PROFILE II

GUATEMALA

JULY 24, 2002

Project name:	Line of Credit for Small and Micro Enterprises		
Project number:	GU-0154		
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Date of Profile I:	April 18, 2001		
Borrower:	Guatemala		
Executing agency:	Ministry of the Economy		
Financing plan:	IDB: OC	US$	US$15 million
	Local:	US$	US$ 5 million
	Total:	US$	US$20 million
Tentative dates:	Analysis Mission	September 2002	
	Executive Directors	October 2002	
PTI:	No		
SEQ:	No		

I. BACKGROUND

1.1 The objective of the Program is to improve the economic welfare of small and micro borrowers by increasing their access to short- and medium-term financing resources. To achieve this objective, the Program will provide the Executing Agency (EA) with resources that will be channeled to the final borrowers through the banking system. The proposed Program is designed as a continuation of the support provided by the Bank through loan 886/SF-GU.

1.2 **Macroeconomic Framework:** Despite some improvement in economic performance and structural reforms since the early 1990s, Guatemala continues to face serious problems of poverty and income distribution. Nearly 60 percent of

the population lives below the poverty line, while the top quarter of the population enjoys about 95 percent of national income. The 1996 Peace Accords set an economic and social agenda to address this ingrained inequality in income and the institutional failures and social barriers that cause these distortions. The Accords contemplate a substantial increase in public investment in social and basic infrastructure to be financed by higher tax revenue and through increased donor support.

1.3 During the last five years ending with the year 2001 the economy has grown at an average annual rate of 3.5%. However, during the same period the population growth has averaged has averaged almost 3.0%, reducing the per capita growth to less than one percent p.a. for the last five years. Additionally, the recent trend has been downward, with real economic growth of only 1.7% in 2001 and with the expectation that this decelerating trend would carry over into 2002. There are several reasons for this poor performance. The initial impulse from the return to peace in 1997 has just about run its course. At the same time, the macroeconomic management at the end of the decade was erratic, producing wide swings in interest rates and leading to a significant devaluation of the exchange rate. Terms of trade effects have played an important role, with the world oversupply of coffee causing coffee exports to fall by US$240 million in 2001. Lastly, the economic downturn in the U.S. has added to these difficulties.

1.4 The fiscal situation is also problematic. Low tax collection and excessive spending have combined to produce persistent central government deficits averaging 2.7% of GDP over the last three years. Guatemala's tax revenues are only about 10% of GDP, one of the lowest figures in the region. The Peace Accords oblige the government to raise tax revenues to at least 12% of GDP in order to enable it to provide the public services that are an important feature of the Accords. In 2001 the VAT was increased from 10% to 12% and a number of other taxes were increased in order to reach the 12% goal. However, legal challenges to some of the taxes and lax enforcement have muted the impact of these measures with the result that the progress made in increasing revenues has not been sufficient to meet the Peace Accords taxation goals.

1.5 More recently Guatemala has signed a 12-month Stand-By arrangement with the International Monetary Fund (IMF). The Arrangement requires that the central government deficit be cut in half to 1.3% of GDP in 2002. The inflation target of the program is 4-6%. In the structural area, the program asks for approval of four financial sector laws (see paragraph 1.8) before completion of the program's mid-term review that is scheduled for August 2002.

1.6 Monetary policy has been the bright spot of economic management. Since the year 2000, policy has been steady and tight, and this has resulted in a return of confidence in the Quetzal. Although inflation did increase from 5% in 1999 to an estimated 9% last year, this relatively narrow range reflects the control that the authorities have had over the money supply. In spite of the tight policy, interest rates, as measured by the average deposit rate of the banking system, have come

down from approximately 12% in 1999 to 8% in May of 2002. During this time lending rates have fallen from 21% to 17%. During this period, the Quetzal has held steady at around Q8.00 to the dollar. International reserves have risen substantially rising from $1.2 billion at the beginning of 2000 to $2.2 billion in April of 2002, the equivalent of 4.6 months of imports of goods and services. Much of the increase was due to large payments received from the privatization of TELGUA, and the proceeds of an international bond issue.

