 1.5bn for reserve accumulation. In 2022, the central bank has sold US$ 416mm due to the FX intervention rule and has bought US$ 1.5bn for reserve accumulation (Exhibit 40).

International reserves stand at US$ 21bn (23.8% of GDP), which is equivalent to 8 months of imports and greater than the total amount of government external debt (Exhibit 38). The investment portfolio of the Central Bank is concentrated in US government securities, government agencies, and supra-nationals (Exhibit 39).

Exhibit 38: Total reserves composition as of May 2022
Reserves total 21bn or 23% of GDP



Source: BofA Global Research, BANGUAT, Haver

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Exhibit 39:Composition of the reserves investment portfolio
Investments concentrated in US government securities

	US$bn	% of total
Securities	19.36	93.3
US govt	6.85	33.0
Govt agencies	4.58	22.0
Foreign govts	0.11	0.5
Supranationals	3.46	16.7
Banks	2.96	14.3
Mortgages	1.27	6.1
Cash	0.13	0.6
Gold	0.43	2.1
SDrs	0.74	3.5
Other	0.23	1.1
Total	20.76	

Source: BofA Global Research, BANGUAT, Haver

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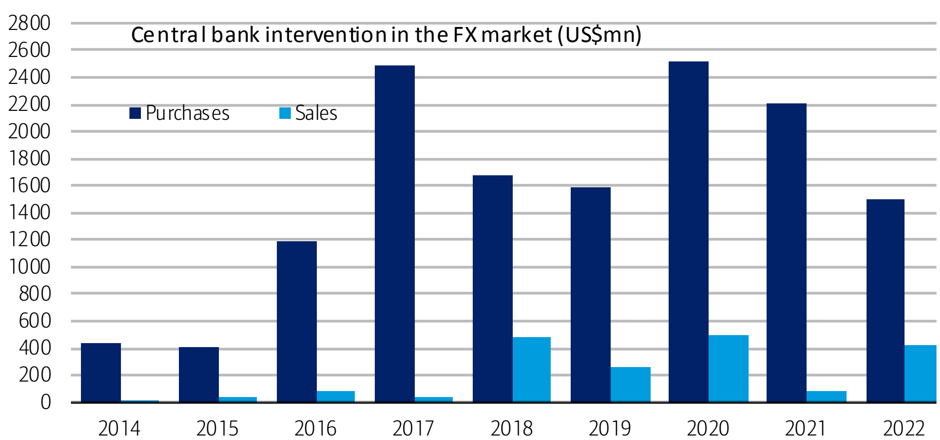
Exhibit 40: Central bank intervention in the FX market (US$mn)
In 2022, the central bank has sold 416mm due to the FX intervention rule and has bought 1.5bn for reserve accumulation



Note: 2022 data up to July 19. **Source:** BofA Global Research, BANGUAT

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Constitutional prohibition to finance the government

Guatemala's constitution prohibits BANGUAT from financing the government. But there is an exception in case a calamity or public disasters.

During the COVID-19 pandemic in 2020, the Congress approved a decree to allow the central bank to purchase government bonds for up to GTQ 11bn in the secondary market. The central bank ended up buying government bonds for GTQ 10.65bn (about 1.8% of GDP). This was indirect financing (secondary market), which nevertheless helped to reduce the government's borrowing costs.

Real exchange rate seems undervalued

Guatemala has been running large current account surpluses

Guatemala has been running current account surpluses for the past six years. The surplus was sizable in the past three years (2.4% of GDP in 2019, 4.9% of GDP in 2020, and 2.5% of GDP in 2021). For 2022, we forecast a surplus of 1.6% of GDP.

BANGUAT's reserve accumulation has repressed GTQ appreciation

In our view, BANGUAT's interventions to accumulate international reserves have kept the GTQ at competitive levels, but may have induced an undervaluation of the exchange. Notably, one of the seven seats of BANGUAT's board is occupied by one representative of the business associations. It seems like BANGUAT has some aversion to GTQ appreciation.

We estimate that the real exchange rate is undervalued by around 10%

To estimate an equilibrium exchange rate, we use our proprietary Compass FX model to calculate the exchange rate that would bring the current account back to its estimated equilibrium. We calculate a current account misalignment of 1.4pp of GDP. The Compass FX model indicates that the real exchange rate needs to appreciate by 10% to take the current account to its equilibrium level.

We forecast current account surpluses that average 0.9% of GDP in the period 2022-2024. Our Compass FX model estimates Guatemala's current account norm at -0.5% of GDP. A high population growth rate, low relative-to-US GDP per capita, and large net fuel imports push the equilibrium current account in the deficit direction.

BANGUAT and IMF also argue the real exchange rate is undervalued

BANGUAT's models suggest the real exchange rate was undervalued between 3% and 6% in 1Q2022. In the same vein, the IMF's article IV from June '22 says that the undervaluation is estimated at 16%. Although the IMF also presents the results of other models which show the opposite conclusion (overvaluation).

Undervaluation seems moderate, so it shouldn't create major macro problems

Having an undervalued exchange rate can stimulate activity (it attracts tourists because the country is cheap, exports become more competitive, etc). However, it can also be risky (financial instability, inflation, house price bubble, among other issues). In the case of Guatemala, we believe the evidence points to a moderate misalignment that shouldn't create large macro distortions.

We forecast a slightly weaker GTQ for the next years

In our scenario, the USDGTQ exchange rate will be at 7.75, 7.90, and 8.01 by the end of 2022, 2023, and 2024, respectively. Given that we expect inflation in Guatemala to be significantly higher than in the US, the small nominal depreciations of the GTQ are conducive to an appreciation of the real exchange rate. If that is the case, then the undervaluation that we explained in the previous paragraphs of the report would correct somewhat.

Financial system: Dominated by banks

Banks account for over 90% of financial system's assets

The Superintendence of Banks is the main regulator of the financial system. It regulates 93 financial institutions with total assets of GTQ 491bn (72% of GDP). The 17 regulated banks represents 90.6% of the financial system assets.

Low credit penetration: Room to improve

Credit to private sector increased to 38.5% of GDP in 2022, from 28% in 2012, but is still low compared with regional peers. High labor informality and the difficulties to bring financial services to the rural population are among the main challenges to increasing credit penetration.

Credit is growing fast

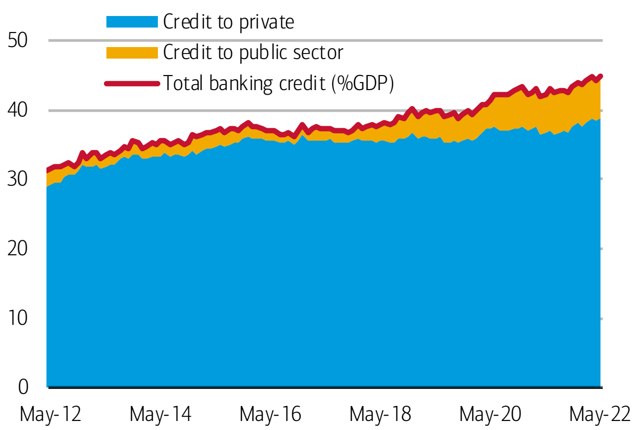
Credit to the private and public sector is increasing at an annual rate of around 15% but we expect it to decelerate in coming months as the domestic and external rates increase the cost of credit.

Financial system is partially dollarized

Credit in foreign currency is 32% of the credit to the private sector (mostly to companies rather than individuals), while deposits in foreign currency represent 22% of total banking deposits. Dollarization in Guatemala is a little bit lower than in Costa Rica and Dominican Republic, two other partially dollarized economics in the CAC region.

Exhibit 41: Total banking credit % of GDP

Credit penetration still low at 40% of GDP. Credit to public sector has increased in recent years



Source: BofA Global Research, Haver, BANGUAT

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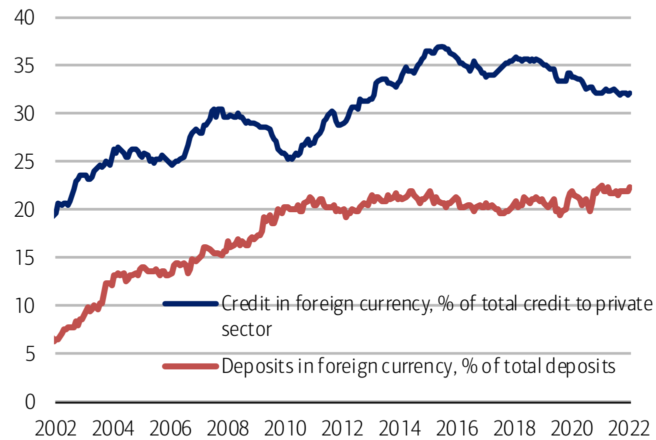
Exhibit 42: Dollarization of credit and deposits

Dollar credits and deposits are mostly owned by firms



Source: BofA Global Research, Haver, BANGUAT

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Deposit insurance is in place

The deposit insurance fund of the banking system was created in 2002 by decree 19-2002. It covers deposits up to GTQ 20,000 per bank account of individuals or firms.[1] The fund is managed by the central bank. It already intervened successfully three times in bank liquidations; in 2006, 2007 and 2019.

As of May 2022, the fund manages total assets of US $1.12bn. The investments portfolio of US$ 1.06bn includes US$ 0.69bn of government bonds and US$ 0.34bn of BANGUAT certificates of deposit. 5% of the portfolio is invested abroad and 13% is denominated in foreign currency.

