

# BANCO DE GUATEMALA



**SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO CONSIDERATION IN SESSION 29-2006, CELEBRATED JUNE 21, 2006, IN ORDER TO DETERMINE THE LEVEL OF THE LEADING INTEREST RATE OF THE MONETARY POLICY**

Guatemala, July 17, 2006

## **SUMMARY OF THE ARGUMENTS THAT THE MONETARY BOARD TOOK INTO CONSIDERATION IN SESSION 29-2006, CELEBRATED JUNE 21, 2006, IN ORDER TO DETERMINE 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 matters 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 the Execution Committee will make and, on the other hand, that the Monetary Board will decide once a month on the changes in the leading interest rate of the monetary policy according to the annual meeting calendar, established in annex 2 of the mentioned resolution. After each decision, and with a delay of one month, a summary of the arguments that the Monetary Board has taken into consideration will be published, according to the established in article 63 of the Organic Law of the *Banco de Guatemala*.

In fulfillment of the agreed in the mentioned resolution, in the following is a summary of the arguments that the Monetary Board took into account to fix their respective position on the level of the leading interest rate of the monetary policy.

1. In session 29-2006 celebrated by the Monetary Board on June 21, 2006, the President of the *Banco de Guatemala* and the Monetary Board presented the analysis made by the Execution Committee in its session 25-2006 dated June 16, 2006<sup>1</sup>, regarding the convenience of adjusting or keeping the level of the leading interest rate invariable. In that regard, it was reported that the analysis made by the technical departments, based on the orientation of the indicative variables and the inflation risks balance, signaled that the factors prevail that advise restricting the monetary conditions. It was pointed out that in the Committee the fact that since March 2006 the tendency to deceleration that the inflationary rhythm had shown from November 2005 and February 2006 was reverted. Also, it was indicated that the Committee observed that the prognosis of the total inflationary rhythm for the end of 2006 and 2007, obtained through the econometric models that have been used, are

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<sup>1</sup> Greater detail of the analysis made by the Execution Committee can be consulted in Act No. 25-2006 corresponding to the session of June 16, 2006, published on the website of the *Banco de Guatemala* ([www.banguat.gob.gt](http://www.banguat.gob.gt)).

located over the inflation goal, including over the tolerance margin of +/- 1 percentage point. On the other hand, the President mentioned that the results of the survey of inflation expectations of the panel of private analysts made in May showed an increase in the inflationary rhythm projected for 2006 and a slight decrease for 2007, and that both prognosis were located over the inflation goal established for said years, emphasizing that to the date of the survey the inflation results for May were not yet known. Also the President referred to the fact that in the Committee some inflationary risks were mentioned associated to the external environment, particularly, the regarding the behavior of the rise in international oil prices, which differing from the increases observed in 2004 and in 2005, were mainly attributable to factors that affect the world offer for oil, which reduces the maneuver margin available to the net oil importing countries to adopt policies oriented toward restricting the aggregate demand and, therefore, moderating the inflationary expectations.

In that sense, the President pointed out that the Committee was of the opinion that the monetary policy has a fundamental role to perform in order to diminish the “second round effects” derived of rises in fuel prices and of the associated to the inflation expectations of the economic agents, reason for which it was pertinent to adopt measures of opportune monetary restrictions that moderate, on the one hand, the referred effects of the second round and, on the other hand, the mentioned expectations. He informed that the Committee highlighted the fact that the international oil price stabilized, after the important registered rise in the third week of April and that, as of the second week of May had begun registering a tendency to decrease, which was maintained after the fall of the main Iraqi terrorist leader, since the markets were expecting this to reduce the pressures of terrorist groups in the Middle East and, therefore, reduce the volatility in the international price of crude oil.

As to the risks of the internal environment, he pointed out that in the Committee it was mentioned that the behavior of the nominal exchange rate during June had registered a marked stability and greater congruence with its seasonality, which allowed the Central Bank to not participate in the exchange market. In that regard, it was reported that in the Committee some considerations on exchange nature were made regarding a possible

increase in that the leading interest rate should take into account that, according to Bloomberg, there is a 100% probability that the United States Federal Reserve will again increase the objective interest rate in its June 29 meeting, therefore the differential of interest rates regarding the policy rate in the mentioned country would be greater each time (in favor of US rates) and with a tendency to continue increasing, therefore a modest adjustment in the domestic interest rate should not significantly affect the exchange market. Regarding inflation, the Committee highlighted that based on the decomposition of the inflationary rhythm, in imported and domestic inflation, on the one hand it was observed that the domestic inflation has been steadily reduced, when going from 6.36% in December 2005 to 4.44% in May 2006 and, on the other hand, that if domestic inflation is added to the average historic imported inflation (0.52%), said rhythm will increase to 4.96%, locating itself closer to the lower limit of the tolerance margin of the inflation goal (6% +/- 1 percentage point). It was indicated that, notwithstanding the above, the Committee emphasized that the relative weight of the imported inflation in the total inflationary rhythm (3.18 percentage points), 2.47 percentage points are attributable to the second round effects, which, at a difference to first round imported inflation, if they can be moderated through monetary policy measures.

