

**BANCO DE GUATEMALA  
DECREE CT- 4/2007**



**EVALUATION OF THE MONETARY,  
FOREIGN EXCHANGE RATE AND CREDIT  
POLICY TO NOVEMBER 2007**

**Guatemala, December 2007**

## INDEX

### EVALUATION OF THE MONETARY, FOREIGN EXCHANGE RATE AND CREDIT POLICY TO NOVEMBER 2008

I.	EXECUTIVE SUMMARY	1
II.	MACROECONOMIC ENVIRONMENT	3
A.	EXTERNAL SECTOR	3
	1. The world economy in 2007	3
	2. Evolution of the international oil prices, corn and wheat	12
	3. Balance of estimated payments for December 2007	21
	a) Current account	21
	b) Capital and Financial Account	25
	4. Net International Monetary Reserves	30
	5. Nominal Exchange Rate	32
B.	REAL SECTOR	33
	1. General Aspects	21
	2. Gross Domestic Product measured by production origin	37
	3. Gross Domestic Product measured by expense destination	43
C.	FISCAL SECTOR	44
	1. Analysis of the budgetary execution	44
	2. Public Debt	51
	a) Internal	51
	b) External	53
	3. Estimation of the closing for 2007	54
D.	FINANCIAL SECTOR	54
	1. Banking Liquidity	54
	a) In national currency	54
	b) In foreign currency	56
	2. Offshore entities	58
	a) Fund-raising	58
	b) Credit to the private sector	59

III.	EVOLUTION OF THE MONETARY POLICY VARIABLES	61
A.	INFLATION TARGET	61
	1. Consumer Price Index	61
	2. Subjacent inflation	65
	3. Imported Inflation	66
	4. Econometric projection of inflation for December 2007 and December 2008	67
	5. Forecast in medium term, Semi-structural Macroeconomic Model	68
	a) Fan Diagram	68
	b) Risks Balance	69
B.	INTEREST RATES	70
	1. Of monetary stabilization operations	70
	a) In national currency	70
	b) In foreign currency	78
	2. Parameter interest rate	79
	3. Parity interest rate	80
	4. Weighted Average Asset and Liabile Interest Rates of the banking system	82
	a) In national currency	82
	b) In foreign currency	84
C.	ANALYSIS OF BALANCE ACCOUNTS OF THE BANCO DE GUATEMALA	85
	1. External monetization	86
	2. Net Internal Assets	87
	a) Position with the public sector	87
	b) Position with banks and financial companies	88
	c) Operative result of expenses and products	88

d)	Monetary Stabilization Operations	88
e)	Estimation of the closing of the monetary program for December 2007	89
D.	PRIMARY LIQUIDITY	91
1.	Monetary Issue	91
2.	Broad Monetary Base	94
E.	TOTAL PAYMENT MEANS	96
1.	Growth Rate	98
2.	Credit Portfolio per economic activity	102
a)	Credit granted for consumption, transfers and others	103
b)	Credit granted for commerce	104
c)	Credit granted for construction	105
d)	Credit granted for manufacturing industry	106
3.	Quality of the granted credit	107
4.	Econometric estimation of the banking credit demand to the private sector	109
G.	SURVEY OF INFLATION EXPECTATIONS TO THE PANEL OF PRIVATE ANALYSTS	110
H.	IMPLIED INFALTION EXPECTATIONS	112
I.	SYNTHETIC INDEX OF THE INDICATIVE VARIABLES	113
J.	ADVANCES IN STATISTICAL IMPROVEMENT	116
1.	Advances in the implementation of the Monetary and Financial Statistics Manual	116
2.	Advances in the implementation of the V Manual of Payments Balance	118
3.	Implementation of National Quarterly Accounts	118
IV.	ADVANCES IN THE OPERATIVE FRAMEWORK OF	

THE MONETARY POLICY	119
A. PLACEMENT OF TERM DEPOSIT CERTIFICATES PER DUE DATE –CDP -	119
B. TRANSFER OF TITLE HOLDER OF TERM DEPOSIT CERTIFICATES IN THE CUSTODY OF THE BANCO DE GUATEMALA	120
V. ASPECTS OF THE EVALUATION OF THE MONETARY POLICY	120
ANNEX	126

# **EVALUATION OF THE MONETARY, FOREIGN EXCHANGE RATE, AND CREDIT POLICY TO NOVEMBER 2007**

## **I. EXECUTIVE SUMMARY**

The Monetary Board in resolution JM-168-2006 issued on December 28, 2006, determined the Monetary, Foreign Exchange Rate and Credit Policy for 2007, in which a 5.0% inflation target was established with a tolerance margin of +/- 1 percentage point for December 2007 and a 4.5% with a tolerance margin of +/- 1 percentage point for December 2008.

The implementation of the monetary policy in 2007 has been consistent with the development in an explicit inflation targeting scheme, that is founded on the election of an inflation target like the nominal anchor of said policy and is consolidated with the updating of a flexible nominal rate regimen, with the use of indirect monetary control instruments (monetary stabilization operations, privileging market decisions), as well as the strengthening of the transparency in the actions taken by the Central Bank.