[1] For more details in the deposits insurance fund see BANGUAT – Deposits insurance. For the latest financial statements see the Deposits insurance financial statements.

External accounts: Comfortable position

Current account surplus to shrink in 2022 and 2023

We expect the current account surplus to dampen in 2022 to 1.6% of GDP, down from 2.5% in 2021, driven by high import prices (particularly oil) and a slowdown in worker remittances. For next year, we believe the surplus will fall to 0.7% of GDP (Exhibit 44).

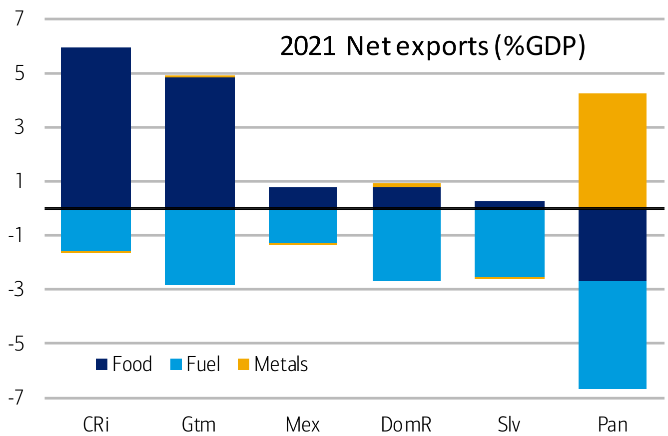
High oil prices exert negative pressure on current account

Guatemala is a net importer of fuels. We estimate that a 10% increase in oil prices deteriorates Guatemala's current account balance by 0.3pp of GDP. On the positive side, food prices reached historical high levels in recent months and this can have a positive impact on the external accounts, considering Guatemala is a net exporter of food (Exhibit 43).

Terms of trade shock is negative

Nevertheless, it is important to clarify Guatemala exports fresh food rather than grains. The price of the former have increased less than the latter. We believe the net effect of the commodity shock is negative. In fact, the latest data shows the level of the terms of trade (ratio of export prices to import prices) is falling 9% yoy. The main driver is oil.

Exhibit 43: Terms of trade shock is net-negative for Guatemala
Guatemala is a net oil importer and a net food exporter



Source: BofA Global Research, Haver. World Bank

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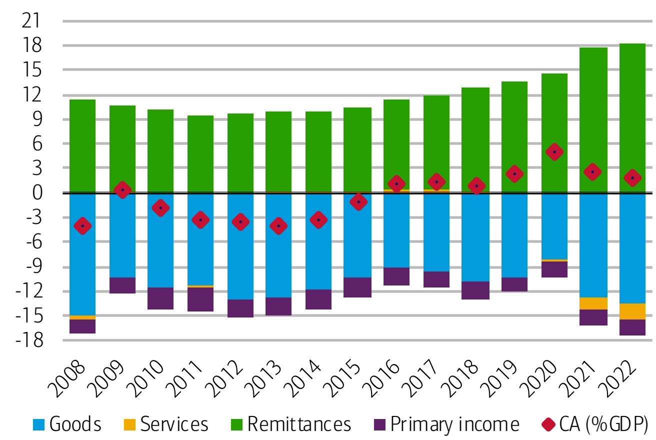
Exhibit 44: Current account has printed surpluses in recent years
Current account surplus has been supportive of the Quetzal and has allowed the BANGUAT to accumulate reserves



Note: 2022 data is the 4q sum up to 1Q22. **Source:** BofA Global Research, BANGUAT, Haver

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Tourism has medium-term upside

Tourism revenues are small, compared to CAC peers

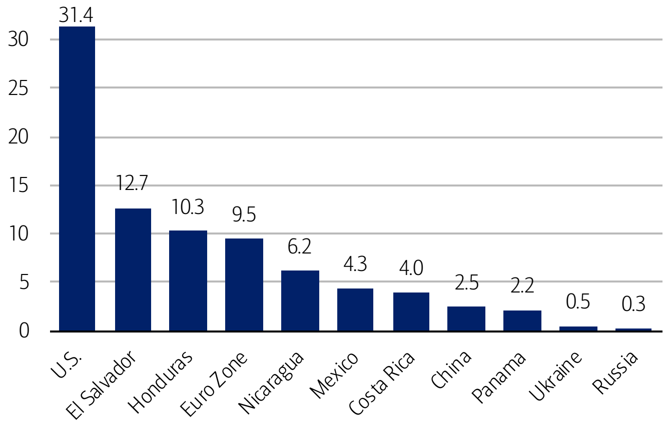
Tourism in Guatemala has a much lower weight in GDP compared with Costa Rica, Dominican Republic, Panama, and El Salvador. Last year, tourism revenues – recorded in the balance of payments – were barely 0.4% of GDP (Exhibit 49). Before the pandemic, they were 1.6% of GDP in 2019. For example, pre-pandemic tourism revenues in Costa Rica and Panama were around 6% of GDP in each country. In Dominican Republic it is significant at 8% of GDP.

Big potential to develop the tourism industry

Guatemala has the potential to increase the weight of tourism-related activities in the GDP and current account metrics, as it has access to both Pacific and Atlantic oceans, Mayan ruins and cities and towns with colonial architecture among other tourist attractions.

Then why does tourism activity have a low weight among the different GDP sectors? We think that the historical low investment in public infrastructure is one of the reasons as it has not contributed to the development of a proper road and overall transport system.

Exhibit 45: Main exports partners in 2021 (% of total exports)
US and CAC region are the main destinations, low exposure to Russia and Ukraine



Source: BofA Global Research, IMF, Haver

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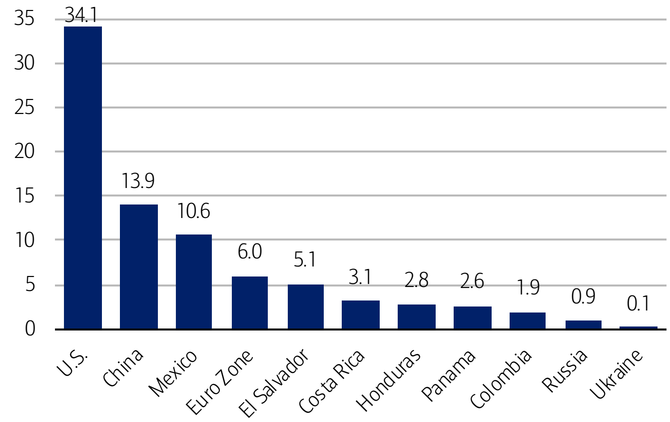
Exhibit 46: Main imports partners in 2021 (% of total imports)
US, China and Mexico are the main imports sources, low exposure to Russia and Ukraine



Source: BofA Global Research, IMF, Haver

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Exhibit 47: Main exports and imports by product in 2021
Clothes and textiles are the main export while fuels account for the main import

top 10 exports	US$mn	% Total exports	top 10 imports	US$mn	% Total imports
Clothes & textiles	1,933	14.2	Fuels	3,596	13.5
Bananas	962	7.1	Auto-related	2,192	8.2
Coffee	926	6.8	Electronic mach.	1,929	7.3
Edible oils	912	6.7	Plastic mfg.	1,708	6.4
Iron & Steel	596	4.4	Textiles	1,569	5.9
Pharmaceutical & cleaning	575	4.2	Chemicals	1,103	4.1
Plastic mfg.	540	4.0	Iron & steel	1,021	3.8
Cardamom	520	3.8	Pharmaceutical	994	3.7
Sugar	508	3.7	Pulp mfg.	925	3.5
Pulp & wood mfg.	493	3.6	Transmitters	867	3.3

Note: Source: BofA Global Research, BANGUAT, Haver

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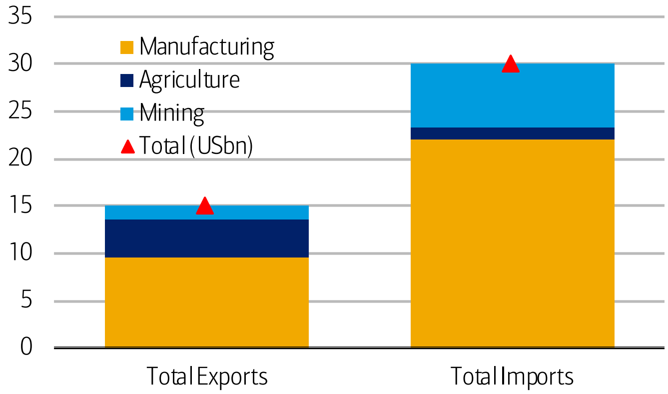
Exhibit 48: Exports and imports composition in 2022
Guatemala exports and imports mostly manufacturing goods-



Note: 12-month sum up to May 2022 **Source:** BofA Global Research, IMF, Haver
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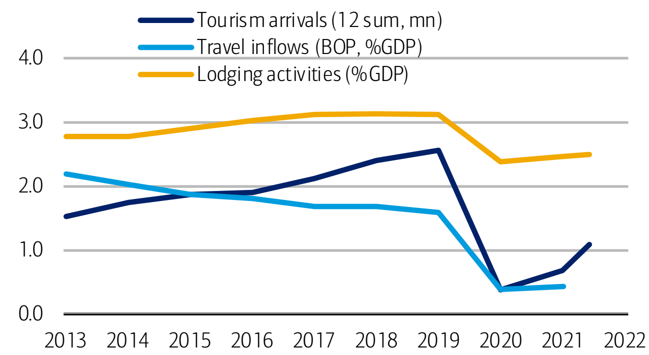
Exhibit 49: Tourism sector lagged the recovery in 2021
Tourism activity still has room to improve to reach prepandemic levels



