BANCO DE GUATEMALA

SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO ACCOUNT IN SESSION 34-2006, CELEBRATED JULY 26, 2006, FOR DETERMINING THE LEVEL OF THE LEADING INTEREST RATE OF THE MONETARY POLICY

Guatemala, August 21, 2006

SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO ACCOUNT IN SESSION 34-2006, CELEBRATED JULY 26, 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.

In session 34-2006 celebrated by the Monetary Board on July 26, 2006, the President of the *Banco de Guatemala* and the Monetary Board presented the analysis made by the Execution Committee in its 30-2006 session celebrated on July 21, 2006[1], regarding the convenience of raising or keeping the leading interest rate level of the monetary policy. In that regard, it was reported that the analysis made by the technical departments, based on the elements that compose the inflation risks balance, the short term inflation prognosis for the third and fourth trimesters of 2006 which will be incorporated as initial conditions in the Semi-Structural Macroeconomic Model, MMS (for its acronym in Spanish), which will produce an inflation prognosis for the end of 2006 and 2007, as well as in the behavior of the indicative variables of the monetary policy, they came to the conclusion that the factors that advise restricting the monetary conditions prevail, therefore an adjustment in the leading interest rate of the monetary policy will contribute, on the one hand, to: moderating

[1] Greater detail of the analysis made by the Execution Committee can be consulted in Deed 30-2006 from session dated July 21, 2006, published on the website of the Banco de Guatemala (www.banguat.gob.gt)

the inflationary expectations of the economic agents and on the other hand, strengthening the credibility of the Central Bank in the management of the monetary policy, aspect of particular importance for the fulfillment of the inflation goal for 2006 and 2007. It was also indicated that the Committee emphasized the fact that, even though the inflationary rhythm in June 2006 was less than the previous month, this is still over the inflation goal, including taking into account the tolerance margin of +/- percentage goal, therefore, considering that for the five remaining months of the year, it was opportune to adopt restriction measures on the monetary conditions for achieving the inflationary goal. As to inflationary rhythm, broken down into its imported and domestic components, the President informed that in the Committee it was highlighted that in June, domestic inflation (4.86 percentage points) reverted the decreasing tendency that has been shown throughout the year (6.36 percentage points in December 2005 at 4.44 percentage points in May 2006). On the other hand, of the 2.69 percentage points that correspond to imported inflation, 2.06 percentage points are attributable to second round effects, which, different from imported first round inflation, can be moderated through monetary restriction measures. It was pointed out that the Committee made emphasis in that in an explicit inflation goals scheme the forward looking analysis becomes relevant for the adoption of opportunely made monetary policy measures. In that sense, it was indicated that, when incorporating the inflation data to June, the total inflationary rhythm prognosis for the end of 2006 and 2007 was observed, obtained through econometric models that have been used, increased regarding the previous month and continue to be located over the upper limit established goal (6% +/- 1 percentage point), which advised adopting measures of monetary conditions restrictions. It was also indicated that the results of the inflation expectations survey by the private panel of experts made in June showed a decrease in the inflationary rhythm projected for 2006, but an important increase for 2007, which, to the Committee's judgment, can be associated to the perception on the possible secondary effects derived of the recent increases in the international price of oil. Reference was also made to the fact that the short term inflation prognosis that will be used as initial conditions in the third running of the Semi-structural macroeconomic model, indicated that the inflationary rhythm will be around 6.83% in the third trimester and at 6.99% at the end of December 2006.

On the other hand, the President referred to the fact that in the Committee there was consensus in that environmental risks had to be taken into account in which the execution of the monetary policy currently takes place. On this matter, it was mentioned that some associated inflationary risks to the external environment were theme of discussion, highlighting the international price of oil scenario, which continued to be the main inflationary risk in Guatemala and showed deterioration in July, due to the surge of two new geo-political occurrences: the launching of long range trial missiles on behalf of North Korea into the Japanese Sea and the recent conflict between Israel and Lebanon. In that context, he made reference that the Committee was of the opinion that the monetary policy has a primary role to perform in lessening the second round effects derived from the rise in fuel prices and associated to the economic agent expectations as well as the manner in which said expectations can affect the determination of costs and futures prices in the market, reason for which, when estimating the increase in the inflation expectation from the panel of private analysts for December 2007 obeys the factor of oil price rises, it was pertinent to adopt opportune measures that moderate said inflationary expectations.