To November 2007, the inflationary rhythm was 9.13%, percentage higher by 4.73 percentage points to the observed in the same month in 2006 (4.40%) and by 3.34 percentage points to the registered in December 2006 (5.79%).

It is worth pointing out that in the presence of supply shocks associated to increases in oil prices and its derivatives, corn and wheat, as well as the demand factors linked to primary liquidity excesses, it was considered prudent to take adjustment measures through monetary with the purpose of moderating the inflationary expectations, reason for which the Monetary Board resolved to increase the leading interest rate of the monetary policy on five occasions: on March 28 from 5.00% to 5.25%, on April 25 from 5.25% to 5.50%, on September 26 from 5.50% to 5.75%, on October 31 from 5.75% to 6.00% and on November 29 from 6.00% to 6.25%. It is worth noting that in the first months of the year the Monetary Board, in a framework of prudence and gradualness, decided to not modify the level of the leading interest rate, but decided to keep stability in the financial system, taking into consideration the link experimented in the same, due to the operations suspension of a banking entity.



The referred adjustments pursued moderating the inflationary expectations of the economic agents, as well as setting the credibility of the Central Bank in the management of the monetary policy, aspect that gives special importance for the fulfillment of the inflation target in 2007 and in 2008.

Last, it is important to highlight the favorable behavior of the following main variables and macroeconomic indicators: a) the level of monetary international reserves showed an important increase, which is mainly associated to the disbursement of loans from the public sector with foreigners; b) the type of nominal exchange rate remained stable showing generally consistent behavior with the season; so in the course of the year the Central Bank has not participated in the exchange market; c) the deficit in the current account of the payment balance was reduced in absolute and in GDP terms, mainly derived from the growth record in goods and services exportations and in the sustained increase of family remittances; d) the evolution of the economic activity through the Monthly Economic Activity Index –IMAE [For its acronym in Spanish.] showed a more dynamic behavior than the registered in the first ten months of 2006, showing the highest inter-annual variation in October in the last eleven years; e) the banking credit to the private sector continued to show inter-annual growth rates over the upper limit of the programmed runner, although in lesser intensity to the registered the previous year; f) the interest rates for the short term as well as the long term showed stable behavior, notwithstanding the suspension of operations of two banks in the system, one in October 2006 and the other in January 2007; and, g) the sovereign risk according to the main international risk qualifiers that has shown favorable evolution, associated to the macroeconomic performance of the country.

## **II. MACROECONOMIC ENVIRONMENT**

### **A. EXTERNAL SECTOR**

#### **1. World Economy in 2007**

According to the International Monetary Fund -IMF<sup>1</sup>, it is expected that the solidity of growth shown by the world economy in the first semester of 2007

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<sup>1</sup> IMF. World Economic Outlook. October 2007.



continue, although with a slight reduction during the rest of the year. Said organism foresees a growth of global economic activity of 5.2% (5.4% in 2006) for 2007, fundamentally sustained in the strength of economic growth in the People's Republic of China, India and Russia, whereas in the United States of America, Japan and the area of the Euro, a reduction in economic dynamism is expected.

It is important to mention that in 2007 the increase in prices of energy and food have generated inflationary pressures, especially in emerging world economies and in developing countries, while in advanced economies it is expected that they experiment a slight inflation reduction. On this particular, the IMF foresees that for 2007, the inflation in the economies with emerging markets in developing countries will be at 5.9% (5.1% in 2006) and in advanced economies at 2.1% (2.3% in 2006). On the other hand, the international price of oil continues to be high, due to the strengthening of world demand of crude oil, as well as to the political problems that have affected the Middle East.

Within the world economy analysis for 2007, the IMF projects that the US economy will grow 1.9% (2.9% in 2006). The lesser dynamism in the US economy has been mainly due to the weakening of internal demand, given the fact that consumption has been affected negatively, among others, due to the increase in the price of gasoline. Also, residential investment, housing market and inventory investments have experienced a reduction. Also, the financial problems that have affected this economy have negatively influenced the trust of economic agents. In contrast, the strength of external demand (stimulated by the depreciation of the US dollar and due to economic growth of the main commercial partners of this country) and the increase of industrial production are factors that have contributed positively in keeping the productive activity of the United States of America. The current account deficit of the payment balance continues to be the main imbalance in this economy, since for 2007 a 5.7% gross domestic product is forecast (6.2% in 2006). The inflation for 2007 is forecast at 2.7%, lower to the registered in 2006 (3.2%); said forecast is especially associated to the lesser economic activity foreseen.



For the Euro area, the IMF estimates a 2.5% growth for 2007 (2.8% in 2006), based on the increase of the investment in machinery and equipment, on the increase in construction and on the growth of exportations. The slight reduction in economic growth forecast is due to the uncertainty on the operation of financial markets and to the lesser growth than the expected of the US economy. On the other hand, inflation for 2007 is estimated at 2.0%, slightly lower than that of 2006 (2.2%).

The Japanese economy, according to IMF, will have a 2.0% growth in 2007 (2.2% in 2006), supported by the solidity of internal consumption as well as corporate investment. It is worth pointing out that the increase of corporate investment has been backed up by profit gain in said sector. On the other hand, a zero inflation rate for 2007 is expected (0.3% in 2006).