In the described ambit, the President reported that in the heart of the Committee there was no analysis that it was a justifiable increase in the leading interest rate of the monetary policy, taking into account, on the one hand, that the monetary policy should act opportunely with the purpose of moderating the inflationary expectations in order to lessen the “secondary round” effects, associated to the imported inflation, taking into consideration that the monetary measures will act with a delay in the inflation (as is confirmed by the empiric studies made by the technical bodies of the *Banco de Guatemala*) and, on the other hand, that the mentioned monetary policy should act with a mid-term vision in order to ensure that the economic growth is sustainable in time, which requires an environment of macroeconomic stability. It was mentioned that in the Committee there was an observation of a moderate adjustment in the leading interest rate made, as has been established in previous sessions, will have the advantage of avoiding that in the future more intense adjustments be adopted to achieve the same purpose. In that order of ideas, the President also indicated that in the Committee the possible impact of a rise in the leading interest rate

was analyzed, reiterating the criteria that, given the national economic activity seems to be growing robustly, a reasonable adjustment in the leading interest rate would, with difficulty, affect the real growth in the short term, and would possibly favor it in the long term; in any case, if the growth effect were produced, this would be very small (according to the confirmed in the Semi-structural Macroeconomic Model) and would be more than compensated with the reduction in the inflation risks or in the external, financial or future exchanges lack of balance.

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

A member of the Board indicated that he considered, for the moment, that it was not opportune to increase the leading interest rate of the monetary policy, due to the fact that, on the one hand, the inflationary rhythm in the last month had had a decreasing behavior, and, on the other hand, that a rise in the mentioned interest rate could induce an increase in the liable interest rate of the banks in the system. However, it was said that if it was taken into account that the inflationary rhythm prognosis in the mid-term were over the inflation goal, it would be necessary to adopt measures of the monetary policy so that inflation converge toward said goal, avoiding the risk of having to make a greater monetary effort in the near future. On this particular, the technical bodies of the *Banco de Guatemala* pointed out that, according to the econometric estimations, the adjustment of 4.25% to 4.50% that the Monetary Board decided to make in the leading interest rate in April of this year, could have induced the slight increase of around 0.10 percentage points (*ceteris paribus*) in the liable interest rate of the banking system, and that also said estimations reflected that an increase of 1% in the leading interest rate of the monetary policy would reduce the Index of the Consumer Prices in 0.34% with a six-month delay. Additionally, the technical bodies emphasized the importance of having a mid-term vision as to the achievement of the inflation goal, pointing out that the parameter with which it is adequate to compare the observed inflation is with a determined inflation goal by the monetary policy, mainly for

December 2007, as long as, if it were true that accumulated inflation showed a lower level than the observed the previous year, was also that the estimations of expected inflation were still over the fixed goal by the Monetary Board. In that sense, it was added that, even though the results coming from the Semi-structural Macroeconomic Model indicated that if it were feasible to reach the inflation goal, the same are subject to adjustments in the rise in the leading interest rate of the monetary policy. Also, it was emphasized that the rest of the auxiliary elements that are used to make the analysis at the leading interest rate level, that are contained in the balance of the inflation risks balance, suggest a restriction in the monetary conditions, particularly the indicative variables, which in their majority point to the convenience of making an adjustment in the leading interest rate to propitiate it fulfill the inflation goal.

Another member of the Board indicated that, according to the information presented by the technical bodies, of the total inflationary rhythms to May 2006, 3.18 percentage points correspond to imported inflation and, of them, 2.47 percentage points were attributable to second round effects, of which, the difference pertain to first round imported inflation, can be moderated through monetary policy measures. In that sense, it was indicated that the manner in which the second round effects can be moderated had to be investigated deeper, those that do not exclusively depend on monetary aspects, suggesting that these could be faced through the inflation expectations channels, through a message of the monetary authority that will give certainty as to what is increasing the leading interest rate of the monetary policy with the objective of moderating said expectations, since from the monetary point of view did not find a direct manner so the second round effects could be lessened. In that regard, another member of the Board indicated that the experience showed that in small and open economies like the Guatemalan, the central banks recognize that it is not appropriate, through monetary policy, to try and revert the first round effects, that it is reasonable and convenient that the monetary policy try to moderate the second round effects that will mainly have effect on the inflationary expectations, through the mechanism of the economic agents, when realizing and believing that the monetary policy is firm in its purpose of reaching the inflation goal, and would be contributing to moderating the banking credit demand as well as the goods and services demand.