Source: : BofA Global Research, BANGUAT, Haver, INGUAT
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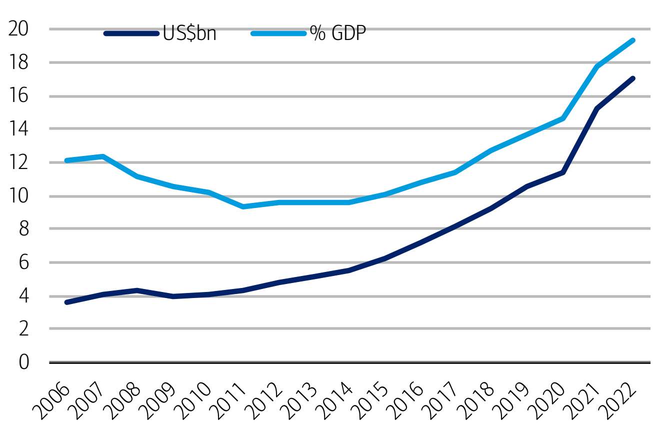
Guatemala's remittances inflows: among largest in LatAm

Record high remittances in 2021 were one of the drivers of the extraordinary GDP growth rebound that Guatemala experienced after the COVID-19 shock. The 12m-sum of remittances stands at US$ 17bn or 19.3% of GDP in June and we expect remittances to total about US$ 18bn by December 2022 (Exhibit 50).

While the deceleration of the US economy will likely moderate the remittances inflows from existing migrants, remittances could benefit from a larger Guatemalan diaspora in the US. According to the U.S. Customs and Border Protection (US CBP) data, the irregular migration flows in the first months of the FY 2022 were slightly above the 2021 levels (Exhibit 51).

There are about 1.7mn of Guatemalans in the US, according to the 2019 American Community Survey (Exhibit 52). The Guatemalan population is concentrated in California, Florida and Texas according to Pew Research.

Exhibit 50: Remittances at record high level
The 12m sum stands at US$17bn or 19.3% of GDP in June



Source: BofA Global Research, BANGUAT, Haver
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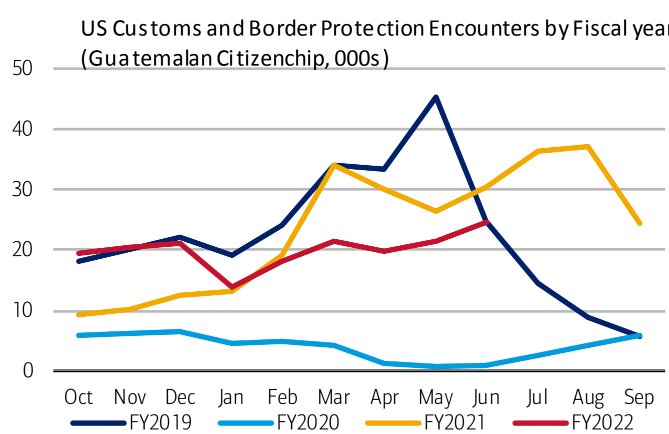
Exhibit 51: Irregular migration flows remain high in 1H22
Migration flows are supportive for remittances



Source: U.S. Customs and Border Protection
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Exhibit 52:Hispanic or Latino origin by specific origin
There are 1.68 mn of Guatemalans in the US according to the 2019 American Community Survey

	Hispanic or latino origin (mn)
Cuban	2.38
Salvadoran	2.31
Dominican	2.09
Guatemalan	**1.68**
Honduran	1.08
Nicaraguan	0.43
Panamanian	0.19
Costa Rican	0.17

Source: U.S. Census Bureau, 2019 American Community Survey 1-Year Estimates

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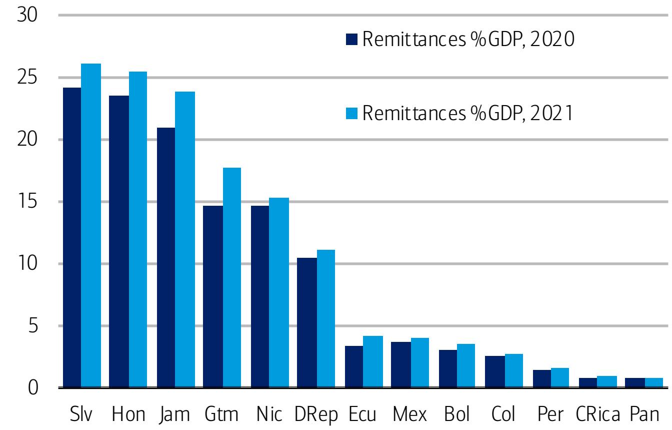
Exhibit 53: Remittances income in the LatAm region
Guatemala had an historical record high income from remittances in 2021



Source: BofA Global Research, Haver

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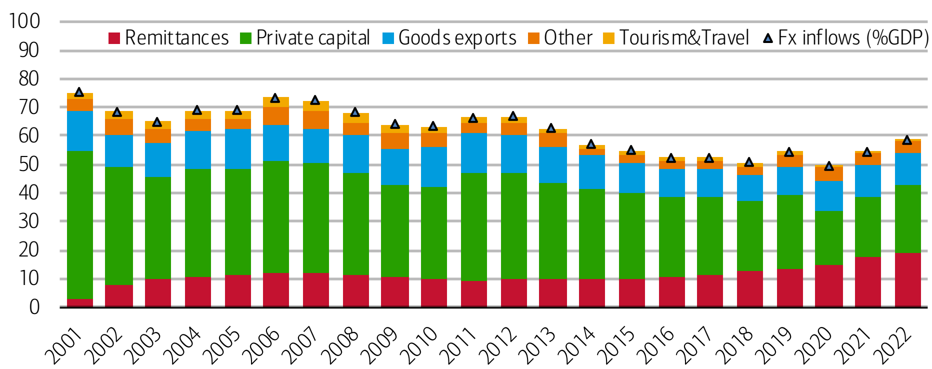
Exhibit 54: Foreign exchange inflows as % of GDP
Remittances is the second source of FX inflows



Note: Data for 2022 is the 12m sum up to May. **Source:** BofA Global Research

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FDI: Challenge to attract more investments

FDI has been historically low, at about 2% of GDP per year. In 2022 there was a strong inflow in the telecom sector (purchase of one of the largest firms in the market) and FDI ended the year at 4% of GDP. We expect the FDI to return to average levels, around 2% of GDP, in 2022.

US nearshoring: opportunity for expanding trade and FDI

Guatemala has a geographical advantage compared with other Central American countries, as it is pretty close to the US. A recent study from the IDB estimates that the LatAm region can potentially benefit with up to US$ 78bn of annual additional exports associated to US nearshoring in the medium term[2].

US Plan to Address Migration: Another opportunity

In 2021 President Biden signed an Executive Order for creation a plan to address the root causes of migration in El Salvador, Guatemala, and Honduras. VP Kamala Harris is leading the diplomatic efforts to promote it. The US government has committed US$ 4bn to fund the initiatives of the plan in the next four years, and is actively

[2] For more details on the potential near-shoring gains in LatAm, see [Nearshoring can add annual $78 bln in exports from Latin America and Caribbean | IADB]

encouraging US companies to investment in the Central American northern triangle countries[3].

VP Harris launched a Call to Action for the private sector and 12 companies committed to provide US$ 750mn in investments to create jobs. The strategy also seeks to counter corruption and any form of democratic backsliding.

In our view, the Biden administration's plan to address the root causes of migration will likely have implications for Guatemala, in the form of aid flows, financing, and private investment that support the economy.

Politics: Conservative political equilibrium

Possibly the most conservative country in LatAm

We believe the political equilibrium in Guatemala is strongly conservative, which is usually conducive to the implementation of disciplined fiscal and monetary policies. From that trail of thought, it is not surprising that Guatemala has strong macroeconomic indicators.

The opposite of Nicaragua's political equilibrium

Similar to several Central American countries, Guatemala had a long civil war, between the 1960s and the last peace agreement that was signed in 1996. Our perception is that the outcome of the civil war in Guatemala was the opposite than in Nicaragua, where the left-wing guerillas, the Sandinistas, prevailed and rule the country until this day.

In Guatemala, it was the conservative political establishment, the business elites, and the military which emerged with the upper hand from the civil conflict. Our view is that this outcome led to a political equilibrium where the business community has a very strong voice in national politics.

Young democracy

Guatemala has been a democracy since 1986 and holds legislative and presidential elections every four years. Nevertheless, its democracy has been shaken by events such as the dissolution of Congress in 1993, by President Serrano, roughly at the same time as Alberto Fujimori did it in Peru. Recall that the final peace agreement was not signed until the second half of the 90s decade. And more recently, the UN-sponsored International Commission against Impunity (CICIG) clashed with the political establishment and its term was not renewed.