For the emerging economies of Asia a 9.2% growth is forecast in 2007 (9.3% in 2006). Within these economies, it is expected that the People's Republic of China will exceed the 11.5% growth expectations (11.1% in 2006). The dynamism of the economy of this country is sustained by the increase of investment and by the increase of exportations. Although with a slight deceleration of economic activity, India also presents a robust economic growth forecast of 8.9% (9.7% in 2006); which is based on the strength of internal demand, particularly of investment. It is important to highlight that the high economic dynamism of these countries has been sustained in the increase of total productivity of the production factors. It is worth stating that, although the productivity of capital has increased due to technological progress, the main element that is promoting total productivity is the increase of work productivity. The greater work productivity, at the same time, has cooperated, not only with expanding the productive capacity of these economies and, therefore, reducing the vulnerability of the same to exogenous shocks, like the increase in the international price of oil, but has also contributed to keeping the unitary labor costs low, which has allowed counteracting the inflationary pressures to which these economies have been exposed, due to their notable economic dynamism. In 2007, for this group of countries a 4.9% inflation is forecast (3.7% en 2006).



As to emerging markets and developing countries economies, the IMF projects a growth rate of 8.1% in 2007 (8.1% in 2006). Regarding inflation rates for 2007, said organism estimates that the same be at 5.9% (5.1% in 2006), due to the increase in the international price of oil, to the greater internal aggregate demand and to the insufficient productive capacity, aspect that has been an impediment for supply to respond adequately to demand. However, the monetary authorities of those countries have achieved containing the inflationary pressures through rises regarding the interest rate of the monetary policy.

As to the countries in the Western Hemisphere<sup>2</sup>, economic growth for 2007 is estimated at 5.0% (5.5% in 2006). It is projected that the Latin American economies will experiment a growth of 5.4% on average. It is important to mention that the strength of the internal aggregate demand is the main factor that has influenced in the greater economic dynamism of the region. Within the economies of this group of countries, Venezuela will have greater growth in 2007 (8.0%), while Argentina, Peru and Colombia will grow 7.5%, 7.0%, and 6.6%, in that order. For Central America, the IMF estimates an average growth of 5.4% in 2007 (5.9% in 2006). The inflation for countries in the Western Hemisphere are forecast at 5.3% (5.4% in 2006), particularly as a result of the implementation of monetary policies that have adequately anchored the inflationary expectations of the economic agents. Also the majority of these economies have been strengthened by their greater exchange flexibility, due to the increase in the level of the international monetary reserves and due to the strengthening of fiscal discipline.

As to the countries in the Middle East, the IMF projects a growth of 5.9% (5.6% in 2006) fundamentally due to the increase in production and oil prices, factors that continue supporting the growth of the GDP. The inflation for this set of countries is projected at 10.8% (7.5% in 2006).

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<sup>2</sup> According to the IMF, the "Western Hemisphere" includes: Antigua and Barbuda, Argentina, the Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Granada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, Santa Lucia, San Vicente and the Grenadines, Surinam, Trinidad and Tobago, Uruguay and Venezuela.



For the Community of Independent States<sup>3</sup>, the IMF projects an economic growth rate of 7.8% in 2007 (7.7% in 2006). This dynamism is the result of favorable prices of some of the main exportation goods as well as a notable increase in productivity. Also, the foreign capital income has influenced in the strengthening of internal aggregate demand, especially in Russia and in Ukraine. As to the inflation rate, it is expected to be located at 8.9% (9.4% in 2006).

As to the African economies in the Sub-Sahara, the IMF forecasts an economic growth rate of 6.1% in 2007 (5.7% en 2006) supported by the solid performance of oil exporting countries, which have started to operate new oil exploitation plants, as well as the improvements of exchange terms that have translated into an increase of internal income, which at the same time, has strengthened the aggregate demand of these economies. For this group of countries, the inflation in 2007 was estimated at 7.6% (7.3% in 2006).

Regarding world commerce of goods and services, it is estimated they will grow 6.6% in 2007 (9.2% in 2006), which is a direct result of lesser global economic growth.

As to the international price of oil, due to the continued problems in the Middle East and that the demand has remained robust, it is estimated that the referred price will continue high for the remainder of 2007. In effect, according to the IMF, the crude oil quotes in the futures market indicate that its price will be over US\$69.00 per barrel, on average, in the remainder of 2007.

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<sup>3</sup> According to the IMF, the Community of Independent States include: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Republic of Kirgizia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.



