

BANCO DE GUATEMALA



SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO ACCOUNT IN SESSION 17-2006, CELEBRATED ON APRIL 26, 2006, IN ORDER TO DETERMINE THE LEVEL OF THE LEADING INTEREST RATE OF THE MONETARY POLICY

Guatemala, May 24, 2006

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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 determination of the leading interest rate of the monetary policy will 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 calendar of annual reunions, established in annex 2 of the mentioned resolution. After each decision, and with a delay of one month, the publication will be made of a summary 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 fulfillment of the decided in the mentioned resolution, the summary of arguments that the Monetary Board took into account in session 4-2006, celebrated on January 25, 2006, to fix its position regarding the level of the leading interest rate of the Monetary Policy is presented in the following.

1. In session 17-2006 celebrated by the Monetary Board of April 26, 2006, the Vice-President of the *Banco de Guatemala* presented the analysis made by the Execution Committee in session 17-2006 dated April 21, 2006¹, regarding the convenience of adjusting or maintaining the leading interest rate of the monetary policy variable or invariable. In that regard, it was reported that the analysis made by the technical

¹ A greater detail of the analysis made by the Execution Committee can be consulted in Deed 17-2006 corresponding to the session of April 12, 2006, published on the website of the *Banco de Guatemala* (www.banguat.gob.gt)

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departments, based on the orientation of the indicative variables and in the balance of inflation risks, indicated that the factors that advise restricting the monetary

conditions prevailed. It was indicated that the Committee emphasized the fact that the inflationary rhythm had increased slightly in March, which could mean that the tendency toward deceleration of the inflationary rhythm that had been registered since November had concluded. It was also mentioned that the projection of the econometric inflation for the end of 2006 was located over the punctual value of the inflation goal for that year (6.0%). The vice-president emphasized that in the context of the scheme of explicit inflation goals, special attention must be given to the fulfillment of a mid-term horizon, therefore for the Execution Committee the fact that the econometric projection of the total inflationary rhythm for 2007 was of 6.57% and the subjacent inflation was of 6.45%, was a motive for discussion and worry, which implies that not only would it be over the punctual value of the inflation goal (5%) fixed for the end of 2007, but it would also be over the margin of tolerance of the referred goal (+/- 1 percentage point). The vice-president also made reference that in the Committee some inflationary risks associated to the external ambit were also mentioned, based on the report on the “Perspectives of World Economy” of the International Monetary Fund corresponding to April 2006, which pointed out that the globalization forces in the last decade had implied an important increase of the competence between offerer and supplier of goods and services in the world market, aspect that has contributed to supporting the efforts of the central banks to keep the stability in the general level of prices; however, it would seem that in the current venture signals were given that a depletion of unused installed capacity was being reached and that the behavior toward the rise of the international price of oil and its derivatives like of some raw materials were indicating that the inflationary pressures at world level could be returning; associated to that, several industrialized countries showed low pressure labor markets, which at the same time would reduce the benign effects that global competition has had on the salaries, which announced that the task of central banks around the world would tend to complicate itself in the next months. In that same context, the vice-president mentioned that the liquidity excesses that in the international markets had shot a search for yields that had affected

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exchange markets like the Guatemalan could be ending, since the monetary restriction in Japan, United States of America and Europe could make a reversal of the capital flow. In addition to the above, it was highlighted that in the referred report it advises that this could give a reduction in the global savings rate on behalf of the corporations, which would also contribute to a rise in the international interest rates and that this normalization of the conditions of world liquidity could mean some degree of volatility in the future markets, where the prices of assets have been inflated, which presents a complex panorama for the central banks to keep macroeconomic stability and, particularly, the stability in the general level of prices, therefore it was prudent to consider the adoption of precautionary measures oriented to preparing the macroeconomic environment for better resisting the adjustments that could be made in the external financial conditions. Also, it was mentioned that for the Execution Committee, on the one hand, the current tendency to rise in the oil prices, which tended to be stationed even over the expected pessimist scenario at the beginning of the year (that projected a price per barrel over US\$70.00) and, on the other hand, the fact that the recent rises were attributable to more offer factors, due to the geopolitical problems in the Mid-East and Nigeria, which made the maneuver margin of the rest of the world for the adoption of policies oriented to restricting the demand to be very reduced, preoccupying. In the described context, the Vice-President mentioned that, even though it was true that the monetary policy could do little to counteract the “first round” effects of the rise in fuel, should not loose sight if it is feasible that the monetary policy could lessen the “second round” effects, especially if opportune measures are taken that moderate the inflationary expectations. As to the risks of the internal ambit, the Vice-president informed that in the Committee it was pointed out that the growth of the banking credit to the private sector continued to be a motive of analysis and reflection. Additionally, it was reported that in the heart of the Committee it was mentioned that in the results of the first run of the Semi-structural macroeconomic model, it was clearly observed that the inflation goal could be achieved, increment that, given the delay with which it operates the monetary policy, should be adopted opportunely for the inflation to converge toward the goal in the foreseen horizon. On the other hand, the vice-president made reference to the fact that the committee analyzed the possible impact of a raise in the leading interest rate and, among