Next presidential elections will be held in 2023

The next elections will take place in June 2023. In Guatemala there is no re-election of the president. Due to the fragmentation of the political system (19 parties represented in Congress) presidential elections are usually decided in a ballotage (second-round run-off). Based on the policies of the leading potential candidates, it is likely that the next government will maintain conservative economic policies. See the Appendix for a description of the main candidates.

Role of the Congress in public finances

Budget approval

In Guatemala, Congress is in charge of approving the annual budget of the nation. The Executive Branch must submit the budget bill to Congress 120 days before the beginning of the fiscal year (January 1st). Congress can approve, modify or reject the budget bill within the 30 days before the beginning of the fiscal year. If the budget is not approved, as happened in 2021, the previous year's budget enters into force.

[3] For more details on the US initiative to address the root causes of migration in Central America see [FACT SHEET: Strategy to Address the Root Causes of Migration in Central America | The White House]

Debt authorization, both domestic and external

All of the government's new debt needs to be approved by Congress, both domestic and external, by a simple majority (50% + 1). Extraordinary financing from the central bank to the government – in a scenario of public disaster (escape clause of Constitutional prohibition) – requires a 2/3 majority vote.

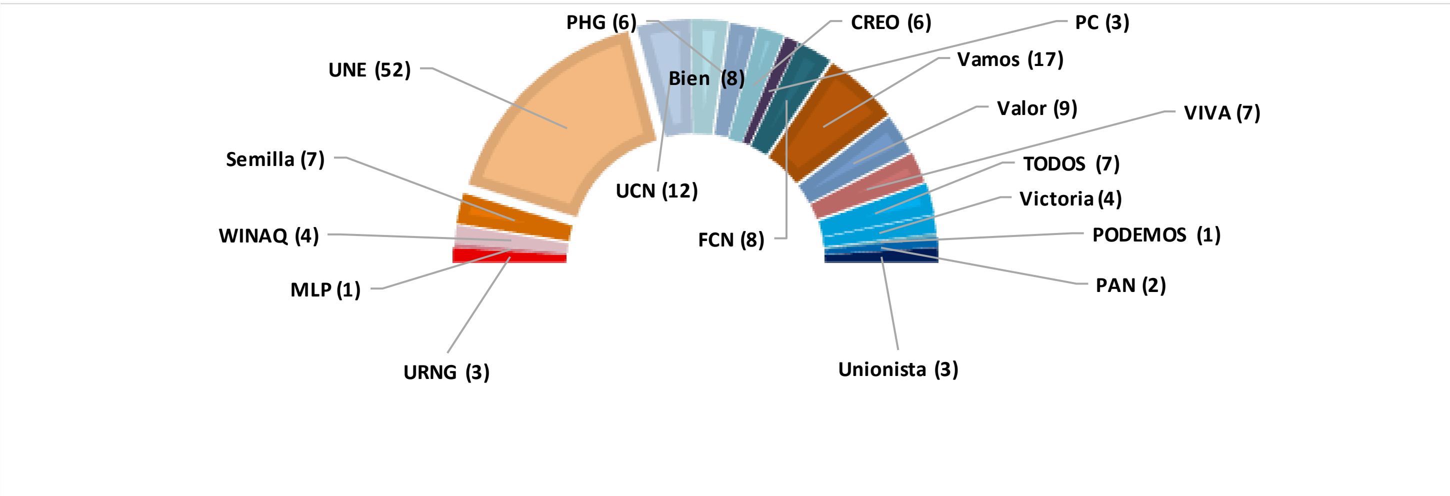
Congress can impeach ministers, including the Minister of Finance

Congress does not intervene in the appointment of the president's cabinet. But it has the authority to oust ministers with a simple majority vote (50% + 1).

Ruling party has working coalition in Congress

President Alejandro Giammattei's party, VAMOS, only has 17 out of 160 seats in Congress. But he has been able to form a relatively stable coalition with a UNE faction (the party to which Sandra Torres belongs), the UCN, and VALOR (led by Zury Rios).

Exhibit 55: nineteen political parties are represented in the fragmented congress
Government party VAMOS, only has 17 out of 160 seats in congress



Note Color or location in chart does not look to reflect the party ideology. **Source:** BofA Global Research

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Exhibit 56: Selected financial and macroeconomic indicators

Guatemala GDP growth will decelerate to 3.7% in 2022 after an strong rebound in 2021

	2014	2015	2016	2017	2018	2019	2020	2021	2022F	2023F	2024F
Summary Data											
Nominal GDP (US$ bn)	57.9	62.2	66.1	71.7	73.3	77.2	77.6	86.0	93.5	100.5	106.1
GDP per capita (US$)	3634	3826	3984	4236	4251	4389	4332	4712	5032	5310	5511
Economic Activity and Prices											
Real GDP growth (% yoy)	4.4	4.1	2.7	3.1	3.4	4.0	-1.8	8.0	3.7	3.0	3.4
CPI inflation (% yoy, eop)	2.9	3.1	4.2	5.7	2.3	3.4	4.8	3.1	8.1	5.0	4.0
CPI inflation (% yoy, avg)	3.4	2.4	4.4	4.4	3.8	3.7	3.2	4.3	6.3	6.0	4.4
Nominal exchange rate (vs USD, eop)	7.60	7.63	7.52	7.34	7.73	7.70	7.79	7.72	7.75	7.90	8.01
Nominal exchange rate (vs USD, avg)	7.73	7.66	7.60	7.35	7.52	7.70	7.72	7.74	7.72	7.83	7.95
Central bank policy rate (eop, %)	4.00	3.00	3.00	2.75	2.75	2.75	1.75	1.75	3.75	4.50	4.50
External Sector											
Current account balance (% of GDP)	-3.3	-1.2	1.0	1.2	0.9	2.4	4.9	2.5	1.6	0.7	0.5
Current account balance (US$ bn)	-1.9	-0.8	0.6	0.9	0.7	1.8	3.8	2.2	1.5	0.7	0.5
Trade balance (US$ bn)	-6.8	-6.4	-6.1	-6.8	-8.0	-8.0	-6.3	-10.9	-13.8	-15.3	-16.5
Exports, f.o.b. (US$ bn)	9.4	9.1	9.0	9.7	9.6	9.9	10.1	12.4	14.7	16.4	18.7
Imports, f.o.b. (US$ bn)	16.2	15.5	15.0	16.4	17.6	17.9	16.4	23.3	28.5	31.8	35.2
Services (US$ bn)	0.1	0.1	0.2	0.3	0.2	0.0	-0.3	-1.3	-1.4	-1.2	-1.2
Income (US$ bn)	4.8	5.6	6.5	7.4	8.5	9.8	10.4	14.4	16.8	17.2	18.3
Remittances (US$ bn)	5.5	6.3	7.2	8.2	9.3	10.5	11.3	15.3	17.6	18.2	19.3
International reserves (US$ bn)	7.3	7.8	9.2	11.8	12.8	14.8	18.5	20.9	22.8	24.5	25.8
Public Sector											
Central gov. primary budget balance (%GDP)	-0.4	0.1	0.4	0.1	-0.3	-0.6	-3.2	0.6	-0.9	-0.5	-0.4
Central gov. overall budget balance (%GDP)	-1.9	-1.5	-1.1	-1.4	-1.9	-2.2	-4.9	-1.2	-2.4	-2.0	-1.8
Central gov. revenues (% of GDP)	11.7	11.1	11.5	11.4	11.3	11.2	10.7	12.4	12.1	11.9	11.9
Debt Indicators											
Gross external debt (% of GDP)	37.3	35.8	35.3	34.9	33.4	31.8	32.5	31.2	30.8	30.8	30.9
Public (% of GDP)	13.2	12.9	13.1	12.4	11.9	12.7	15.1	14.7	14.2	14.3	14.4
Private (% of GDP)	24.1	22.9	22.2	22.4	21.4	19.1	17.3	16.6	16.6	16.6	16.6
Gross government debt (% of GDP)	24.8	24.9	25.0	25.2	26.5	26.5	31.6	30.8	30.0	30.1	30.4
Domestic (% of GDP)	12.8	12.9	13.0	13.7	14.9	14.7	18.0	17.9	17.4	17.5	17.7
External (% of GDP)	12.0	12.0	12.0	11.4	11.5	11.8	13.6	12.9	12.6	12.6	12.7

Source: BofA Global Research, Haver, BANGUAT; MoF

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EXD Strategy

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Initiate Guatemala with Overweight recommendation

Investment grade style macroeconomic stability but with high-yield spreads

We initiate our coverage of Guatemala's external bonds (Ba1 Stable/BB- Positive/BB-Positive) with an Overweight recommendation. Guatemala's most attractive features are its macroeconomic stability, conservative fiscal management, low debt ratio, high level of international reserves (24% of GDP), and no need to issue externally in 2022.

When global uncertainty is elevated, investors tend to value countries with macroeconomic stability. We thus think that Guatemala's bonds should remain attractive in the currently uncertain global backdrop. Important risks to our view are social protests, governance, and relatively more limited trading liquidity.

Guatemala's external bonds: How do they compare to other BBs?

Guatemala's external bonds total $5.6bn in face value, spread across 9 issues, and with amounts outstanding between $330mn and $1.4bn per issue. Guatemala represents about 4% of the market value of BB-rated sovereigns (I1GV index).

Compared to the index of BB-rated bonds (I1GV), Guatemala has a one-notch higher credit rating (BB2 vs. BB3), lower average spread (349bp vs. 364bp), lower average coupon (5.2 vs. 5.4), and higher duration (7.5 vs. 6.6) (Exhibit 57).

