BANCO DE GUATEMALA

SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO ACCOUNT IN SESSION 13-2006, CELEBRATED MARCH 22, 2006, FOR DETERMINING THE LEVEL OF THE LEADING INTEREST RATE OF THE MONETARY POLICY

Guatemala, April 18, 2006

SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO ACCOUNT IN SESSION 13-2006, CELEBRATED MARCH 22, 2006, FOR DETERMINING THE LEVEL OF THE LEADING INTEREST RATE OF THE MONETARY POLICY.

The Monetary Board in Resolution JM-185-2005, dated December 27, 2005, determined the Monetary, Exchange Rate and Credit Policy for 2006, in which, among other aspects, indicates, on the one hand, that the decisions in matter of determining the leading interest rate of the monetary policy would be adopted by the Monetary Board, based on the analysis that for the effect would be made by the Execution Committee and, on the other hand, that the Monetary Board would decide once a month on the changes in the leading interest rate of the monetary policy according to the annual calendar of reunions, established in annex 2 of the mentioned resolution. After each decision, and with a one month delay, a summary will be made public of the arguments that the Monetary Board has taken into account, according to the declared in article 63 of the Organic Law of the *Banco de Guatemala*.

In the fulfillment of the declared in the mentioned resolution, the following is presented in a summary of the arguments that the Monetary Board took into account to fix its position regarding the level of the leading interest rate of the monetary policy.

1. In session 13-2006 celebrated by the Monetary Board of March 22, 2006, the President of the *Banco de Guatemala* and the Monetary Board presented the analysis made by the Execution Committee in its session 12-2006 dated March 17, 2006[1], relative to the convenience of adjusting or maintaining the leading interest rate level invariable. In that respect, the President reported that the analysis made by the technical bodies, based on the orientation of the indicative variables and in the balance of inflation risks, indicated that the factors oriented to restricting the monetary conditions prevail. It was indicated that the Committee declared that even though some elements of judgment declared were perceived as favorable for maintaining the leading interest rate of the monetary policy invariable, this perspective was valid only in the very short term, but that, when considering the horizon in

[1] A more detailed analysis can be made by the Execution Committee by consulting Deed No. 12-2006 corresponding to the session from March17, 2006, published on the Website of the *Banco de Guatemala* (www.banguat.gob.gt).

the mid term the factors that suggest restricting the monetary conditions through an increase in the leading interest rate prevail. In that sense, declared that, notwithstanding that the inflation continued its tendency toward deceleration in February, it was observed that the inflation prognosis was over the inflation goal of 6% (+/- 1 percentage point) for December 2006 (in a strict interpretation), therefore it was advisable to keep in mind that the assets of the monetary policy in an explicit inflation goals scheme must opportune and gradual, in order that the inflation expectation be moderated and the inflation goal be reached at the least cost possible. Also, the President informed that in the Committee indicated that another source of inflationary pressure in the mid term came from the direct imported inflation, given the composed index of inflation of the main commercial partners of Guatemala is still relatively elevated. Regarding the behavior of the international price of fuel, reported that the last information available illustrated, on the one hand, an increase in the international price of oil in the last few days and, on the other hand, that the futures prices continue over the prices projected in the international market in February 2006, tendency that, if kept, could generate inflationary pressures in the next months. It was also mentioned that for the Committee it was convenient to follow up on the information of Global Insight relative to the existing breach between the world supply and demand of oil that continued to be minimum, which showed the vulnerability of said market, so that any event of economic nature or policy could positively or negatively influence in the behavior of the price of crude oil.

Regarding the indicative variables of the monetary policy, the President reported that the Committee indicated that, regarding the previous month, the global balance of these deteriorated in relative terms, whereas the two variables that the past month suggested relaxing the monetary policy (the payment means and the banking credit to the private sector), now suggest that it remain invariable. In the Committee it was also pointed out that precaution must be had in interpreting the variables of banking credit to the private sector and payment means, since it was still pending the evaluation of the validity of the projection method of the expected runners that are being used for both variables. It was also highlighted that the fact persisted that the relative variables to the monetary program (particularly the monetary issue and the operations of monetary stabilization) continued deviated (in an expansive sense), situation that has been observed since several months ago.

The President reported that reference was also made to the fact that according to the monetary program, confirmed with information provided by the *Ministerio de Finanzas Públicas* [Equivalent to the Department of the Treasury], the level of public expense execution is going to accelerate in the next months, which, notwithstanding that the level of deposits of the Central Government in the *Banco de Guatemala* has been over the programmed, will imply a greater monetary effort through an increase in the monetary stabilization operations and, on the other hand, that the execution of public finance in February 2006 registered a deficit of Q574.8 million, greater to the observed in February 2005 (Q125.5 million).

In the described context, the President reported that the Execution Committee abstained from the analysis that the current situation should correspond to an adjustment in the leading interest rate of the monetary policy.

2. Derived of the presentation of the analysis of the Execution Committee of the *Banco de Guatemala* and of the balance of inflation risks corresponding to March 2006, the members of the Monetary Board began the analysis and discussion regarding the determination of the leading interest rate in the monetary policy.

A member of the Monetary Board suggested that, based on the information received, the leading interest rate of the monetary policy will go up 25 basic points, taking into account that, even when the behavior of the inflation to February offered certain tranquility, the importance was visualizing its tendency in a mid term horizon, given a scheme of explicit inflation goals, it was evident that the assets of the monetary policy only exercise influence with certain delay on the general level of prices.