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other factors, it was mentioned that a factor that favored an increase in the referred rate was the national production that seemed to be growing robustly, so that a moderate adjustment of the leading interest rate, in the current circumstances, with difficulty would affect the economic growth rhythm in the short term, and would more likely favor its sustainability in the long term. Also, it was indicated that in the committee the exchange dilemma was analyzed that could affect the decision of raising the leading interest rate. In that regard, it was mentioned that it would be worthwhile to have a mid-term vision, since the differential of the short term interest rate is observed between the United States of America and Guatemala with greater frequency, in favor of the US rates and with a tendency to continue increasing, which allows inferring that an adjustment of the domestic interest rate should not significantly affect the exchange market.

Taking into account the previous context, the Vice-president informed that in the heart of the committee the analysis of the fact that an opportune analysis of the leading interest rate of the monetary policy could have positive effects on the inflation expectations of the economic agents and, therefore, favor the achievement of the inflation goal and the economic growth in the long term was discussed.

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

A member of the Monetary Board declared that, considering that the analysis of the Execution Committee indicated the convenience of increasing the leading interest rate of the monetary policy to moderate the inflationary expectations, it would have to analyze the effect that said increase could have in the long term interest rate (active interest rate in the banking system), due to the fact that the level of the same could be constituted as a fundamental element for the maintenance of the favorable

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macroeconomic conditions for a sustained economic growth, especially if the current venture projects for 2006 have an increase of the GNP of 4.4% and that the Economic Active Monthly Index (IMAE, for its acronym in Spanish) to March registered an inter-annual rate of 5.6%, emphasizing that it is important that the long term interest rate be kept relatively competitive, highlighting the fundamental requirement for this to happen is that the same be sustainable in order not to generate distortions in the assignment of resources, situation that could achieve through the application of coherent policy measures (monetary as well as fiscal) that allow keeping the inflation expectations of the economic agents, low. Also, preoccupation was declared in the sense that an increase to the leading interest rate would eventually create a distortion in the yield curve. In that same context, the effect said increase would have on the economic growth was referred to, taking into account that if said increase in the mid-term interest rate could produce an increase in the active interest rate of the banking system which, together with the exchange appreciation that has been observed in absolute as well as real terms could propitiate that the economy lose competitiveness and, consequently, affect the economic activity. In this context, it was indicated that evaluations were needed for; if an increase in the leading interest rate was given, the dynamism that the IMAE is demonstrating would not be stopped. In that regard, the technical bodies of the *Banco de Guatemala* pointed out that, according to the results of the first running of the Semi-structural Macroeconomic Model, an increase in 25 basic points in the leading interest rate could influence in a reduction in the economic growth, in accumulated terms, of 0.07 percentage points in a period of 9 months; therefore the effect of the referred increase was almost imperceptible and that, in any case, a measure of the monetary policy that propitiates macroeconomic conditions of stability, points out that in the long term favors the economic growth. In that sense, the same member of the Monetary Board indicated that the active interest rate of the banking system when it is a long term includes, among other elements, a premium for inflation, for which an adjustment in the leading interest rate gives special importance given that it contributes to sending a correct signal on the restriction in the monetary conditions, which could lessen the referred premium and, therefore, induce a reduction or at least keeping the level of the interest rate in the long term, reiterating in that aspect, in their opinion, it is fundamental of the

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maintenance of favorable macroeconomic conditions that allow sustainable economic growth.

Another member of the Monetary Board indicated that notable stability in the indicators of monetary origin was observed, particularly, in the behavior of the parameter rate, which indicated that there were monetary pressures, as well as the level of the payment means, that is even under the lower limit of the estimated runner for said variable. However, it was indicated that taking into account the substantial increase that has been observed in the international price of oil, considered that the increase of the leading interest rate by 25 basic points was prudent with the only purpose of moderating the inflationary expectations of the economic agents.