**ECONOMIC GROWTH AND INFLATION  
PER REGIONS AND SELECTED COUNTRIES  
DATA OBSERVED IN 2006 AND ESTIMATIONS FOR 2007  
(Percentual Variation)**

<b>ECONOMIC GROWTH</b>	<b>2006</b>	<b>2007</b>
World Economy	5.4	5.2
Advanced economies	2.9	2.5
United States of America	2.9	1.9
Area of the Euro	2.8	2.5
Japan	2.2	2.0
Emerging economies of Asia*	9.3	9.2
People's Republic of China	11.1	11.5
India	9.7	8.9
Economies with emerging markets and developing countries	8.1	8.1
Western Hemisphere (Latin America and the Caribbean)	5.5	5.0
Venezuela	10.3	8.0
Argentina	8.5	7.5
Peru	7.6	7.0
Colombia	6.8	6.6
Central America	5.9	5.4
Middle East	5.6	5.9
Community of Independent States	7.7	7.8
Russia	6.7	7.0
Central and Eastern Europe	6.3	5.8
Africa	5.6	5.7
Sub-Sahara	5.7	6.1
<b>INFLATION</b>		
Advanced Economies	2.3	2.1
United States of America	3.2	2.7
Area of the Euro	2.2	2.0
Japón	0.3	0.0
Emerging economies of Asia*	3.7	4.9
People's Republic of China	1.5	4.5
India	6.1	6.2
Emerging economies markets and developing countries	5.1	5.9
Western Hemisphere (Latin America and the Caribbean)	5.4	5.3
Venezuela	13.7	18.0
Argentina	10.9	9.5
Peru	2.0	1.5
Colombia	4.3	5.5
Central America	7.0	6.5
Middle East	7.5	10.8
Community of Independent States	9.4	8.9
Russia	9.7	8.1
Central and Eastern Europe	5.0	5.1
Africa	6.3	6.6
Sub-Sahara	7.3	7.6

\* Includes developing Asia, recently industrialized Asian economies and Mongolia.

Source: IMF. World Economic Outlook, October 2007.



## INSERT 1 LIQUIDITY CRISIS IN INTERNATIONAL MARKETS

In recent years, the concept of liquidity has been widely discussed. On the one hand, it is assumed that the international economy has excess liquidity, due to the following factors: a) there has been a fall in the prime risk of many financial assets; b) the prices in the markets of real estate, bonds and stocks has increased; c) the long term interest rate has remained at low levels; and, d) the flow of capital has increased considerably. On the other hand, other analysts consider that the global market is lacking adequate liquidity, due to the fact that many main central banks of the world have adopted restrictive monetary policies, which has promoted that, in August 2007, some Money markets will become illiquid, with the consequent increase of the spread of many risky financial assets. This illiquidity later induced these central banks to give liquidity in order to stabilize the short term interest rates.

It is important to state that the analysis of liquidity in international markets must be sustained in the identification of a source that generates said liquidity. In that regard, some analysts associate the creation of liquidity at low interest rates induced by lax monetary policies implemented by the main central banks of the world, while others consider that the creation of liquidity is caused by an increase of international financial integration, as well as by greater innovation and deepening of the main international financial markets. Following, is an analysis of both criteria.

### **Orientation of the monetary policy**

The orientation analysis of monetary management is regularly based on the evolution of the interest rate that the central bank uses as a stabilization variable (interest rate of the monetary policy.) In that sense, when the monetary policy is accommodated, said rate is negative in real terms. In the case of the United States of America, for example, since the first quarter of 2003 to the third quarter of 2005, the monetary management was accommodated, since the monetary policy rate was negative.

Another approach used to monitor the orientation of the monetary policy is sustained in the deviations of the nominal interest rate in the short term regarding the "Taylor Rule". This rule consists of modifying the leading interest rate of the monetary policy regarding the gap in inflation targeting and the product gap. A nominal interest rate in a lesser short term than the Taylor Rule indicates that the monetary management is expansive, which is what occurred in the United States of America in the period understood between 2002 and 2006.

An alternative scheme consists of the follow up of a global monetary aggregate based on the growth of the monetary base of advanced countries. From 2002 to 2004 this indicator increased significantly in those countries, which confirms the expansionist orientation mentioned of the monetary policy in that period. On some occasions, the global accumulation of the international monetary reserves is added to the global monetary aggregate, since this accumulation can be considered an indicative variable of the monetary expansion degree in the countries with a surplus in the payments balance. In this case, international liquidity has shown a substantial increase during the last decade.

However, although recently in the United States of America as well as in the Eurozone, monetary management has turned more restrictive, the real interest rates in the long term of governmental financial assets in the advanced countries has remained low, regarding the historic averages. It is worth pointing out that, the excess in savings as well as investment as a surplus in the payments balance of the oil exporting countries and of Asian countries, has contributed to increasing capital flow and, therefore, in keeping the long term interest rates low.

### **Liquidity in the financial markets**

The monetary indicators mentioned do not incorporate the liquidity generated by innovation and financial deepening that has been observed in the last decade.

According to the monetary theory and the financial theory, one of the main attributes of a financial asset is its liquidity degree. A financial asset possesses greater liquidity when the cost of converting it into cash is lower. The cost of settling assets is reduced when a holder of them can distribute it in sales over time, but for that has to count on external financing, which, at the same time, will depend on others participating in the market and wanting to grant financing. This implies that the degree of liquidity of a financial asset can not be defined independently from liquidity in the market in which it is interchanged. Also, the liquidity of a market can be reduced if some economic agents of that market reevaluate the risk of other participants, which has been recently declared by the fact that the main central banks have temporarily injected large amounts of funds to support liquidity in the inter-banking market.