1.7 **The Banking Sector:** The banking system consists of 29 domestic commercial banks, 2 branches of foreign banks, 19 private-sector finance companies, one state-owned finance company, a state-owned mortgage finance company, and 156 credit cooperatives. The Superintendency of Banks regulates all of these except the coops, which have their own law and are regulated by the INACOOP, the National Institute for Cooperatives. Twenty-eight of the larger credit coops belong to a trade association called FENACOAC.

1.8 The financial sector passed through a difficult period between 1998 and 2001 largely as a result of some serious deficiencies in the legal framework. The authorities intervened three insolvent banks in 2001, and have recommended to the judiciary that these banks be liquidated. (The owners of these banks are challenging the liquidation orders in the courts.) At the same time, the authorities, with the help of the IDB, the IMF and the WB, have drafted a new legal framework for the system, the first major change in Guatemala's financial legislation in more than 50 years. The four laws[1] in the framework were approved by the National Congress and came into effect on June 1, 2002

1.9 One important feature of the new legal framework is that it enables the Superintendency of Banks (SB) to take corrective actions promptly, before an institution becomes insolvent. Additionally, the new Banking Act gives the SB and the Monetary Board (MB) the authority that they need to impose strict prudential measures, to levy fines and to require the recapitalization of a bank if its capital falls below required levels. One of the most important features of the new Banking Act is that it requires the SB to supervise the financial system on a consolidated basis. It is expected that this will help to solve the problem of financial groups using their related companies to hide problems, a factor that contributed to the demise of the three banks that were intervened. Additionally, these measures should improve the quality of the banking system information published by the SB, because the more stringent prudential norms require the banks to report risk assets and provisions more conservatively and because of the inclusion of the offshore banking activity.

1.10 **The Credit Market for Small and Micro Borrowers and the Dimensioning of the Program.** According to a study by IDC/USAID conducted in 2000, Guatemala has an estimated 750,000 small and micro businesses. The same study estimated that these businesses employed more than 2,000,000 people, or 63% of

[1] The Banking Act, the Financial Supervision Act, the Central Bank Act, and the Monetary Act.

the economically active population. Most of these businesses are financed exclusively with owner's equity. Twenty-eight percent of them had access to some kind of credit, evenly divided between loans from friends or relatives and credit received from banks, credit cooperatives or specialized NGOs. Many small and micro businesses are operated out of the owners home. Credit for the kind of home improvements or expansion that are necessary to accommodate the business are particularly scarce, since they usually require term financing.

1.11 The number of entities that offer credit to this sector has grown in recent years, particularly since the signing of the Peace Accords in 1966. In 2002 4 commercial banks, 28 credit coops and 65 NGOs were lending to small and micro borrowers. The amounts lent have grown at a rate of 26% p.a. from an estimated US$92m in 1998 to US$183m in 2001. In spite of the growing activity, 86% of borrowers still lack access to credit from non-family sources. In order to meet the growing demand, it is necessary to introduce new lending technologies to the microfinance institutions (most MFI's specialize by using only a single lending technology, typically group lending or individual lending) and to supply a steady source of resources to the market.

1.12 The operation has been dimensioned at US$15 million. This operation, plus a parallel operation prepared by CABEI for US$30 million will help to cover the continued growth in the demand for credit on the part of small and micro borrowers, while providing technical assistance to strengthen the institutions involved and promote new credit technologies.

1.13 With the increased lending to these businesses, have come efforts by the government and the lenders to create organizations to promote the orderly expansion of this activity. The government created the Vice Ministry of Micro Enterprises within the Ministry of the Economy with the objective of centralizing the government's efforts to strengthen this sector. In addition, the donor organizations, including the IDB, CABEI, GTZ, USAID, and the Vice Ministry have joined together to create the National Advisory Committee (NAC). The NAC meets regularly to give direction and coordination to the efforts of the donors, the Government and the lenders to the sector.

1.14 **The Bank's activities in the market for small and micro enterprises.** The Bank's strategy in the small and micro sector is based on four "pillars": (i) the support for the development of a regulatory framework that will facilitate the development of the sector; (ii) activities to increase the supply of financial services to small and micro borrowers; (iii) activities to increase the supply of non-financial services to the sector, and (iv) the promotion and development of microfinance institutions that are sound and deliver high-quality services to their customers. The proposed operation is directed at the fulfillment of the second pillar. The Bank is the lead donor institution in the microfinance area, with 2 loans, 16 technical cooperation projects, and 4 small projects in execution.

