FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Guatemala to 'BB-'; Outlook Stable

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Fitch Ratings - New York - 03 Apr 2020: Fitch Ratings, New York, April 3, 2020: Fitch Ratings has downgraded Guatemala's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'BB-' from 'BB' and revised the Rating Outlook to Stable from Negative.

KEY RATING DRIVERS

The downgrade of Guatemala's IDRs reflects diminishing fiscal flexibility due to the government's low tax collection amid continuous political gridlock preventing forceful fiscal measures, as well as a downward revision to growth prospects related to the global pandemic. Congressional elections in 2019 resulted in a fractured Congress, leading to continued political gridlock and diminished reform prospects. A continued failure to enact reforms in the tax administration and pass new tax measures will lead to further erosion of revenues. Low tax collection, coupled with high budget rigidity, limits the government's capacity to address large infrastructure and social needs, which will be further stretched by the public health crisis represented by COVID19 and the consequent shock to the economy.

Fitch projects real GDP will not grow in 2020 after a 3.5% expansion in 2019 due to the global coronavirus impact and the government's measures to contain the outbreak. Our estimates incorporate a contraction of private consumption over the year driven by lower remittances inflows. Commerce is the largest sector in the economy (18% of GDP) and will be disproportionately affected by social distancing measures. Tourism (accommodation and restaurant services) will also be severely affected; however, it accounts for only 3% of GDP (and 9% of current account receipts), limiting its direct impact on growth.

Risks remain tilted to the downside as remittances, a key growth driver, are highly vulnerable to coronavirus impact on the U.S. economy. Guatemala's economic activity relies heavily on private consumption (86% of GDP), which in turn is financed by workers' remittances from the U.S. (21% of total private consumption, 13.8% of GDP). Remittances have grown on average 13% per year over the past five years as Hispanic unemployment in the U.S. reached historical lows. However, containment policies in the U.S. have disproportionally affected the service sector, which accounts for 24% of Hispanic employment. A significant unemployment rise in the U.S. could disrupt remittances flow and affect Guatemala's private consumption, exchange rate volatility and the current account balance.

Fitch estimates the fiscal deficit will reach 3.8% of GDP in 2020, up from 2.3% in 2019 due to the impact of COVID-19. Tax revenues are expected to fall given the economic slowdown. The health crisis is likely to increase government expenditures, adding pressure on an already-growing deficit. On March 18, 2020, the government presented to Congress a budget expansion for Q7 billion (1.2% of GDP) to mitigate the impact of the current health crisis. The government had previously planned to present a budget expansion of similar magnitude. Congressional gridlock resulted in a failure to approve the 2020 budget and the 2019 budget remained in effect, restricting the government's expenditure capacity. Political polarization has prevented budget approvals in the past, with the most recent in 2018.

Despite the fact that Guatemala's fiscal deficits have remained below the 'BB' median and led to a low debt burden relative to GDP, other key fiscal metrics are weaker relative to rating peers. Interest/revenues at 13.0% is higher than the 'BB' median of 7.8% signaling lower debt tolerance than similarly rated peers due to weak tax collection. Guatemala's government revenue/GDP ratio is the lowest of our rated sovereigns, except for Bangladesh and Nigeria. Government revenue growth has lagged economic growth, gradually declining to 11.4% of GDP in 2019 from its peak of 12.8% in 2007. The Central Bank's revision to national accounts, which resulted in a lower nominal GDP level, benefited the revenue/GDP ratio.

Low revenue levels and weak tax collection performance reflect institutional challenges at the tax authority, high levels of tax evasion, a narrow tax base and weak control of corruption. VAT evasion is estimated above 30% of potential collection, while income tax evasion is estimated close to 70%, according to the tax authority. Administrative measures tackling tax evasion (e.g. broad usage of electronic billing) could improve VAT collection; however, Fitch expects such measures to have a moderate impact.

In late 2019, the Constitutional Court ruled in favor of Guatemala's public university on how the government calculates budget transfers, which will increase budget rigidity. Guatemala already has a rigid expenditure profile; earmarked expenditure items account for 90% of expenditures. Revisions to budget transfers would also apply to municipalities. The new calculation will result in a budget reallocation of Q8 billion (1.3% of GDP), according to authorities. Budget rigidity, coupled with low tax collection, limits the government's investment capacity on infrastructure and economic development.