Another member of the Monetary Board indicated that they supported the analysis of the Execution Committee in the sense of increasing the leading interest rate in 25 basic points. It was mentioned that they estimated that if no actions were implemented to contain the inflation, at the end of the year the total inflation will be greater to 6%. Additionally, they added that they considered that the efforts of the Central Bank to reach the objective of the inflation goal will contribute to strengthening its credibility, aspect that was favorable given that it can have a positive influence on the expectations for the determination of other macroeconomic prices, particularly, the long term interest rate. In that sense, it was pointed out that if, on the contrary, there is no certain message of the economic agents as to the fulfillment of the inflation goal, will demand a premium due to higher inflation in the market interest rate, which would result prejudicial for the economy of the country.

Another member of the Board declared their point of view in the sense that the leading interest rate of the monetary policy by 25 basic points, in virtue that, as such suggest the econometric measurements made by the technical departments of the Central Bank, the increases of the leading interest rate in 2005 and in 2006, even with a delay, has had an effect over the observed inflationary rhythm.

Another member of the Monetary Board indicated that, if the inflationary rhythm was over the goal and that the inflation prognosis is also located over said goal, had to consider that a direct imported inflation component exists that is out of control of the monetary policy, therefore if the inflation goal is not reached at the end of the year due to the impact of said direct imported inflation where the effort of the monetary authority to reach said goal must remain clear anyway, although it does not converge, due to the exogenous factors that are out of the control of the monetary policy, like the increase in the prices of fuel, associated to the increase in the international price of oil. Also, it was indicated that another aspect that was important to emphasize was the positive behavior of the fiscal policy, in virtue of the fact that to date a pretty acceptable fiscal deficit was observed and the same was projected at the end of the year to be less than the foreseen, but still considered it important to be commented, without subtracting the work of the *Ministerio de Finanzas Públicas* (Equivalent to the Department of the Treasury) and of the Superintendence Tributary Administration, and it is because there also exist contributors that have allocated resources for that result, so that the fiscal result were not an exclusive effort

of the Central Government but of the society that is contributing more taxes, product of much more stable macroeconomic conditions present in the country. Additionally, it was indicated that another macroeconomic variable to highlight was the behavior of the banking credit to the private sector, which has been maintained with a very acceptable growth and that if it is true that the active weighted average interest rate observed does not show a tendency toward the low, it is true it has remained stable, even though it could be lower for Guatemala, given that the risk conditions of the country have decreased, as a result of the good macroeconomic performance. It was pointed out that taking into account the described factors, as well as the position declared the month before that there had to be another precaution and wait to see which would be the behavior of the macroeconomic variables for the present date, also observing that the subjacent inflation had not continued with the decrease that had been observed in that variable, if it considered that on that occasion it were opportune to make an adjustment of 25 basic points in the leading interest rate of the monetary policy.

Another member of the Monetary Board declared that, in this opportunity, they supported the initiative of raising the leading interest rate by 25 basic points, based on the arguments that have been presented as to an adjustment in the leading rate that could moderate the impact of the second round inflation and have effects through the channel of the inflation expectations. Additionally, it was indicated that their decision also supported the fact that the economic growth would look solid, sustained by the dynamics that have been observed in the Economic Activity of the Monthly Index, IMAE (for its acronym in Spanish), as well as the growth of the banking credit to the private sector.

Lastly, a member of the Board expressed that given the expectations planted and the control of the inflation being one of the essential objectives of the monetary policy, and conscious of the effects that the inflationary level has in any instance of society, supported the 25 basic points increase in the leading interest rate of the monetary policy, but also declared that if in a future analysis on the revision of the level of said leading interest rate will observe that the inflation rate would decrease, in that same direction would have to act to adjust the leading interest rate of the monetary policy.



3. After having exposed the arguments and observations for determining the leading interest rate level of the monetary policy, the Monetary Board by unanimity decided to increase the leading interest rate of the monetary policy from 4.50% to 4.75%. Also, the Board decided to issue the annexed press release in order to communicate their decision.

## ANNEX



# BANCO DE GUATEMALA

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## PRESS RELEASE

### **THE MONETARY BOARD WILL INCREASE THE LEADING INTEREST RATE OF THE MONETARY POLICY FROM 4.50% TO 4.75%, AS OF THURSDAY, JUNE 22, 2006**

The Monetary Board in its session celebrated June 21, 2006, decided to increase the leading interest rate of the monetary policy by 25 basic points from 4.50% to 4.75%. In its decision, after having heard of the follow up on the indicative variables and the inflation risks balance corresponding to June, 2006; took into consideration the incidence that the increase in the observed inflationary rhythm in May 2006 had on the inflation prognosis for 2006 and 2007 that are still located over the established goal in current monetary policy.

Also, the Board estimated that, even though the monetary policy can not avoid the direct effects of imported inflation produced by the rise of fuels, it is proceeding to adopt measures tending to moderate the inflationary expectations and in that way limit the second round effects<sup>2</sup> that can be derived of said imported inflation.

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, gradually and consistently take measures of monetary policy that allow that inflation converge toward the established goal for the mid-term, propitiating the most favorable monetary conditions for the orderly growth of the national economy.

Guatemala, June 22, 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](http://www.banguat.gob.gt)*

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<sup>2</sup> 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.