It is worth pointing out that the primary risk of a financial asset incorporates a premium risk for liquidity. Also, the degree of liquidity of an asset possesses a value and a price, so that when the liquidity of an asset is greater, the lower the risk, which facilitates that those investors incorporate assets with greater risk in their portfolio.



There are three basic indicators of liquidity in financial markets. The first indicator is the yield differential between treasury bonds from the United States of America with a three year term to settle in the secondary market regarding the bonds yield of the same term but with a more recent issue date. The second indicator is built with information from the stock market and it is estimated dividing returns on volume. The numerator is the absolute daily return of said market, while the denominator is calculated dividing the settled volume in that market on the capitalization registered in the stock market. This indicator grants information on the volume of exchanges that can be made without significantly affecting the prices and speed with which prices fluctuate, as a result of the spreading of the transactions in the mentioned market. This indicator is used to monitor the liquidity of the stock markets in advanced countries as well as in economies with emerging markets. The third indicator is used to analyze the liquidity in the bonds markets and is measured through the efficiency quotient of the market, which is built dividing the volatility of the returns of the bonds with a five day horizon on the daily volatility multiplied by the period used in the numerator (five days.) This indicator must usually have a value of one, which indicates that the market is stable, due to the fact that the volatility of prices fades quickly.

According to the IMF, from the decade of the eighties, liquidity has increased in the market of Treasury Bonds from the United States of America and in the global market of bonds, while the stock market has had an increase of liquidity since the mid-nineties. Although the indicators of liquidity mentioned exhibit certain volatility, the same is not closely related with the movements in the real interest rate of the monetary policy of the main economies of the world, which suggests a substantial improvement of the fundamental determinants of the indicated financial markets; in other words, a reduction of the liquidity premium that has influenced in the fall of the risk premium.

However, the problems in the sub prime market that in mid-August affected the financial market of the United States of America, propitiated a reduction of the liquidity in the money markets of various advanced economies and, in that context, the liquidity indicators in the global stock market as well as the bonds had an accentuated reduction.

#### **Conclusion**

Notwithstanding the mentioned events, the long term interest rates and the spreads of many financial assets continue at lower rates regarding their historic averages, which seems to not be related to the accommodated monetary policies implemented by the main central banks in the world during the last decade, so an increase in global liquidity and the reduction of risk premiums can have been generated by structural changes in financial markets. These structural changes have been propitiated by the globalization and financial innovation, as well as by greater financial integration of the main economies.

Source: IMF. World Economic Outlook. October 2007.

## **INSERT 2 INTERNATIONAL LIQUIDITY STABILIZATION FUND**

During the period of 2001- 2003, the Federal Reserve of the United States of America, with the object of increasing the liquidity in the financial system and giving incentive to the productive activity, which in those years had a strong recession, relaxed the monetary conditions through a decrease in the objective interest rate. The effects of the monetary policy were gradually declared in the mid term in such a degree that in the last two years of the US economy have registered high growth rates. An important behavior in the economic recovery was the dynamism of the real estate sector, which was benefited under the low interest rates and of the creation of financial products that allow diversifying the credit risk.

On the other hand, the low cost of financing increased the credit demand, considerably. Additionally, the increase of available liquidity for loans in hands of the financial system generated a relaxation of the requested requirements for the banks to grant credit and an increase in the amounts granted in high risk mortgages, known as sub prime, which are mortgages mainly destined for the acquisition of homes for poor credit history clients. Therefore, the same goes hand in hand with a level of risk of non-payment higher to the average of the rest of the credits. Also, the interest rate of these credits is higher than in fiduciary loans.

Given that the debt can be the object of negotiation through the issue of bonds or credit titles, the sub-prime mortgages could be retired from liable of the balance of the consigning entity through a transfer of investment funds or pension plans. The problem arises when the investor (that can be the financial entity, a bank or an individual) ignores the real risk assumed. In a global economy, in which financial capital circulates at great speed and changes hands frequently and offers extremely sophisticated and automated financial products, not all investors know the nature of the hired operation. The adverse effect in granting said credits began to become evident when the holders of sub-prime credits began to default



on the amortizations of their debts, associated to the restrictive monetary policy that the Federal Reserve was gradually promoting. Therefore, the level of delinquent payments in credits began to increase, which caused the generation of the mortgage crisis registered in 2007, which was made evident through the publications made on behalf of important banking entities and large investment funds on the amount committed of their assets in high risk mortgages. This caused a sudden withdrawal of credit and an increase in the volatility of the stock market assets, which at the same time generated a spiral of lack of confidence on behalf of investors, as well as a drastic fall in all world stock exchanges.

In the described context, the main banks of the United States of America announced a plan to diminish the impact of the sub-prime mortgage crisis, through which the creation of a financial mechanism to restore the credit market liquidity that increases the confidence of economic agents and contributes to reducing the risk of bankruptcy of the most affected financial institutions. This new proposal to recover liquidity in the credit market, known as Master Liquidity Enhancement Conduit, consists of acquisition, in a determined term, of "high quality" assets that could not otherwise be placed on the market. The resources destined for said program could ascend to US\$75 billion.