As to internal environmental risks, the President pointed out that in the Committee the behavior toward the appreciation of the nominal exchange rate was mentioned, that has been observed recently to advise not adjusting the leading interest rate, based on the fact that a rise in the internal interest rate would create incentives of short term capital inflow into the country, which, at the same time, could intensify the referred appreciation. In that regard, it was reported that in the committee it was considered that the fact that, according to Bloomberg, there existed a probability of 65% that the Federal Reserve of the United States will again increase its objective interest rate to 5.50% in its August 8 meeting, with the differential that interest rates regarding leading interest rate would be more in favor (in favor of the American interest rates), therefore a modest adjustment in the domestic leading interest rate should not significantly affect the exchange market. He indicated that in the Committee the observed appreciation in the nominal exchange rate to July was highlighted; it was of 0.43%, lower to the observed in an equal period in 2005 (2.08%) and of 2004 (2.44%).

In the described context, the President reported that in the heart of the Committee the criteria that it was advisable to increase the leading interest rate prevailed, taking into account that the monetary policy, on one hand, should act opportunely with the purpose of strengthening the message that the Central Bank maintains as its objective the fulfillment of the inflationary goal, in order to moderate the inflationary expectations that contribute to lessening the second round effects associated to imported inflation, taking into consideration that the monetary policy delays action on inflation (as was confirmed by the empiric studies made by the technical bodies of the *Banco de Guatemala*) and, on the other hand, that it should operate with a mid-term vision in order to cooperate with a path of sustainable economic growth in time, which necessarily requires, among other factors, an environment of price stability.

It was also indicated that the Committee had the opinion that an adjustment of the leading interest rate would allow nearing what the Semi-structural Macroeconomic Model suggests, as to reaching the inflationary rhythm for December 2006 at 6.88%, the leading interest rate of the monetary policy should be around 5.16% in the second trimester of 2006, in the third trimester at 5.53%, and in the fourth trimester at 5.47%, this last level will mark the beginning of a gradual process in the reduction of said rate that would extend to the end of 2007, congruent with the mid-term inflation horizon. In that sense, in the Committee there was consensus in that the increase of the leading interest rate of the monetary policy should be moderate (25 basic points) in order to not produce volatility in the short term interest rates in the money market and propitiate a positive environment among economic agents, and therefore, favor the sustainability of economic growth in the mid-term.

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

A member of the Board declared that the decision to raise the interest rate or not in the current juncture was already complex, since some variables exist that indicated that it was necessary to make an adjustment, whereas some did not; however, the member indicated that there were other aspects that should be taken into account. In that sense, it was mentioned the first aspect to consider was the behavior of the nominal exchange rate toward appreciation, still taking into account that the exchange rate is not the objective of the monetary policy, so an adjustment in the leading interest rate of the monetary policy toward the rise could be counter-productive and transfer a confusing message to the economic agents, in the sense that it could generate greater increase in capital, that, at the same time, could induce the Central Bank into participating in the exchange market buying foreign currency, which would expand the monetary issue and complicate the monetary scenario even more. It was indicated the that the second aspect to consider, and that has an intimate relationship with the nominal exchange rate, was the enforcing of the Free Trade Treaty between the United States of America, Central America and the Dominican Republic, therefore an adjustment in the leading interest rate could induce a greater appreciation and deterioration of the exportation behavior, in detriment of the deficit in current account of the payments balance and the mid and long term economic growth. It was mentioned that a third aspect to take into account was related to the great certainty that among the international financial analysts of the Federal Reserve of the United States they would not raise the objective interest rate in the August 8 meeting, aspect which would induce a minor differential of interest rates. A fourth aspect to mention was the latest review on behalf of the main international risk qualifiers regarding the grading of Guatemalan sovereign debt, which gave a positive result when increasing the grade of risk country, wherefore estimating that said improvement would induce a revision toward a decrease of the Treasury Bond interest rate for the ten year term that was at 9.0%. It was indicated that a fifth aspect to keep in mind was the inflation projections for December 2006 and December 2007, which even though were over the established goals, can be reached, since an important decrease was observed in the subjacent inflation, when going from 7.29% in May to 6.91% in June, aspect that gave a margin of certain tranquility in the decision making of the monetary policy; in that same direction; finally, reference was made toward the behavior of domestic inflation, which was below the goal and even below 5.0%.