1.15 **The Cooperation with CABEI.** The Bank and CABEI have been working together to prepare two parallel loan programs to respond to the demand described above. During preparation the two organizations have coordinated their work with the Vice-Ministry in order to help Guatemala to develop a growing capacity for intermediating resources to the target groups and to ensure that the country has a supply of resources that can respond to this growing demand.

1.16 CABEI has a methodology for evaluating NGO microfinance intermediaries that uses a modified CAMEL framework. The methodology evaluates an NGO's capital, profitability, liquidity and the quality of its management. CABEI uses the methodology in several countries to qualify NGO participants in CABEI microlending programs. The IDB has a long experience of working with commercial banks as lenders to small and micro borrowers, and has the specific experience of the Global I. Accordingly, to respond to the demand from the various kinds of small and micro-lenders, CABEI and the IDB are preparing parallel operations, with the CABEI operation being channeled through NGOs and credit cooperatives and the IDB operation being channeled through the commercial banks. Since the market for financial services to the target borrowers is a complex one that is served through all of these channels, it is important for both institutions to have an understanding of the activities of all three intermediary channels. Accordingly, the two operations will be jointly supervised during project execution in a way that is described in Section III F.

II. OBJECTIVE AND THE PROGRAM DESCRIPTION

A. Objective

2.1 The objective of the Program is to improve the economic welfare of small and micro borrowers by increasing their access to short- and medium-term financing resources. To achieve this objective, the Program will provide the Executing Agency (EA) with lending resources that will be channeled to the final borrowers through the banking system. In parallel, CABEI will provide a loan for US$30m that will be intermediated through the National Program, a program also run by the Ministry of the Economy that supports the small and micro-lending activities of NGO and credit cooperative intermediaries**.**

B. Program description

2.2 The proposed Program has two components: i) a credit component that will be channeled to small and micro entrepreneurs through financial institutions that meet the eligibility criteria of the Program; and ii) a technical assistance component which will finance activities to strengthen the EA's ability to manage a larger lending portfolio and to strengthen the capabilities of the participating intermediaries to reach out to a greater number of customers. This operation is a follow-on program from the Global Credit Loan for Small and Microenterprises (Global I, 886/SF) that has channeled US$8.5 million to small and micro

enterprises over the last three years. The proposed program draws upon the lessons learned (see Section III E) during the execution of Global I.

2.3 The total cost of the Program is estimated at US$20 million. The credit component will account for US$18 million and the technical cooperation component is estimated at US$2 million. Bank resources will provide US$13 million of the credit component with local counterpart funding the remaining US$5 million. The local counterpart would come from the participating financial institutions.

2.4 **Credit Component (IDB resources -- US$13 million).** The Program will provide resources to the EA to enable it to increase its support of small and micro-lending activities of participating institutions. The Program will provide a maximum of 70 % of the funding for sub-loans that participating banks will make to the target sub-borrowers. The sub-loans will finance the purchase of fixed assets, permanent working capital associated with an increase in productive capacity, small home improvements, and the contracting of specialized services that are needed to expand production or comply with environmental requirements. In all, approximately 4000 loans with an average loan size of US$ 5,000 are expected to be granted, over a period of four years.

2.5 The Credit Component will have a multi-sector focus, that is, resources may be provided to any sector as long as the Bank's environmental and procurement policies are followed and provided that the activity being financed is not on the Bank's negative list. The borrowers may be located in rural or in urban areas. The resources will be made available to the participating banks on market terms and the banks will on-lend the resources to the sub-borrowers. The banks will assume the full risks of the loans that they make in the Program and they will therefore be free to establish and negotiate the terms of the sub-loans.

2.6 Guatemala does not have a second-tier bank. During the preparation of the operation various operating arrangements were considered. The creation of a second-tier government bank was considered. However, weaknesses in many Guatemalan institutions made the project team cautious about proposing the creation of a government-owned financial institution. Additionally, CABEI already works as a second-tier bank in Guatemala (and in the other Central American countries) so there is no pressing need for a second-tier institution. Consideration was also given to using a private-sector institution, but this would have presented several difficult to solve problems including how to promote the microfinance "business", and whether it was advisable to pass public resources through a private institution. In the end, the successful experience that the EA has had in administering Global I meant that the advantages of staying with it were considerable.