The publication made by *Citigroup*, *JP Morgan Chase* and *Bank of America*, was made the same day that *Citigroup* reported a source of decrease in its profits in the third quarter of the current year, due to amortization of titles with problems greater to the forecast. Other financial institutions, like *Merrill Lynch* had also had to take substantial amortizations for this type of poor quality credits.

SOURCE: The Wall Street Journal.

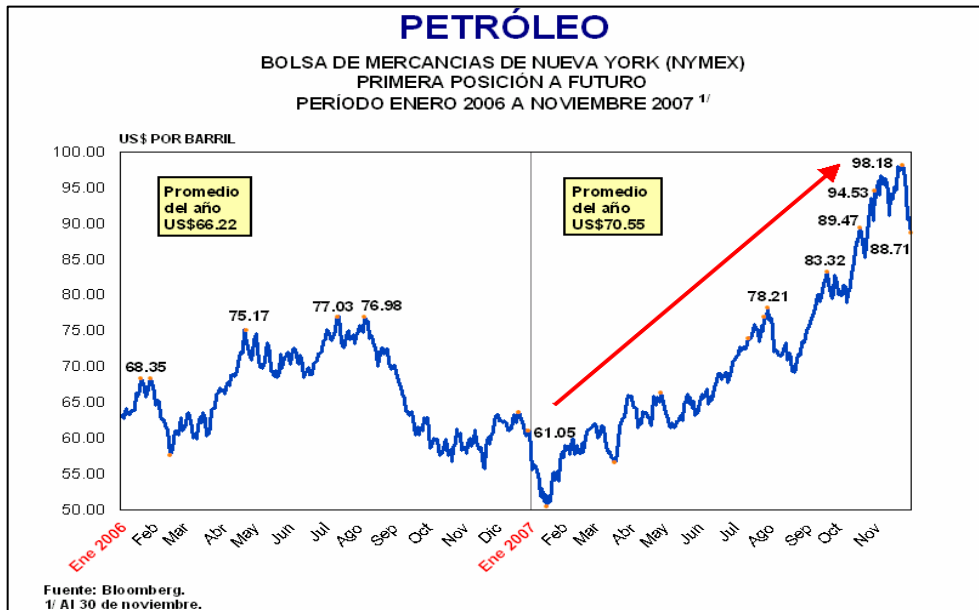
## 2. Evolution of international oil, corn and wheat prices

To November 30, 2007, the average price of the oil barrel on the international market was US\$70.55, higher than the average price registered in 2006 (US\$66.59 per barrel). During 2007 a rising tendency was registered, until reaching a maximum of US\$98.18 per barrel on November 23. It is important to point out that the evolution of the international oil price during 2007 has been the result of a combination of supply and demand factors, as well as of the speculation in the crude oil market. The factors that stand out are: the insufficient oil production, the limited capacity for oil refinement, the growth of the world demand of crude oil, the geopolitical tension in the main oil producing areas, the speculation in the stock exchanges and the weakening US dollar before other currencies, especially the Euro.

Following is a graph that shows the behavior of the international price of oil since January 2006.



## OIL



In the described context, *Global Insight*, which is dedicated to the oil market analysis, in a base scenario, projects that the international oil barrel would remain at around US\$72.00 per barrel on average for 2007<sup>4</sup>.

It is worth mentioning that the international oil price continues to register volatility, due to the sensibility before any change in supply and demand of the same. In that regard, *Global Insight* for 2007 forecasts that the world demand of oil could rise 0.92 million barrels daily, which would make total global demand 85.66 million barrels daily, whereas total supply would be projected at 85.66 million daily barrels; which would generate a deficit of 0.18 million barrels daily, which would have to be covered using existing inventory in the consumer countries.

<sup>4</sup> Global Petroleum Monthly, November 2007.



**OIL**  
**WORLD SUPPLY AND DEMAND**  
**Millions of barrels daily**

		2005	2006 <sup>p/</sup>	2007 <sup>py/</sup>
SUPPLY	MEMBERS OF OPEC <sup>1/</sup>	34.24	34.32	35.34
	NON MEMBERS OPEC	50.25	50.95	50.14
	<b>TOTAL SUPPLY</b>	<b>84.49</b>	<b>85.27</b>	<b>85.48</b>
DEMAND	OECD <sup>2/</sup>	49.64	49.32	49.16
	REST OF THE WORLD	34.05	35.42	36.50
	<b>TOTAL DEMAND</b>	<b>83.69</b>	<b>84.74</b>	<b>85.66</b>
<b>GLOBAL BALANCE</b>		<b>0.80</b>	<b>0.53</b>	<b>-0.18</b>

p/ preliminary numbers

py/ projected numbers .

1/ Organization of Petroleum Exporting Countries (12 producing countries.

2/ Organization for Economic Co-operation and Development (30 industrialized nations).

Source: Global Insight (November 2007).