Exhibit 57: Guatemala is rated one notch higher than index of BB-rated sovereigns, trades at tighter spreads and has higher duration
Key bond index indicators

Country	Rating	Yield	Coupon	Spread	Duration	Price	Face Value ($bn)	# of Issues
Brazil	BB2	5.7	5.2	281	6.7	91	36	16
Azerbaijan	BB1	5.2	4.3	239	4.2	93	3	3
Paraguay	BB1	6.1	4.6	315	8.9	86	6	9
Guatemala	**BB2**	**6.4**	**5.2**	**349**	**7.5**	**90**	**6**	**9**
BB-Rated Sovs	**BB3**	**6.6**	**5.4**	**364**	**6.6**	**89**	**133**	**92**
Morocco	BB1	7.0	3.7	405	9.6	72	4	4
Colombia	BBB3	7.2	4.8	427	8.0	79	32	17
South Africa	BB3	7.2	5.5	420	6.8	85	22	15
DomRep	BB3	7.9	5.9	495	7.1	83	25	15

Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Note: Colombia is not part of the ICE BB-rated index (I1GV) because its average credit rating rounds up to BBB3. We include Colombia for comparison purposes since it has two BB1 ratings.

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Guatemala outperformed during recent periods of high global uncertainty

Guatemala's external bonds have outperformed when global uncertainty was very high, such as during the outbreak of the pandemic in March 2020 and the start of the Russia-Ukraine conflict in February 2022. Currently, Guatemala's external bonds are trading about 15bp tighter than BB-rated sovereigns, as measured by the respective ICE indices (Guatemala is rated one-notch higher than the index and has positive outlooks from two agencies).

Guatemala traded as much as 160bp tight to BBs during COVID shock

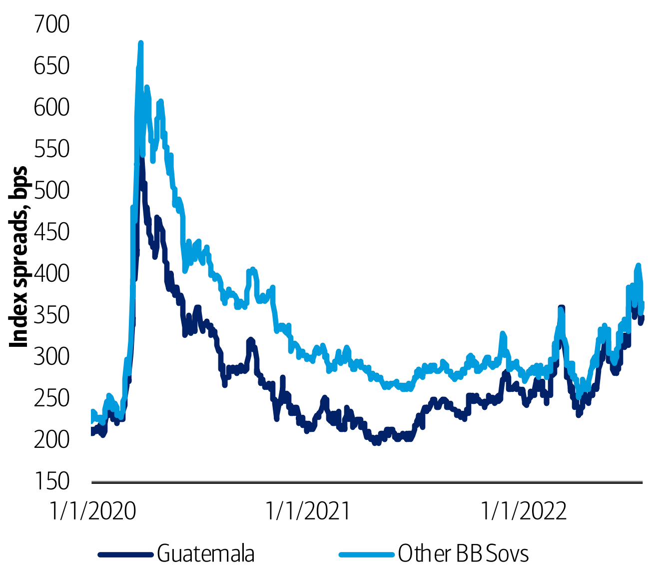
When the pandemic broke out in March 2020, Guatemala outperformed and moved from 10bp tight vs BB-rated sovereigns to 160bp tight vs BBs (Exhibit 58, Exhibit 59). Over time, this outperformance eroded as global uncertainty declined. This erosion of Guatemala's outperformance happened despite Guatemala's strong macroeconomic performance during the pandemic, such as experiencing a relatively small 2020 recession and quick recovery in fiscal metrics.

Guatemala outperforming again since Russia-Ukraine conflict

Since the outbreak of the Russia-Ukraine conflict, Guatemala has outperformed again, with spreads moving from about flat to BBs to as much as 40bp tight to BBs (though bonds remain much wider than at the height of the COVID-19 shock).

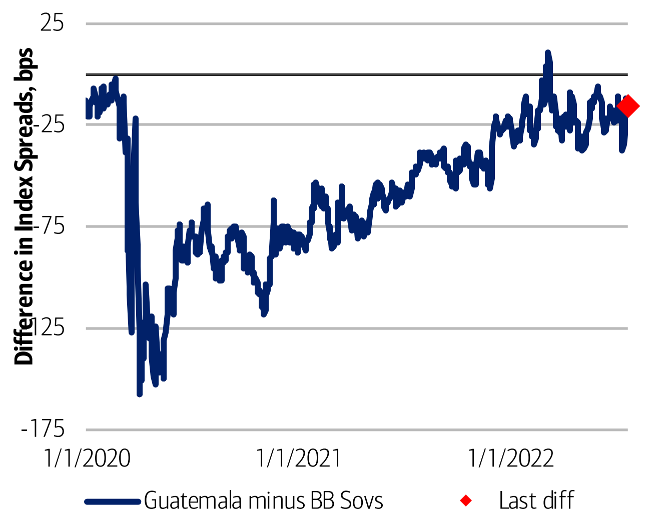
Note that Guatemala is actually a terms-of-trade loser from the conflict, given that it is a net energy importer (though a significant share of its electricity is hydroelectric) and its exports mostly fresh foods but not commodity grains. We think this bond outperformance reflects a preference for Guatemala's history of stable macroeconomic indicators.

Exhibit 58: Guatemala's spreads widened less than BB-rated sovereigns when the pandemic started in early 2020
Index spreads of Guatemala and BB-rated sovereigns



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg.
BofA GLOBAL RESEARCH

Exhibit 59: Guatemala's COVID outperformance eroded over time, but it began outperforming again after the Russia-Ukraine conflict started
Index spreads of Guatemala and BB-rated sovereigns



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg.
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Macro stability and fiscal policy back to pre-pandemic levels

The main credit positives for Guatemala are its macroeconomic stability and conservative fiscal policy, which have contributed to its low debt ratio.

Guatemala stands out as one of the few commodity-importing EM countries where fiscal deficits, both primary and overall, have already returned to pre-pandemic levels (we expect some widening of the deficit into year-end, but the full-year deficit for 2023 is expected to be very similar to 2019's deficit). The economy has also returned to its pre-pandemic growth trend, despite relatively contained fiscal stimulus in 2020. Moreover, Guatemala's growth has historically been above the LatAm median, but with lower volatility.

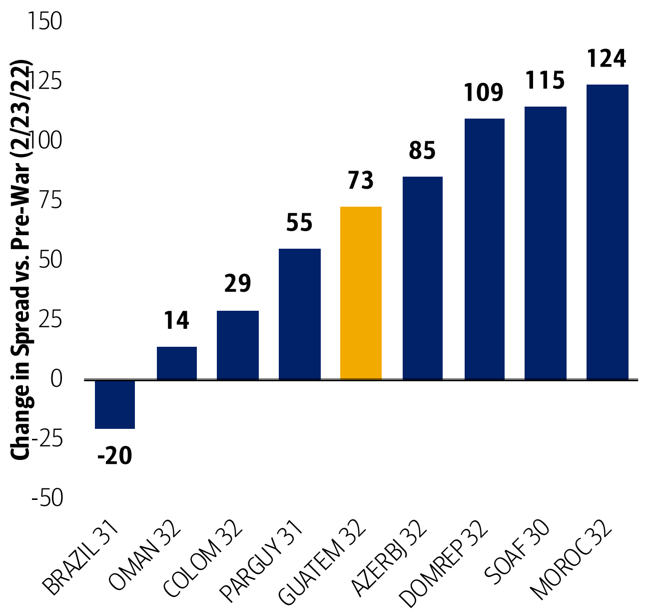
Guatemala's current account surplus is another advantage in an environment where financing wide current account deficits has become much more difficult. Countries with wide current account deficits, such as Chile and Colombia, are experiencing greater downward pressure on their currencies.

Focus on conservative fiscal policies, not just the low debt ratio

Guatemala's low and stable debt ratio is an important credit positive, but we think it is more important to focus on Guatemala's historically conservative fiscal management and aversion to indebtedness than to simply take comfort in its low debt ratio.

It could be misleading to rely just on Guatemala's low debt ratio because Guatemala's capacity to carry debt is likely lower than many LatAm peers. It would be difficult for Guatemala to sustain a large debt ratio due to its low institutional capacity and historical unwillingness to increase tax revenue. Moreover, the high labor informality makes it difficult to expand the tax base even if there were political willingness.

Exhibit 60: Guatemala outperformed and widened less than many BB-rated sovereigns since outbreak of the Russia-Ukraine conflict
Change in 10y external bond spread



Source: BofA Global Research, Bloomberg.

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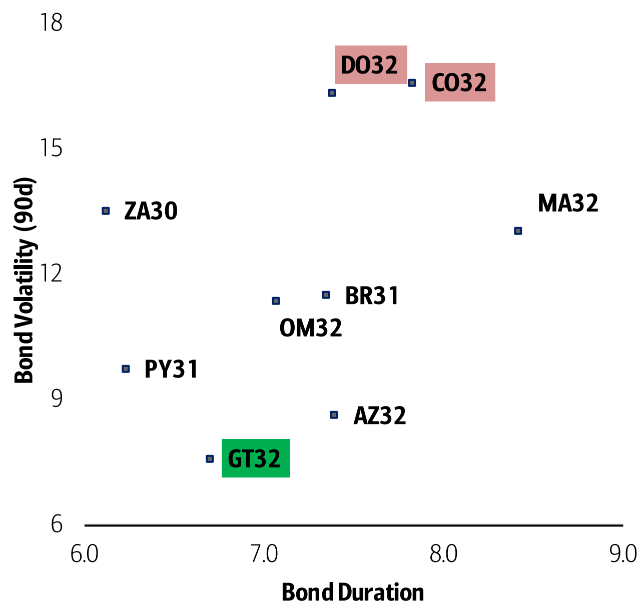
Exhibit 61: Guatemala's bonds recently experienced lower volatility recently relative to their duration
Bond volatility (90 days) vs. bond duration for 10y bonds



Source: BofA Global Research, Bloomberg.