Another member of the Board expressed that on this occasion, they supported an increase of 25 basic points in the leading interest rate of the monetary policy for the following reasons: in the first place, because the volatility of the international price of oil exercises inflationary pressures, aspect that advises taking prevention measures opportunely, with the object that, later, they would not have to be taken abruptly.

In second place, due to the fact that inflation in the main commercial partners of the country, especially that of the United States of America, is relatively high and generally the transmission of that inflation is direct through the importations of the country, so that said effect represents an important risk to reach said inflation at the end of the year, reason for which preventive measures must be taken. In third place, because even though it is true that the level of open market operations are found below the programmed, it is also true that the deposits of the central government in the *Banco de Guatemala* were over the foreseen, situation that if it is analyzed with the expectation that in the second semester of 2006 foresaw a greater execution of public expense, could represent a greater risk of inflationary expectations, which suggest restricting the monetary policy. In fourth place, the econometric inflation projections for December 2006 and 2007 were over the established goal, and considering that the regimen of explicit inflation goals requires much discipline due to the delay with which the monetary policy actions are transmitted, and was necessary to take opportune, prudent and gradual measures in order to achieve the inflation goal. They also considered the Central Bank has achieved the transmission of the correct message to markets and economic agents as to inflation control, which is observed in the fact that the mid and long term interest rates, especially banking interest rates and those of the Treasury Bonds of the *Ministerio de Finanzas Públicas* [Equivalent to the Department of the Treasury.], has been almost unaffected by the rises in the short term interest rate, therefore they were of the opinion that they should not abandon this demonstration of prudent steadfastness.

Another member of the Board expressed that taking into account the orientation of the indicative variables, it was clear that the most convenient decision was to increase the leading interest rate of the monetary policy by 25 basic points; however, they made reference that it must be considered that, even when it were possible that the impact of an adjustment in the leading interest rate does not reflect an increase in the active leading interest rate of the banking system in the short term, this would not mean that the same would not happen in the future. They also added that another subject of reflection referred to the fact that if the political conditions changed at the end of the year and at the beginning of 2007 and the appreciation of the nominal exchange rate continue, the economic activity of the country could be adversely affected.

A member of the Board declared that from their point of view, the most important reason for which a 25 basic point interest should be sustained in the leading interest rate of the monetary policy was the channel of inflation expectations, because if it were analyzed that it could be used to placate the effects of the rise in oil price through the monetary policy it could affect the channel of inflation expectations through a steadfast message on behalf of the monetary authority as to how much inflation is controlled. In that sense, would prefer that the decision were prudent and that the adjustment of the leading interest rate would be applied in function of what the Semi-structural Macroeconomic model establishes, which gives the tendency that should be followed in the referred interest rate.

Another member indicated that, with the purpose of making an appropriate decision regarding the level of the leading interest rate, there were some elements that had to be considered; for example, that there was enthusiasm in the economic agents for the current evolution of economic growth; even over that foreseen, therefore an increase of the leading interest rate could put a brake on this tendency. It was also highlighted that it would be important not to lose sight of the competitiveness, given that, for example, the exportations of the country are not growing. It was indicated that another element was at the level of the active interest rate of the banking system of the country, that even though it had been decreasing in the last years, this tendency had been stalled in the last few months and continued to be elevated in real terms, aspect that is added to the exchange rate, which far from depreciating, is appreciating to date this year. In that sense, it was reiterated that one must be prudent in making decisions, because the real interest rates in the country continue to be high compared with the commercial partners, especially the United States of America, therefore should not worry about the inflation level, but the inflation differential that transmits the international price of oil, when it is not of monetary character, it would be difficult to control through the restriction of monetary conditions and that if the rest of the countries are having the same effect, it would be worthwhile to be prudent and to not overreact increasing the leading interest rate.