It is important to mention that the Organization of Petroleum Exporting Countries –OPEC- agreed to make an increase in its production volume of 0.5 million barrels daily, as of November 1, 2007<sup>5</sup>. *Global Insight* estimates that the increased forecast in the production of crude oil is insufficient and considers that the final objective of OPEC is to reduce the volume of accumulated world inventory during the last two years, reason for which it forecasts that the international price of crude oil will be around US\$90.00 per barrel on average during the fourth quarter of 2007<sup>6</sup>.

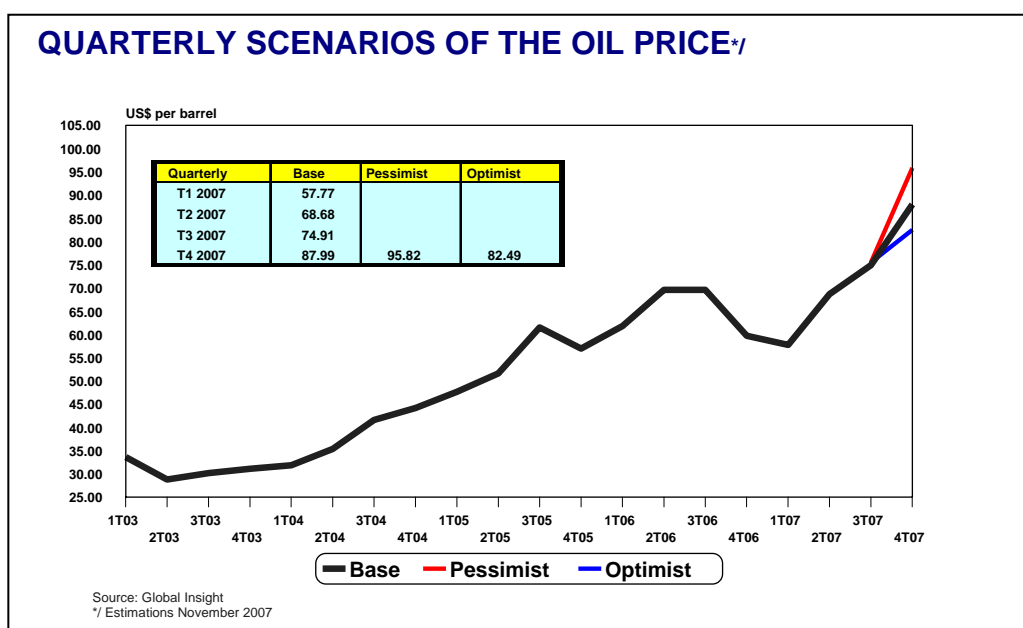
Given the limited capacity of non member OPEC countries to increase production and in the case the volume of demand continue without being affected by high prices, the actions that OPEC can adopt and its expectations regarding the price of petroleum, as well as the diverse factors that can affect oil world supply, will be the determining elements in the international market for the rest of the year.

<sup>5</sup> OPEC agreed to increase its production volume in the meeting held on September 11, 2007. Said organization informed that the increase made is part of the effort of the organization to keep the stability in the world oil market in benefit of the world economy (OPEC, Monthly Market Report, September 2007).

<sup>6</sup> Global Petroleum Monthly, November 2007.



*Global Insight* presents three scenarios that could influence the behavior of the international price of oil. In an optimistic scenario, it is considered that a reduction in the current level of the international price of crude oil, influenced by a deceleration of world economy, would translate into less oil demand; estimating that the price level would be around US\$82.49 per barrel. In the same manner, the definite resolution of the Iranian nuclear program, as well as the normalization of the production of crude oil in Nigeria, the greatest producer in Africa could influence in a price decrease. On the other hand, a pessimistic scenario would place the oil barrel at US\$96.00 and the following factors prevail: the relative tension of the Iranian nuclear program; the interruption of oil production in Nigeria, Iraq and Turkey due to political factors; the speculation in the main stock exchanges worldwide; and, the seasonal increase of demand at the end of the year due to the beginning of winter in the northern hemisphere. Finally, in a base scenario the price of US\$87.99 is forecast and will remain under current market conditions, as is illustrated in the following graph.



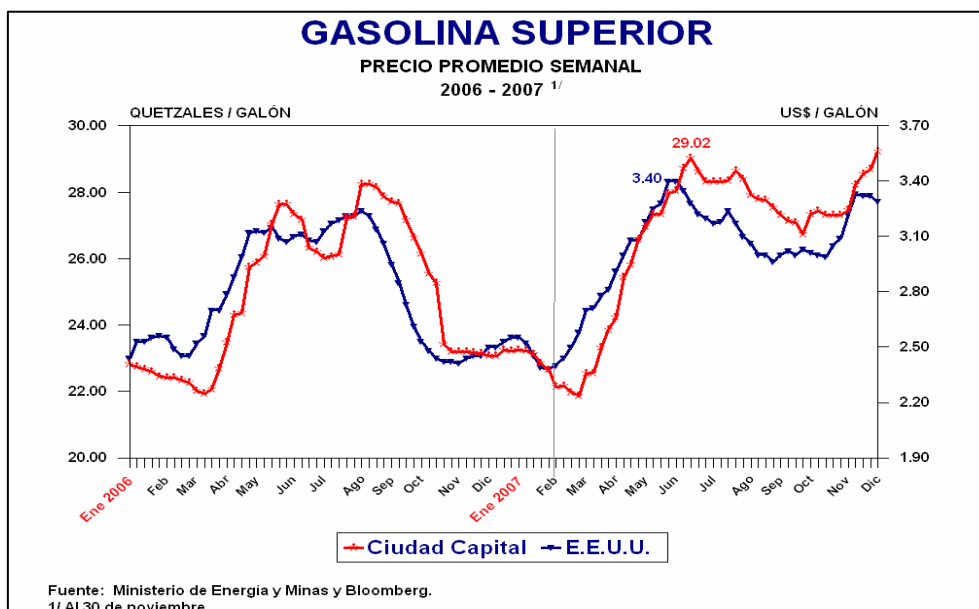
In the described context, the increase in the international price of oil, to November 30, 2007, was located, as was indicated, over the registered average the past year (in 2006, the daily historic level was of US\$77.03, on July 14). During the months studied the tendency of the international price has been