2.7 The Global I program has successfully fulfilled its objective of reaching many microborrowers in many areas of the country, including the rural areas. Mor than 11,000 sub-loans have been made mainly to micro borrowers located in rural

areas. The average loan size was around US$1000[2]. Past due loans are 5.2% of total loans, a figure that is considered reasonable for these kinds of loans.

2.8 Since both Global I and the proposed program have the same target groups and institutional channels, they will operate under one set of Credit Regulations. They will contain some modifications from the ones originally used in Global I, to reflect the lessons learned in that program. The main change is the elimination of the auction mechanism and its replacement by a formula for determining the rate of interest that the EA charges to the participating bank. (The formula is described in Section III B1.) The auction is being eliminated because the number of participating institutions is not expected to be large enough to ensure a dynamic competition for resources. If the number of institutions grows to the point where the Bank or the EA feels that an auction would ensure a better competition for the resources, either party can request a meeting to discuss changing to the auction system. If both the EA and the Bank agree, the Credit Regulations can be modified to reflect the requested change.

2.9 **Technical Assistance Component (IDB resources -- US$2.0 million).** The Technical Assistance Component has two activities. The first is to strengthen the institutional capability of the EA. The second is to expand the microlending capacity of the banks that participate in the Program.2.10 In Global I the Bank provided lendable resources of US$8.5 million. In order to manage the larger level of resources contemplated in the proposed operation, and to enable the EA to manage other sources of funds that may be offered in the future, it is important to strengthen its administration and technical skills, its independence and its ability to manage its resources in a sustainable way. Consultants will be hired to develop a new organization chart for the EA, to develop the regulations of the operations of the unit's board of directors, and to draft operational policies that are consistent with the new organization chart and with the new board's functions. While the Program will permit a small part (say 20%) of the credit resources to be disbursed before the institutional strengthening activities mentioned above are completed, (in order to promote a smooth flow of resources to the Program's participants) the disbursement of the rest of the resources will be conditioned on full completion of them.

2.10 In addition, resources will be provided to enable the staff of the EA to visit other microfinance lenders in the region in order to learn from those experiences. Other activities in the TC component include staff training in credit analysis and in administration. The idea is that during the execution of the Program, the EA will be run like a financial business, operating on a sustainable basis within the limits of its revenues, producing regular management reports and financial statements that are audited on an annual basis.

[2] The large number of loans made and there small average size is due in part to the strategy of Bancafe of working with community banks (bancos comunales).

2.11 The Program will also provide TC to the intermediaries themselves to enable them to increase their lending to small and micro borrowers. This TC will provide training in credit technologies, including group credit and individual credit, which some banks are already using, and new technologies, like the microfinance of housing, which so far has been confined to credit cooperatives and NGO intermediaries. This training will address the marketing of financial services to small and micro borrowers, credit analysis, disbursements and loan recoveries. In this way, the participating intermediaries will be able to adopt the credit technology that is best suited for their individual markets, and will have access to help in developing new technologies if they wish to enter new markets. Additionally, training will be provided in the administration of portfolios consisting of large numbers of small loans.

III. PROGRAM EXECUTION

A. Executing Agency, Commitment and Disbursement Period

3.1 The Program will be executed by the Ministry of Economy through the semi-autonomous Executing Agency that is responsible for the execution of Global I. The ES presently has six staff members – a project coordinator responsible for the overall management of the Global I, three other professional staff, and two administrative staff. The addition of one or two staff will be necessary to put the EA in a position to administer both programs. The EA will act as a second-tier institution to the eligible intermediaries and will administer the funds of the Technical Cooperation component.

3.2 The Ministry of Economy delegated substantial authority to the EA to carry out its functions in the earlier program. However, with the proposed Program, the EA will have a larger role to play and more resources to intermediate. The technical cooperation component described above is designed to improve the lending and monitoring skills of the EA. To ensure that the EA also has the necessary independence for performing its technical functions the Ministry will change the institutional arrangement of the EA in order to give it a Board of Directors. The board will have six members that are appointed by the Minister of Economy, three from the private sector and three from the public sector. They will be elected to staggered terms in order to ensure a degree of political independence in the management of the EA and of the Program. In addition to approving loans to the participating intermediaries, the Board will have the power to name the senior staff of the EU, approve its annual budget, and to approve its financial statements, its policies and annual work plans.