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High reserves and current account surplus mitigate risk of FX debt

We are comfortable with Guatemala's share of debt denominated in foreign currency (43% of the debt stock) given its current account surplus and high level of reserves (24% of GDP for Guatemala, among the highest in LatAm). Foreign reserves significantly exceed government debt in foreign currency (13% of GDP) and Guatemala's level of reserves compares favorably to CAC regional peers Dominican Republic (13%) and Costa Rica (9%).

Guatemala's share of FX debt has fallen over time, but it remains elevated in absolute terms and in comparison to larger LatAm issuers. But it compares more favorably to peers in the CAC region. Guatemala's share of FX debt is similar to Costa Rica's (42%) and much lower than Dominican Republic's (76%).

No need to issue external bonds in 2022

Although the government has the authorizations to issue external bonds in 2022, we believe they do not need to do it. Guatemala's ability to avoid issuing is an advantage in the current environment where there has been very limited issuance of high-yield bonds (and issuance has demanded high concessions). Demand from domestic investors, primarily local banks, for domestic debt reduces reliance on external financing. Local demand and low deficits are some of the reasons that Guatemala has historically been a relatively less frequent issuer in Eurobond markets (Exhibit 63).

Risks of bank ownership of domestic debt are mitigated by their long maturity

Typically, the high bank ownership of government bonds would be considered an important risk because banks tend to prefer short maturity bonds, they may not be long-term holders of debt compared to pension funds (private pensions funds do not exist in Guatemala), and because high bank holdings of government bonds could amplify a sovereign debt crisis.

In the case of Guatemala however, we are comfortable with this risk given Guatemala's currently low indebtedness, stable outlook for the debt ratio, and the relatively long maturity of domestic debt (similar to Eurobonds).

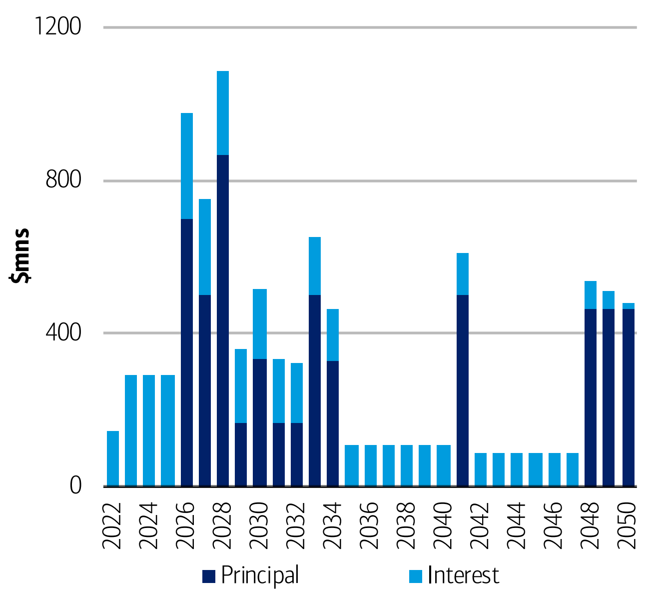
Manageable Eurobond maturity profile

We see Guatemala's Eurobond maturity profile as manageable. The next amortization is not until 2026 ($700mn, 0.8% of '22 GDP), which is the beginning of a maturity "hump" that spans 2026-2028 (total amortizations of $2.1bn, or $690mn per year on average) (Exhibit 62).

The amortizations due in those hump years are similar to the levels of primary market access that Guatemala has historically enjoyed. From 2019-2021, Guatemala issued $1.1bn per year of Eurobonds on average (Exhibit 63). Some of the recently-issued bonds are sinkers, which smooth out the amortizations and reduce rollover risk (Exhibit 66).

Exhibit 62: Eurobond bond amortizations are generally well spread out, but with a maturity "hump" in 2026-2028

Eurobond debt service



Source: BofA Global Research, Bloomberg.

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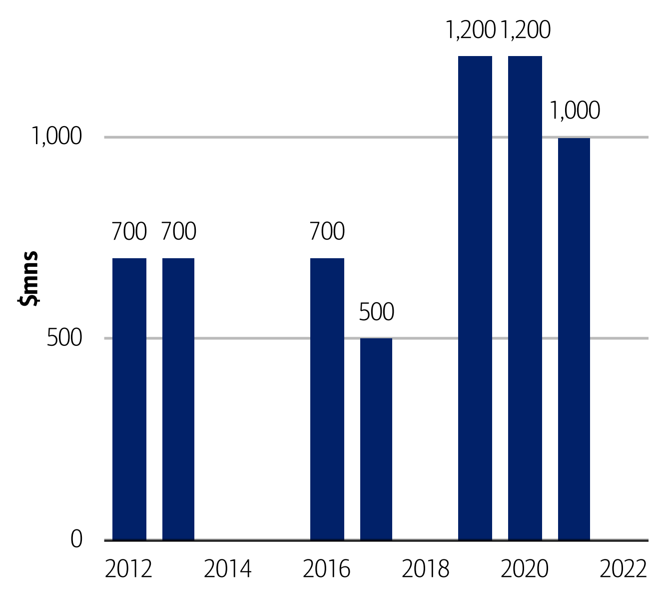
Exhibit 63: Largest amortization ($860mn in 2028) is manageable given market access Guatemala has historically enjoyed of $1.1bn per year on average in past 3 years

Guatemala's Eurobond issuances in primary markets



Source: BofA Global Research.

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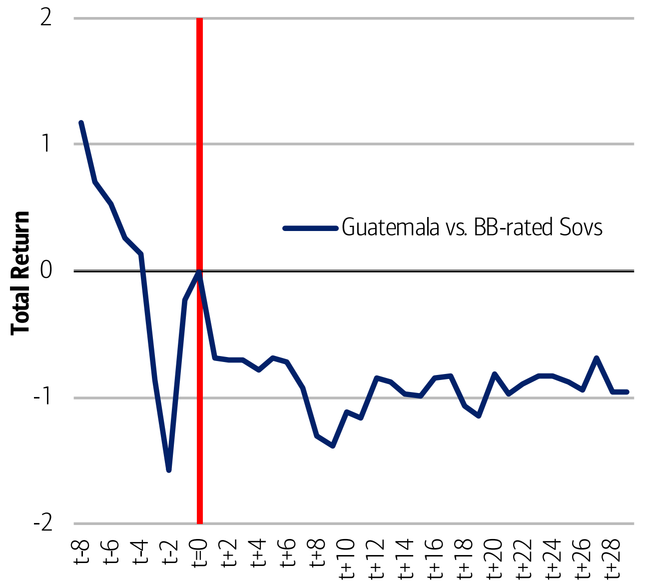
Exhibit 64: Market reaction to Nov 2020 protests was relatively mild
Total return of Guatemala's bonds compared to BB-rated sovereigns (t=0 is first day of protest, 11/23/20).



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Note: t=0 is first day of protest, 11/23/20.

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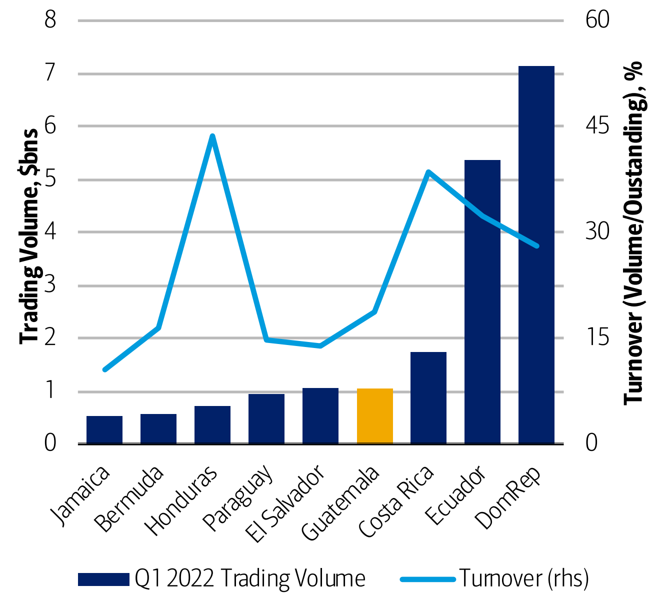
Exhibit 65: Guatemala's trading volume is similar to El Salvador's and Paraguay's and lower than Costa Rica's volume
2022 Q1 trading volume and turnover (trading volume/outstanding)



Source: BofA Global Research, EMTA.

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Risks to the View

Risks to our Overweight recommendation are social protests, natural disasters, governance and institutional capacity, exposure to potential US recession, lower remittances, strains in the US bilateral relationship, and relatively smaller trading liquidity.