Central government debt rose to 26.9% of GDP in 2019 after hovering around 25% since 2010. The debt burden will continue to increase reaching 30% of GDP by 2021 due to the impact of coronavirus, according to Fitch estimates. Guatemala's general government debt/GDP of 24.5% of GDP (net of social security government debt holdings) remains one of the lowest in the 'BB' category. Nevertheless, Guatemala's general government debt/revenues rose to 215% in 2019 from 199% two years ago, due to weak revenue performance; central government ratio reached 236%. This ratio is above the 'BB' median of 184%, also signaling lower debt tolerance relative to peers.

The current account has shown surpluses over the last four years, averaging 1% of GDP as large remittance inflows (14% of GDP) offset a large trade deficit (12% of GDP). Fitch expects a narrowing of the current account surplus to 1% of GDP in 2020 from 2.1% of GDP in 2019, assuming a 20% decline in remittances coupled with a contraction in imports. Foreign reserves remain high, covering more than seven months of imports, and one of the highest liquidity ratios among rating peers.

General elections - electing the president, local government and the unicameral legislature - were held in June 2019, with a presidential second-round runoff in

August. Alejandro Giammattei, from conservative political party Vamos, was elected president and sworn in to office in Jan. 14, 2020 for a four-year term. The presidential election outcome has resulted in a marked improvement in business confidence as the campaign focused on reducing red tape, fostering investment and reducing security concerns.

Legislative elections led to a fractured Congress resulting in continued political gridlock and diminishing reform prospects. The official party attained 17 out of 160 seats. Opposition party UNE won the largest share, 44 seats of the unicameral assembly. The remaining seats were split among more than 15 political parties.

Corruption scandals and weak judicial institutions underpin Guatemala's weak governance indicators, particularly rule of law and control of corruption. Entrenched corruption and impunity are likely to continue as outgoing President Jimmy Morales did not renew the UN-backed International Commission Against Impunity in Guatemala's (CICIG) two-year mandate. CICIG was a UN-backed body that investigated corruption cases within the country since 2007; the last two-year mandate expired in September 2019. President Giammattei formed a new commission to tackle corruption under the executive branch. However, this will be employed for administrative tasks improving government transparency.

Guatemala's ratings are supported by a track record of prudent monetary and fiscal policies, macroeconomic stability, low public debt to GDP and sound external liquidity. These strengths are counterbalanced by a narrow tax base that constrains policy flexibility and limits debt tolerance. They are also counterbalanced by reliance on remittances inflows to offset large trade deficits and weak governance, investment levels and human development indicators.

ESG - Governance: Guatemala has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Guatemala has an average WBGI ranking at 27.9 percentile driven by weak rule of law and a high level of corruption.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Guatemala a score equivalent to a rating of 'BB+' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

-Structural: -1 notch, to reflect political tension and congressional gridlock that limits the government's ability to pass reforms, including the approval of the budget.

-Public Finances: -1 notch, to reflect continued deterioration of tax collection levels, which limits the government's investment capacity in a context of large social and infrastructure needs and to reflect a forecast deterioration in the public finances not yet reflected in published data.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

--Lower-than-expected growth performance and weaker medium-term growth prospects, for example, caused by lower remittances or lasting impacts from the growth slowdown on key sectors of the economy.

--Political gridlock that constrains government financing flexibility and effective policy making or leads to a trend rise in debt that materially undermines fiscal metrics.

The main factors that could, individually or collectively, lead to positive rating action/upgrade are:

--Improvements in tax collection that enhance fiscal policy flexibility;

--Higher investment and growth medium-term prospects, for example, by addressing Guatemala's infrastructure needs that constrain productivity;

--Improvements in governance and human development indicators relative to peers, particularly on control of corruption and rule of law.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance.

KEY ASSUMPTIONS

Economic assumptions are consistent with our baseline macroeconomic forecasts that are currently being reviewed and updated very frequently to keep pace with developments resulting from the coronavirus.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Guatemala has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are relevant to the rating and a key rating driver with a high weight.

Guatemala has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Guatemala has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as World Bank Governance Indicators have the highest weight in the SRM and are relevant to the rating and a rating driver.

Guatemala has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver, as for all sovereigns.

RATING ACTIONS

ENTITY/DEBT	RATING		
Guatemala	LT IDR	BB-	Downgrade
•	ST IDR	B	Affirmed
•	LC LT IDR	BB-	Downgrade
•	LC ST IDR	B	Affirmed
•	Country Ceiling	BB	Downgrade
• senior unsecured	LT	BB-	Downgrade

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 05 Jul 2019)

Sovereign Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)

Sovereign Rating Model, v3.11.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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Sovereigns Latin America Guatemala