3.3 The commitment period of the proposed operation will be 42 months with disbursement period being 48 months.

B. Credit Component

3.4 The resources of this component will be channeled through institutions that meet the eligibility criteria of the Program. Its execution will be governed by the Program's Credit Regulations, the Program's loan agreement, and the participation agreements and loan agreements that the Executing Agency subscribes with each eligible intermediary.

1. Eligibility Criteria for Participating Lenders.

3.5 All financial institutions that are legally registered in Guatemala, and regulated and supervised by the Superintendency of Banks can apply to participate in the Program. (It is expected that only banks will apply, but the door is left open to finance companies and other regulated entities that meet the Program's eligibility criteria.)

3.6 To be eligible an institution must: i) be in full compliance with the banking and financial laws and regulations and; ii) not be under any special surveillance or intervention, or financial liquidation plan of the SB, BANGUAT, or the Monetary Board; iii) have an acceptable credit score as measured by the eligibility methodology required by the credit regulations. (The methodology calculates a score based on a bank's (a) capital adequacy, (b) asset quality, (c) liquidity, and (d) profitability.)

2. Eligibility Criteria and Terms for Sub-loans

3.7 Businesses with less than 20 employees and with sales that are less than US$300,000 p.a. are eligible to participate in the Program, as are owners of homes with an appraised value of less than the equivalent of US$30,000. Given the experience of Global I, where the average loan size was approximately US$1000, the expectation is that most of the loans will go to micro borrowers.

3.8 The Program resources can be used to finance investment projects for existing enterprises in all the economic sectors of the country, in particular: i) the acquisition of fixed assets; ii) the creation of permanent working capital; iii) the microfinance of housing, and iv) the contracting of technical and managerial support services for the fixed asset investment including pre-investment, and environmental impact studies. In all cases the norms of the Executing Agency and of the Bank must be met and the productive technologies employed by the sub-borrowers must not adversely affect the environment conservation, public health and security.

3.9 The credit will finance short, medium-term sub-loans with the maximum tenure of 5 years. The average amount of the Program sub-loans will not exceed US$10,000, an amount that will be reviewed annually by the Bank and the Executing Agency. To enable participating lenders to attend to a demand for loans from small companies, and not just micros, this amount is set at a level that is higher than the average loan size of the previous program. The maximum

exposure of the Program to a single borrower or group of related borrowers will not exceed US$20,000.

3.10 The participating institutions will be assuming the full financial risks of the sub-loans. These loans cannot be fully or partially guaranteed by guaranty funds financed by public or private sources. Since the lenders will be assuming all of the lending risks, they will be free to determine interests rates and commission, loan amounts and tenors, grace periods, amortization schedules, repayment methods and other conditions of the loans.

3. Terms of Financing of the Executing Agency and Allocation Mechanism.

3.11 The proposed loan will be made to the Republic of Guatemala through the Ministry of the Economy. The funds will be disbursed to the Ministry who will deposit the funds in a special account of the EA

3.12 The EA will lend these funds in Quetzales to intermediaries participating in the Program in accordance with the terms and conditions that are set out in the Credit Regulations. The intermediaries will pay to the EA a variable rate of interest based on the funding rate of the banking system adjusted for the cost of reserve requirements. If they elect to request medium-term loans from the EA, the IFI will pay a higher rate of interest that is at least as high as the government bond rate for instruments of the same maturity, adjusted for the reserve requirement. A commitment fee of 0.25% will be charged on the unused amount of the line of credit that the EA makes available to the participants.

3.13 The foreign exchange risk will be borne by the EA or by the Ministry. The recently approved Central Bank Act that require all government agencies to hold their accounts at the Central Bank at a zero rate of interest may affect the EA's revenues and also how the foreign exchange risks of the Program are managed. These issues will be investigated during project analysis.

3.14 Eligible participants will receive a credit limit that is not larger than the institution's quota. This quota will be set from time to time by the EA based on the institution's capital, profitability, liquidity and the quality of its lending portfolio. The participating institution will draw amounts from the line and repay amounts to the line as their portfolio of qualifying transactions grows and shrinks. They may only draw an amount equal to 70% of their qualifying transactions, the balance being the counterpart contribution of the participating institution.