As to the reference nominal exchange rate, a member of the Board made reference to the fact that they do not perceive incongruence regarding the participation of the Central Bank in the exchange market and the need to increase the leading interest rate, because there are two different aspects. In that sense, it was indicated that the current Monetary, Exchange Rate and Credit Policy express that the exchange rate is determined by the interaction of the supply and demand, and that the *Banco de Guatemala* has an explicit participation rule in the exchange market that knows the economic agents and whose purpose it is to moderate the volatility of the exchange rate without modifying its tendency. As a consequence, it was indicated that the variations of the nominal exchange rate would not happen independently from the fact that the inflation could accelerate for reasons that were previously commented, in order that the most important in the inflationary matters was that the Central Bank act opportunely on the inflation expectations for reasons that are purely inflationary.

Another member of the Board declared that he shared the criteria that the Board should give a moderate increase of 25 basic points in the leading interest rate of the monetary policy for the following reasons: in the first place, because the projection of the inflation for December of 2006 and 2007, is a passive projection, indicating that if the Monetary Board did nothing, the inflation would be over the goal. In second place, because the inter-annual growth rhythm of the banking credit to the private sector is projected in 28% but, facing a change in the economic conditions, they could generate important pressure on inflation. In third place, because the fact that domestic inflation grew from May to June was worrying, and if it continued like that, could be higher than the inflation goal if it were not opportunely slowed down and, in a monetary scheme that gives privilege to a forward looking orientation, the most probable is that this time they should raise the leading interest rate of the monetary policy or the next time slow down the behavior of domestic inflation. They also added that the leading interest rate of the monetary policy has the function of slowing down inflation through the moderation of the added demand, therefore considering that there was no direct relation in the affirmation that an increase in the leading rate transfers automatically to the market credit interest rates, because said situation had not occurred like that in the last 18 months. In that sense, they added that it were preferable that the Monetary Board transfer the message that measures were being taken against inflation, because the risks run were significantly less with a rise in the leading interest rate, regarding those that could be had if they doubted the commitment of the Central Bank as to the stability in the general level of prices.

3. After having expressed the arguments and observations to determine the level of the leading interest rate in the monetary policy, the Monetary Board by unanimity decided to increase the leading interest rate of the Monetary Policy from 4.75% to 5.00%.

Also the Board decided to issue the attached press release in order to communicate their decision.

ANNEX

BANCO DE GUATEMALA

PRESS RELEASE

THE MONETARY BOARD WILL INCREASE THE LEADING INTEREST RATE OF THE MONETARY POLICY FROM 4.75% TO 5.00%, AS OF THURSDAY, JULY 27, 2006

The Monetary Board, in its session celebrated on July 26, 2006, decided to increment the leading interest rate of the monetary policy by 25 basic points from 4.75% to 5.00%. In their decision, after having heard the follow up on the indicative variables and the inflation risks balance corresponding to July, 2006, took into consideration the inflation prognosis presented by the technical departments of the *Banco de Guatemala*, for 2006 as well as for 2007, which were still over the established goal for each of those years, aspect that, in the context of the scheme of explicit inflation goals, advises restricting the monetary policy.

Also, the Board observed that, even though the monetary policy can not avoid the direct effects of imported inflation produced by the rise of fuels, it estimated that it is proceeding to restrict the monetary conditions in order to ensure the moderation of the inflationary expectations and in that way limit the second round effects[2] that can be derived of said imported inflation, particularly before the scenario where the international price of oil is more and more volatile.

In the opinion of the Monetary Board, the economic growth indicators continue to show robust behavior in the real activity of the country, at the same time that the majority of the indicative variables point toward; with adequate monetary and fiscal policy conduction, the achievement of the inflationary goal in the mid-term as feasible. The Board emphasized that, for said perspectives to be sustainable, it is proceeding to opportunely adopt the measures of monetary policy that allow that inflation to converge toward the established goal for the mid-term, propitiating the most favorable monetary and financial conditions for the orderly growth of the national economy.

Guatemala, July 27, 2006

With a one month delay, 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

[2] It refers to the increase in the price of those goods and services that in their cost structure do not incorporate oil derivatives, but are indirectly affected by aspects such as the increase in the price of transportation, electricity and others.