It was also indicated that in their judgment, in the current conjunction, the inflation is still found over the goal by 1.26 percentage points and that the analysis of inflation risks balance also suggests the presence of inflationary pressures in the immediate future. On the other hand, emphasis was made on the fact that, on the one hand, deviations persists in the monetary issue and, on the other hand, that the level observed of the monetary stabilization operations, to this date, was below the programmed. It was signaled that the Board did not act now, even in a scenario in which the inflation continued decelerating in the next months, the risk was run that said tendency would be reverted, which could alter the expectations of the economic agents as to the stability in the general level of prices. It was added that an increase of 25 basic points in the leading interest rate would send an appropriate message to the market of commodities and services, of money and exchange, which would strengthen the credibility of the Central Bank regarding the fulfillment of the inflation goal.

Another member of the Board expressed that, in this opportunity, making a decision was complex, but that the opinion was shared that the measures to prevent the effects of inflation must be taken not only gradually but opportunely, reason for which an adjustment in the leading rate was necessary, given that it would offer a message to the economic agents as the Central Bank remains firm in the control of the future inflation, which would guarantee that unnecessary increases would be produced in the interest rates in the long term.

On the other hand, a member of the Board highlighted that the inflationary rhythm is decelerating from November 2005, which constituted a positive signal for the monetary policy and that, if said tendency were maintained, there would be no difficulty in fulfilling the inflation goal for December 2006. It was added that the projections of subjacent inflation for December 2006 and for December 2007 presented an even more favorable scenario, wherefore an increase in the leading interest rate of the monetary policy was not recommendable. Also, it was indicated that the indicative variables, payment means and banking credit to the private sector were within the tolerance margins, which also supported not restricting the monetary policy. It was also added that the only indicative variable that really suggests the need of restricting the monetary conditions was the monetary issue deviation but that, in their opinion, the mentioned variable was only one of the variables to which follow up was given. Additionally, it was indicated that two aspects exist that advise not elevating the leading interest rate; the first, regarding the fact that the weighted average interest rate of the banking system from the beginning of the year stopped its tendency toward the decline, situation that allowed inferring that the measures of monetary restriction applied in 2005 have had some effect in the credit cost and, the second aspect referred to, according to the results from the February survey of inflation expectations to the panel of private analysts, these reported a growth rate of the gross national product for December 2006 greater than the one made known in January 2006, reason for which, an increase in the leading interest rate could put them at risk. In that context, it was estimated that the result of inflation for March and of the projections of total and subjacent inflation, based on the econometric models, in effect that if in March some inflationary rebound were observed that would change the tendency that has been observed in the last months, then there would be justification to increase the leading interest rate of the monetary policy, so that deciding an adjustment in the current conjunction when all indicators are performed in the positive route, would be a rash decision.

In support of the proposal of not modifying the leading interest rate of the monetary policy, some members of the Board expressed that it must be taken into account that, according to the situation of the indicative variables, eight of them suggest that the monetary policy remain invariable; two suggest that the monetary policy be restricted; and none suggest to relax the monetary policy, therefore when considering said variables together, the monetary policy should not be restricted. In particular, a member of the Board expressed that, in their opinion, a decision in the sense of increasing the leading interest rate should not be congruent with the manner in which the indicative variables have been interpreted until now, for which there is no differentiated weighting, if it did coincide in some of these variables (particularly the relative to the monetary program) showed an important deviation, the greater the rest of said variables (that have equal weighting) did not suggest monetary restriction.

Another member of the Board expressed not agreeing with the comment that the inflationary rhythm to February (7.26%), was outside the goal, given that, on the one hand, the last estimations of inflation in the mid term that offer a Semi-structural Macroeconomic Model were decreasing and, on the other hand, that sight should not be lost that the inflation goal was determined for December 2006 and for December 2007, so that increasing the leading interest rate, when the inflation is registering a marked deceleration, not only was justified, but could be counterproductive.

3. After having presented the arguments and observations in order to determine the level of the leading interest rate of the monetary policy, two members of the Monetary Board were of the opinion of increasing the leading interest rate of the monetary policy to 4.50%, whereas the remaining members stood behind the position of keeping said rate invariable, therefore, by majority of members, the Monetary Board kept the leading interest

rate of the monetary policy at 4.25%. Also, the Board decided to issue the press release annex in order to communicate this decision.

ANEX

BANCO DE GUATEMALA

PRESS RELEASE

THE MONETARY BOARD KEEPS THE LEADING INTEREST RATE OF THE MONETARY POLICY AT 4.25%

After analyzing the report presented by the Execution Committee of the *Banco de Guatemala*, the follow up of the indicative variables and the balance inflation risks corresponding to March 2006, the Monetary Board, in its session celebrated March 22, 2006, decided by the majority of its members to keep the leading interest rate of the monetary policy, invariable.

The Monetary Board highlighted the fact that in the significant reduction in the inflationary rhythm registered in the last months, tendency that, it were to continue, would allow the inflation to converge gradually toward the goal established for 2006 and 2007, which would be forced to keep its relative stability in the international price of oil in the last days that at the same time, has coincided favorably in the maintenance of the price of fuel in the domestic market.

Complementarily, the Board considered other variables relevant to the monetary policy such as the banking credit to the private sector, the payment means (Money offer) and the estimation of the level of the interest rate in the short term compatible with the maintenance of the economic stability (parameter rate), variables whose evolution is found within the levels foreseen for 2006 and that together with the maintenance of the fiscal discipline, are consistent with the dynamism foreseen for the economic activity of the country in an environment of macroeconomic stability.

The Monetary Board reiterated its commitment of opportunely and gradually adopting the measures that are necessary in the future, in order to abate the inflationary threats that can present themselves and reach the mapped goals in the current Monetary, Exchange Rate and Credit Policy.

Guatemala, March 23, 2006

A month behind, a summary of the arguments presented in each session of the Monetary Board, where the leading interest rate of the Monetary Policy is decided, will be able to be consulted on the web page of the Banco de Guatemala at www.banguat.gob.gt