TABLE OF COSTS ($000s)			
COMPONENTS	BID	LOCAL	TOTAL
Credit Program	13,000	5,000	18,000
Technical Cooperation Program			
A. Strengthening the EA	1,000	0	1,000
B. Strengthening the Intermediaries	1,000	0	1,000
TOTAL	15,000	5,000	20,000

C. Technical Assistance Component

3.15 The execution of the Technical Assistance Component will be managed by the EA according to a Plan of Operations that will establish in detail the goals and activities of the component. This Plan will be developed during project analysis. The EA will hire the specialized consulting services that are required to implement the activities of the TC.

D. Environment and Social Impacts and Proposed Actions

3.16 The environmental impact of the Program will be neutral given that it is a second-tier financial operation. However, the Program recognizes the possible negative environmental impact associated with individual first-tier lending operations and will attempt to mitigate any such problems. One area of concern is the deforestation of Peten. The Program will not permit the financing of activities that exploit the forest in Peten in an unstainable manner. In addition, the Bank will retain an environmental expert to advise the project team on how to cover possible environmental risks. The consultant will review the relevant environmental regulations and their application in Guatemala, and in addition will analyze how these risks are being managed in Global I. The consultant's recommendations will be described in the Program's Loan Document and reflected in the Credit Regulations. The Credit Regulations will also include provisions that prohibit discrimination based on race, gender or any other social characteristics.

E. Lessons Learned

3.17 Global I was designed with the Central Bank as the second-tier intermediary. However, a change to the Central Bank Act that was made after the operation was approved in 1993 prohibited the Central Bank from fulfilling its role as second-

tier lender. As a result, the program was restructured in 1997 and the EA was created to do the lending to the intermediaries. Once restructured, the program was successful with credit being provided to thousands of small borrowers. In addition, the program had a good demonstration effect, showing other lenders that it was possible to make money on small loans.

3.18 This success was not achieved immediately. The audit of the program for the year 2000 revealed that some transactions in dollars were not being recorded properly and that there were some weaknesses in the internal controls of the program. These problems have been resolved. Additionally lessons have been learned as a result of regular reviews of the program conducted by the Representation Office, and by a study conducted by a microfinance expert in December 2000.

3.19 The problems that are encountered as a result of these reviews are discussed with the EA. In this way the EA has improved its performance, solving problems, learning lessons and gaining confidence during the program's execution. One lesson learned was the importance of making the EA responsible for all of the aspects of the program that would determine its success. In the credit component of Global I, the responsibility for determining the eligibility of banks and the adjudication of the auction was delegated to an external committee that included representatives of the Ministry of the Economy, the Ministry of Public Finance, and the Central Bank. While this multi-institutional support was important early on, as both the program and the EA were new, it came at the cost of slowing down the process of declaring banks eligible and managing the auction. Additionally, as the EA gained experience, as the quality of bank supervision improved, and as the financial information available from the SB became more detailed, the extra support became unnecessary. The application of the eligibility criteria in the proposed Program is, consequently, a responsibility of the EA, while the approval for the lines of credit to individual banks will be the responsibility of the EA´s board of directors. This is expected to speed up the loan approval process.

3.20 The TC component of Global I made consulting companies responsible for a key activity, monitoring the portfolios of sub-loans, that arguably should have been carried out by the EA itself. Since it is essential that the EA have a detailed understanding of the impact the Program is having, and since it is important for the EA to know about any problems the intermediaries are having, this function is now a direct responsibility of the EA. Furthermore, the TC component in the proposed operation is demand driven, so that the EA can respond rapidly, for example, to an intermediary's desire for training in new lending technologies, by helping the intermediary identify and pay for the appropriate technical assistance.

F. Monitoring and Evaluation

3.21 The Program will be monitored during its execution to identify any changes needed, either to the Program's management or its operating mechanisms, and to

allow the national authorities and the Bank to verify compliance with the Program's objectives and with its contractual conditions. The monitoring will be done by reviewing the information prepared and sent periodically by the EA to the Bank, by the Program's external auditing process, and through an evaluation of the impact of the Program at the end of its execution.