Investors are increasingly sensitive to risks of social protests

Social protests have led to significant sell-offs in asset prices in LatAm (for example Ecuador 2019 and 2022; Chile 2019; Colombia 2021) and elevated food and energy inflation have made investors increasingly sensitive to the risk of social protests. Guatemala looks particularly vulnerable given its low GDP/capita and small social safety, which amplifies the impact of inflationary shocks. Mitigating this risk somewhat is Guatemala's history of limited government, as citizens may expect greater intervention from welfare state governments.

2020 social protests caused only mild market impact

We acknowledge that there is always a risk that future protests evolve in a different way, but we note that the 2020 protests in Guatemala (which resulted in protestors burning the Congressional building) triggered only a mild reaction in its external bonds (Exhibit 64).

We believe that investors did not react strongly to the 2020 protests because they did not see Guatemala's small-government model to be at serious risk. This assumption could change in the future, but stable macroeconomic fundamentals and low debt tend to dampen the impact of social protests on asset prices, in our view.

Trading volume: Similar to El Salvador, lower than Costa Rica

One of the disadvantages of Guatemala's sovereign bonds in the current environment is that their trading liquidity is more limited compared to larger issuers. According to the EMTA (Emerging Markets Traders Association) survey, trading volume in Guatemala's bonds totaled about $1bn in Q1 2022 (compared to a debt stock of $5.6bn) (Exhibit 65).

Guatemala's trading volume is similar to El Salvador's and Paraguay's, but lower than Costa Rica's.

Most liquid bonds are '50s, '32s, and '33s

The most liquid bonds are the '50s, '32s, and '33s. The '50s are the largest issue ($1.4bn), well above the average issue size of about $600mn (the '50s were re-tapped in 2020 for $700mn). The '26s and '27s tend to be closely held and trade less frequently. The '32s are labeled social bonds, with use of proceeds directed towards eligible social spending (such as COVID-19 response, food security, affordable basic infrastructure, access to essential services, and socioeconomic advancement).

Exhibit 66: Guatemala's outstanding external bonds
Key indicators

Bond	Price	Yield	z-spread	z-spread Δ since 2/23/22	Coupon	Mod. duration	Issue date	Amount Out ($mn)	Maturity	60d price volatility	Sinker?
GUATEM 26	97.9	5.12	242	30	4.50	3.4	5/3/2016	700	5/3/2026	4.2	N
GUATEM 27	96.1	5.30	268	37	4.38	4.3	6/5/2017	500	6/5/2027	6.2	N
GUATEM 28	96.1	5.70	308	39	4.88	4.7	2/13/2013	700	2/13/2028	6.6	N
GUATEM 30	93.7	5.91	349	60	4.90	5.6	5/31/2019	500	6/1/2030	7.8	Y
GUATEM 32	93.7	6.24	375	70	5.38	6.7	4/24/2020	500	4/24/2032	8.5	Y
GUATEM 33	79.1	6.33	369	76	3.70	8.6	10/7/2021	500	10/7/2033	11.5	N
GUATEM 34	107.7	7.17	451	90	8.13	7.7	10/6/2004	330	10/6/2034	8.2	N
GUATEM 41	76.6	6.86	418	69	4.65	11.3	10/7/2021	500	10/7/2041	15.4	N
GUATEM 50	88.6	7.07	448	33	6.13	12.1	5/31/2019	1400	6/1/2050	16.0	Y

Source: BofA Global Research, Bloomberg.

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LDM: Local market that stays local

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Local debt markets are larger than external debt markets

Guatemala's outstanding local currency bonds amount to about GTQ 87bn (USD 11.3bn), which represents roughly 13% of GDP. While this might seem low relative to other countries in the region, it is actually significantly larger than the external debt market. In fact, outstanding local currency bonds are almost 1.7x more than foreign currency bonds. The local currency yield curve is also very steep. For instance, 10y bonds are yielding close to 6%, while the policy rate is only at 2.25%.

Still, local market players are mostly local banks, which tend to buy bonds in the primary market and hold them to maturity. Retail investors can also participate in the primary market, through a special auction program. However, the allocation is minimal with only about GTQ 500mn (USD 65mn) expected issuance for this segment. Finally, Guatemala does not have a private pension fund system, further limiting demand for domestic debt. As a result, the secondary market for local bonds is very shallow.

A large primary local debt market

Guatemala issues both local and foreign currency bonds in its domestic market. However, the bulk of domestic bond issuance is in local currency. Out of the USD 15.4bn in debt issued domestically, only USD 4bn is denominated in US dollars while an equivalent of USD 11.3bn is issued in local currency.

The local market includes debt issued by the government, as well as by the central bank. CERTILETRAS are zero-coupon and, similar to Treasury bills, are issued by the government at maturities less than a year. Bonos del Tesoro AC and CERTIBONOS are coupon bonds issued by the government with maturities of up to 15 years. Bonos del Tesoro AC are issued electronically, while CERTIBONOS are issued physically. Coupons are paid semi-annually. The central bank also issues Certificados de Deposito a Plazo (CDPs), which are zero-coupon notes that tend to have maturities close to a year but can also be issued at longer tenors. Any individual or company can purchase these securities through one of the 17 authorized brokers. Settlement is T+1.

The face value of Bonos del Tesoro AC is GTQ 1k (USD 130), which allows the participation of retail investors in the primary market. Retail investors must purchase at least GTQ 10k (USD 1.3k) and increase their allocation in steps of GTQ 1k (USD 130) until a maximum of GTQ 500k (USD 64k). Retail investors can invest at 1-year, 2-year and 3-year maturities. For CDPs and CERTIBONOS, face value is GTQ 100k, GTQ 1mn and GTQ 10mn. There is also availability for GTQ 10k face value CERTIBONOS.

But a very thin secondary market

While the primary local debt market is quite large, secondary trading of local debt instruments is significantly low. Local bonds trade in the Bolsa de Valores Nacional (BVN). According to the BVN, average traded volume of government securities in the secondary market was only GTQ 85mn (about USD 11mn) per day in 2021.

BVN also provides a market for repos, with an average volume of roughly GTQ 1.4bn per day (USD 180mn) in 2021. Most of these repos were concentrated in the 1-3 day (60%) and the 4-7 day maturity (20%).

FX market is small

Guatemala's FX market is also small. According to the central bank, the spot FX market had an average traded volume of about USD 245mn per day. The forwards market is not well developed, but some local institutions offer non-deliverable forwards (NDF), usually at the 1-year horizon. According to central bank data, the median trade size is roughly USD 1mn. However, it is not strange to see trades above USD 5mn, which we see about 25% of the time, and even reach close to USD 20mn. The average daily volume traded in 2021 was USD 3mn.

Appendix

I. Central bank independent by constitutional mandate

Background.

Banco de Guatemala (BANGUAT) follows a fully-fledged inflation-targeting regime. In 2013, the BANGUAT board fixed 4% as the long-run inflation target with a tolerance band of +/- 1%. Inflation has ended inside the target band for most of the years with the exception of 2017 (5.7%) and 2018 (2.3). Inflation has accelerated in recent months. It stood at 7.55% as of June, up from 2.98% in February and we forecast that consumer prices inflation will end the year well above the upper ceiling of the target band.

Policy framework.

BANGUAT is legally autonomous and has a mandate to preserve price stability. According to the article 132 of the Guatemalan Constitution, the central bank is an autonomous entity and manages its own budget. The central bank law assigns it the mandate to contribute to the creation and maintenance of the most favorable conditions for the orderly development of the national economy, for which it will promote the monetary, exchange and credit conditions that promote stability in the general price level.

Board composition

The monetary board is the entity in charge of the monetary, exchange and credit policy in Guatemala. The members of the monetary board are:

a) The President of the monetary board, which is also the president of the BANGUAT. BANGUAT's president is appointed by the President of the Republic for a 4-years period.

b) The minister of finance, the minister of economy and the minister of agriculture.

c) A congress representative (choose by congress)

d) A representative of the chambers of commerce, industry and agriculture.

e) A representative of the domestic private banks

f) A representative of the San Carlos University.

The current president of the monetary board is Sergio Francisco Recinos Rivera, who is serving his second consecutive term as the president of the board and BANGUAT. Mr Recinos is a former vice-president of the central bank and also was general manager and financial manager of the BANGUAT. He has worked in the central bank for over 35 years.

Mr. Recinos is an economist from the San Carlos University with a masters degree in economic policy from the Tilburg University.

Base rate

The Monetary Board meets twice per month but currently there are only 8 meetings per year when they decide about the Leading Monetary Policy Interest Rate (Tasa de Interes Lider de Politica Monetaria). Meetings are held in February, March, April, May, June, August, September and November

A post-meeting press conference is held after each meeting, during which the central bank president presents the decision and relevant macro-economic data to the press. The leading rate (GUIRLR Index in Bloomberg) is the minimum repo rate to be offered at BANGUAT's daily auction. Meeting minutes are released a month after the monetary policy meeting takes place. The BANGUAT also publishes a quarterly Monetary Policy Report (Informe de Politica Monetaria) and presents an annual report to Congress discussing macroeconomic results and key policy decisions.

Open market operations

BANGUAT has three main instruments to regulate liquidity, aside from the monetary policy. 1 day repos, short term certificates of deposits (CDs) with different maturities up to 2 years and long term CDs with 4, 6 and 8 yrs maturities.