Another member of the board declared their worry due to the dilemma that increasing the leading interest rate of the monetary policy represents for restricting the monetary conditions, in virtue of the fact that if as a result of it there is an increase in other terms, a greater flow of capital from abroad can be initiated, which at the same time, will propitiate the participation of the *Banco de Guatemala* in the exchange market buying foreign currency and issuing *quetzales* that again have to be neutralized. On the other hand, it was indicated that when observing the behavior of the monetizing and demonetizing factors of the accounts in the *Banco de Guatemala* in accumulated terms to the most recent date (from December 31, 2005 to April 20, 2006), if they are compared to the disbursements for the foreign loans received by the Central Government, that have increased the International Net Reserves, with the counterpart in *quetzales* of said disbursements in the deposits in the Central Bank, both values almost compensate therefore, in their opinion, the excess liquidity that was generated on behalf of the referred increase in the NIR (external monetization) was mainly derived from the purchase of foreign currency that the *Banco de Guatemala* has made in the exchange market for moderating the volatility of the nominal exchange rate, therefore finding a counter sense in that, on the one hand, increasing the leading interest rate with the objective of restricting the liquidity in the economy and, on the other hand, of giving liquidity through the purchase of foreign currency on behalf of the Central Bank, which suggested having special care in the sense of not sending contradictory signals to the markets; indicating that if the analysis of the Execution Committee and the

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conclusions derived from the balance of inflation risks suggest restricting the monetary conditions in order to avoid an exacerbation of the inflation expectations, supporting the measure of making an adjustment of 25 basic points in the leading interest rate of the monetary policy.

On the other hand, the board declared that it supported the increase in the leading interest rate of the monetary policy, considering that it was necessary to take measures for moderating the inflation expectations. It was indicated that they were warned of inflation dangers that they should opportunely act, in order to not allow that the same generate the expectation in the market, that inflation is out of control, taking into account the effect that an inflation premium has on the active interest rate of the banking system, which, in their opinion, would significantly damage the economic growth in the future. In that sense, it was highlighted in that given the vigorous growth that is being shown in the economy and, with the purpose of making it sustainable, supporting an increase of 25 basic points in the leading interest rate of the monetary policy, which would allow sending the economic agents the signal that the monetary authority is willing to avoid a raise in the inflation and with that propitiate that the active interest rate of the banking system be maintained in the levels at which they are currently found.

Another member of the Board indicated that it might be prudent to increase the 25 basic points in the leading interest rate of the monetary policy, given the external conditions derived of the increase of the oil prices and its derivatives, which obviously can have a cascade effect in the increase of the price of products for the basic food basket. Also, it was indicted that another of the factors to take into account is the decision that could be taken by the Open Market Operations Committee of the Federal Reserve of the United States, in the sense of increasing its objective interest rate to 5.0% in the next meeting on May 10.

Another member of the Board declared that considering the cost an increase in the general level of prices has for society, it was preferable to make an adjustment of 25 basic points in the leading interest rate now, than wait for a greater inflation in the near future, therefore it was prudent to opportunely take action in the monetary policy.

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3. After having presented the arguments and observation in order to determine the level of the leading interest rate of the monetary policy, the Monetary Board decided to increase the leading interest rate of the monetary policy in 25 basic points from 4.25% to 4.50%.

Also, the Board decided to issue the following press release to communicate their decision.

ANNEX



BANCO DE GUATEMALA

PRESS RELEASE

**THE MONETARY BOARD WILL INCREASE THE LEADING INTEREST
RATE OF THE MONETARY POLICY FROM 4.25% TO 4.50%,
AS OF THURSDAY, APRIL 27, 2006**

The Monetary Board, in its session celebrated April 26, 2006, decided to increase the leading interest rate of the monetary policy by 25 basic points from 4.25% to 4.50%. In its decision, after having heard the follow up of the indicative variables and of the balance of inflation risks corresponding to April 2006, it took into consideration that the inflationary rhythm in March 2006 registered a slight increase, that breaks the deceleration that came from March 2006 registered since November 2005. Also, the Board observed that in the external ambit, the behavior to rise in the international oil price involved clear risk in future inflationary pressures.

In the opinion of the Monetary Board, the economic growth indicators showed a robust behavior of the real activity of the country, at the same time that the majority of the indicative variables point toward that, with an adequate conduction of the monetary and fiscal policies, the achievement of the inflationary goal in the mid term is feasible. The Board highlighted that, so said perspectives are sustainable, it is convenient to opportunely take the measures of the monetary policy that allow: (i) moderating the second round effects ² derived of imported inflation; (ii) avoiding that the macroeconomic adjustments that in the near future world economy could register distorting domestic stability; and, (iii) strengthen the expectations of the economic agents in the sense that the

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.

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monetary authority could make all necessary efforts to ensure that the inflation converge with the established goal for 2006 and for 2007.

The Monetary Board reaffirms its obligation to continue adapting the measures that are necessary in the future, in order to diminish the inflationary threats and propitiate the most favorable monetary conditions for the orderly growth of the national economy.

Guatemala, April 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.banquat.gob.gt