3.22 The EA, which will be required to submit semi-annual reports to the Bank's country office within 30 days of the closing of each semester. These reports should detail the status of the Program, including the amounts and conditions of the loans to the participating intermediaries, number and amount of the sub-loans, the interest rates charged to the sub-borrowers, the most recent credit analysis that the EA has conducted on the participating institution and the activities undertaken in the area of technical assistance. They should also identify any problems and describe the corrective actions that have been or will be taken.

3.23 In addition, to demonstrate the sustainability of the Program, the EA will prepare a income statement showing its income, expenses and profits and a balance sheet showing its assets and liabilities. These statements will be prepared semiannually in accordance with International Accounting Standards, the standards that Guatemala has adopted, and will be audited annually by the Program's external auditor.

3.24 The Representative Office will conduct a special review of the Program when 30% and 70% of the Program resources have been disbursed. The main purpose of these missions will be to ensure the smooth execution of the Program and to enable the Bank and the EA to make any changes that are necessary to ensure a good execution.

3.25 Since CABEI's operation provides resources to the same kind of borrowers as the proposed IDB operation, the operations have been prepared in close coordination. This coordination will extend through the execution stage. The Bank will participate in the administration missions of the CABEI loan and CABEI will participate in the special reviews of the Bank's loan. A memorandum of understanding with CABEI has been entered into to this effect.

3.26 Following the execution of the Program, its impact will be evaluated. This evaluation will measure the sales of a sample of the participating businesses and compare them with the sales of a control sample of small and micro businesses that have not participated in the Program, and it will measure the number of employees before and after participation in the Program and compared with the control group.

G. Justification

3.27 The Program is part of the Bank's effort to help Guatemalan achieve sustainable economic development through the enhanced productivity and competitiveness of private enterprise. The achievement of this goal is based on a continual process

of industrial modernization and expansion, which in turn requires access to medium-term financial resources. Commercial bank financing is an important source of financing, for small and micro enterprises. Nevertheless, this sector faces serious limitations in terms of accessing funding. The Program will encourage financial intermediaries to expand their lending to the target groups in a sustainable and competitive manner, using not only the Bank's resources but also their own. The successful execution of this Program should improve access to credit for the target groups and this should translate into higher incomes for the small and micro borrowers and increased employment in the businesses that they run.

H. Risks

3.28 The success of the Program depends ultimately on a positive macroeconomic environment that will support economic growth and lead to a healthy demand for credit in the private sector. During the 1990s there were wide swings in monetary policy that were reflected in volatile interest and exchange rates that led to capital flight, a declining exchange rate, and a contraction of credit. The risk of this recurring is mitigated by the tighter control on the macroeconomic variables that the authorities have had since the year 2000, by a new Central Bank Act that provides a firmer foundation for the conduct of monetary, credit and exchange rate policy, and by the IMF Stand-By program that the GGU entered into in April of 2002.

3.29 The proposed Program depends on the commercial banks to intermediate its resources, so the health of the banks, or rather the lack of healthy banks, represents a risk to the Program. This risk is mitigated in several ways. Firstly, the enactment of the Banking Act in April 2002 has lowered this risk by requiring the banks to have higher levels of capital and by putting strict controls on risky practices, like insider lending and under-provisioning. Secondly, the Credit Regulations of the Program help to mitigate this risk, by establishing eligibility criteria that only healthy banks will be able to meet. Lastly, the EA will conduct an annual in-depth credit analysis of the participating institutions that goes beyond the measurement of the eligibility criteria and looks at other elements of risk, such as interest rate gaps and currency mismatches, the quality of management, and the overall reputation of an institution.

3.30 In addition to being sound, the banks must have a strong business interest in lending to the microfinance sector. There is a risk that they lose interest and do not participate in the Program. This has happened in other countries and could happen in Guatemala if, for example, traditional banking business began to earn higher returns on capital invested. This risk is higher with regard to the microfinance target group and is thus partially mitigated by including small businesses among eligible sub-borrowers.

3.31 Lastly, there is a risk that the Program could be administered according to political goals instead of being guided by the principles of sustainability and equal

access to Program resources by eligible entities. The experience of Global I has shown that it is possible to manage such a program in a non-political way. The Program contains measures to mitigate political risk by supporting the creation of a board of directors to manage the EA. As explained earlier, the private sector will be well represented on this board.