Reserve requirements

In July 2022, the deposits reserve requirement is 14.6%, rate has been flat since 2002. Same rate is applied for domestic and foreign currency deposits.

FX policy

Guatemala's exchange rate regime is best characterized as a managed float. The BANGUAT intervenes in the exchange market based on a rule-based framework that counteracts the short-term volatility. The central bank also purchases dollars for reserve accumulation and also has the capacity to intervene when they consider that the volatility is unusual.

Guatemala had parity regime with the USD between 1963 and 1984. Then there was a short period of 6 months when they managed multiple exchange rates. Between 1985 and 1991 the FX regimes were different methods of managed devaluation. Guatemala has a floating regime since 1991[4].

The IMF classifies the de facto exchange rate arrangement as "stabilized". The de facto exchange rate arrangement was reclassified to "stabilized" from "crawl-like" back in 2018 according to the IMF.

Unconventional policies.

In 2020 the central bank financed the government, it bought GTQ 10bn of domestic government bonds as an extraordinary measure, approved by congress, to face the Covid shock.

II. Fiscal measures implemented during the pandemic

According to the IMF fiscal monitor, the government implemented measures that totaled about 3.3% of GDP. Among the main measures implemented to alleviate the Covid shock were:

- Upgrade national healthcare facilities (0.2% of GDP)
- Cash transfers to vulnerable households (1.0% of GDP)
- Cash transfers to private-sector formal workers (0.3% of GDP)
- SMEs financial support (0.4 percent of GDP)
- Food assistance program (0.1 percent of GDP)
- Deferred income tax payments by 1 quarter

III. Contingent liabilities of central government to BANGUAT and IGSS

Liabilities not accounted in public debt statistics

As we explained in the previous sections, the government has liabilities to the Central Bank (BANGUAT) and the Social Security Institute (IGSS) which escape the accounting of public debt statistics. They are sizable, over 10pp of GDP, adding them together. So we believe it's worth explaining them with a bit more detail.

[4] For further details on the historical FX regimes, see BANGUAT working paper 119

As of December 2021, the government had a liability of GTQ 27.7bn with BANGUAT due to pending capitalization transfers, and GTQ 57.9bn with IGSS attributable to missing contributions (arrears) for pensions and health services.

Liability with BANGUAT originated in 2002

The liability with the central bank exists since 2002 when a government decree mandated the Ministry of Finance to increase the capital of BANGUAT. Specifically, the purpose was to compensate BANGUAT for the losses related to the implementation of monetary, credit and FX policies. Notably, BANGUAT is quite active in the FX market, to reduce the volatility of the Quetzal, making sterilization operations that are costly because they pay interest.

Difference between accounting of QE purchases and re-capitalization

In 2020 BANGUAT did quantitative easing (QE) by purchasing government bonds in the secondary market, for GTQ 10bn. Those assets were registered as an investment in domestic securities. In contrast, the re-capitalization liabilities are registered in a receivables account of BANGUAT's balance sheet.

Liabilities to Social Security Institute are larger than those to BANGUAT

The arrears to IGSS have increased at an annual rate of 12% since 2003. They stood at GTQ 57.9bn, 8.7% of GDP, as of December 2021. In the pay-as-you-go social security system of Guatemala, the government contributions are one of the three contribution streams received by IGCSS. The others come from employers and workers. The IGSS's balance sheet registers the missed contributions (arrears) from the government as a receivables account.

IGSS finances are robust, despite of the arrears, because of demographics

Guatemala's demographic dividend (relatively low-aged population and high population growth rates) allow the IGSS to operate without significant financial pressure. The number of affiliated people continues to increase and contributions exceed benefit payments. Put simply, revenues are larger than expenditures.

IV. 2023 elections: Main candidates

Polls show three main presidential candidates

The electoral process will begin on January 20, 2023, according to a statement released by the electoral court earlier this year. However there are already some surveys with voting preferences. Notably, three individuals appear significantly above the rest of candidates in the polls: Zury Rios from VALOR party, Sandra Torres from UNE and Edmond Mulet from PHG party (Exhibit 67).

Zury Rios: right-wing conservative

Zury Rios is a politician and leader of the conservative party VALOR. Mrs. Rios tried to run for the presidency in 2019 but the Constitutional Court ruled against her participation. Article 186 of the Guatemalan constitution prohibits the participation in the presidential elections by any relative of former participants in a coup d'état. Mrs Rios is the daughter of José Efrain Rios Montt, former de facto president back in 1982 after a military coup.

Sandra Torres: former First Lady, from center-left side of political spectrum

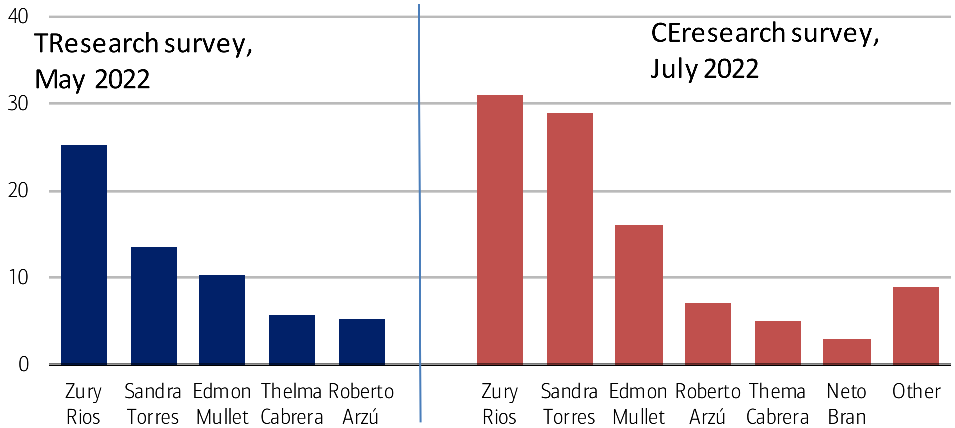
Sandra Torres is the leader of the center-left party UNE. She is a former first lady with President Alvaro Colom in the 2008-2011 presidential term. Colom was probably the most progressive president that Guatemala has had in the recent past, inclined to the center-left. However, he was market-friendly, and maintained prudent macroeconomic policies compared to LatAm peers. Sandra Torres and Alvaro Colom were divorced in 2011. Torres was a presidential candidate in 2015 and 2019. The party to which she belongs currently has 52 out of 160 seats in congress, and 108 out of 340 municipalities.

Edmon Mullet: Former Diplomat from political establishment

Edmon Mullet is the leader of Partido Humanista (PHG). The PHG controls only 6 out of 160 seats in congress. Mr Mullet is a politician and diplomatic, former Congress president back in the nineties. Mr Mullet is also Guatemala's former Ambassador to the US and worked in several positions for the United Nations.

Exhibit 67: Vote intention for 2023 presidential election

Zury Rios, Sandra Torres and Edmon Mullet rank high in in the surveyed people preferences



Note: TResearch survey was consulted online in the following link (See GUATEMALA: 2023 (tresearch.mx)). CEresearch survey was consulted online in the following link (See GUATEMALA. 2023. (ceonline.com.mx)) **Source:** TResearch International, CEresearch

BofA GLOBAL RESEARCH

Valuation & risk

Guatemala (GUATEM)

We rate Guatemala's external bonds at Overweight. Guatemala's most attractive features are its macroeconomic stability, conservative fiscal management, low debt ratio, high level of international reserves (24% of GDP), and no need to issue externally in 2022. Investors value macroeconomic stability, like that of Guatemala, when global uncertainty is elevated. We think uncertainty will remain elevated for the foreseeable future and this should keep Guatemala's bonds attractive.

Risks to our Overweight recommendation are social protests, natural disasters, governance and institutional capacity, exposure to potential US recession, lower remittances, strains in the US bilateral relationship, and relatively smaller trading liquidity.

Analyst Certification

We, Claudio Irigoyen, Jane Brauer and Lucas Martin, CFA, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

Some of the securities discussed herein should only be considered for inclusion in accounts qualified for high risk investment.

Disclosures

Important Disclosures

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Issuer Recommendations: If an issuer credit recommendation is provided, it is applicable to bonds and capital securities of the issuer except bonds and capital securities specifically referenced in the report with a different credit recommendation. Where there is no issuer credit recommendation, only individual bonds and capital securities with specific recommendations are covered. Loans, CDS and equity preferreds are rated separately and issuer recommendations do not apply to them.

BofA Global Research credit recommendations are assigned using a three-month time horizon:
Overweight: Spreads and /or excess returns are likely to outperform the relevant and comparable market over the next three months.
Marketweight: Spreads and/or excess returns are likely to perform in-line with the relevant and comparable market over the next three months.
Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

BofA Global Research uses the following rating system with respect to Credit Default Swaps (CDS):
Buy Protection: Buy CDS, therefore going short credit risk.
Neutral: No purchase or sale of CDS is recommended.
Sell Protection: Sell CDS, therefore going long credit risk.

Sovereign Investment Rating Distribution: Global Group (as of 30 Jun 2022)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	7	15.22%	Buy	4	57.14%
Hold	34	73.91%	Hold	14	41.18%
Sell	5	10.87%	Sell	2	40.00%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only Sovereign issuer recommendations. A Sovereign issuer rated Overweight is included as a Buy, a Sovereign issuer rated Marketweight is included as a Hold, and a Sovereign issuer rated Underweight is included as a Sell.

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