toward the rise, registering the highest quotes in November to the maximum the previous year (on November 23, 2007 registered a quote of US\$98.18, the highest since January 2006). As a result of the increase observed in the international price of crude oil, they also evidenced hikes in those derived from these, particularly in super gasoline and diesel.

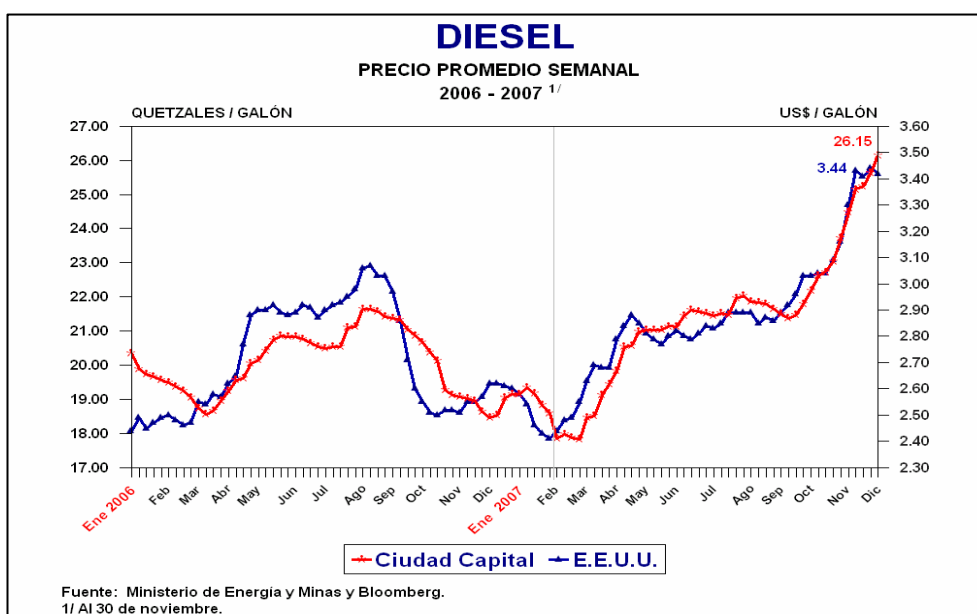
In the case of super gasoline, it registered its highest quote in the US market on May 21, 2007, at US\$3.40 per gallon, while in the metropolitan area of Guatemala; it registered its highest quote on June 11, 2007, when located at Q29.02 per gallon. Among the main causes of the referred tendency toward the rise are the following: the volatility in the international price of oil, generated by the narrow margin between supply and demand of crude oil; and the lower refining capacity, especially on behalf of the United States of America, due to the maintenance and repair work on some plants. As of the second semester of 2007, the tendency in the price of gasoline was toward the fall, influenced mainly by the reinitiating of operations in some plants that were under repair and maintenance.

### SUPER GASOLINE





As to the price of diesel<sup>7</sup>, it registered its highest quote in the US market on November 26, 2007, at US\$3.44 per gallon, while in the metropolitan area of Guatemala; it registered its maximum at Q26.15 per gallon on November 30, 2007. It is worth highlighting that the tendency in the price of diesel has been rising during 2007, contrary to the behavior of gasoline as of the second semester. This situation is explained by the increase in the world demand of this fuel, particularly from the People's Republic of China, Europe and of the United States of America, since added to its use as fuel for heavy transportation, it is used to substitute fuel used for heating<sup>8</sup>.



As a consequence of the negative incidence generated by the rise of the international price of fuel, some countries, among them the United States of America, have promoted the use of ethanol as a fuel, using corn as its raw material, situation that has caused the international price of the grain to rise. In that regard, FAO, in its Crop Prospects and Food Situation report<sup>9</sup>, indicated that the levels of prices observed during 2007 are higher to those registered the previous year, fundamentally due to the demand from the industry of bio-fuels.

As of September 2006 a tendency toward the rise was registered that remained until the third week of February 2007, in which the highest quote was

<sup>7</sup> Diesel does not form part of the goods and services basket that is quoted for the calculation of the Consumer Price Index -CPI-, its impact on the quotes of these goods and services is indirect.

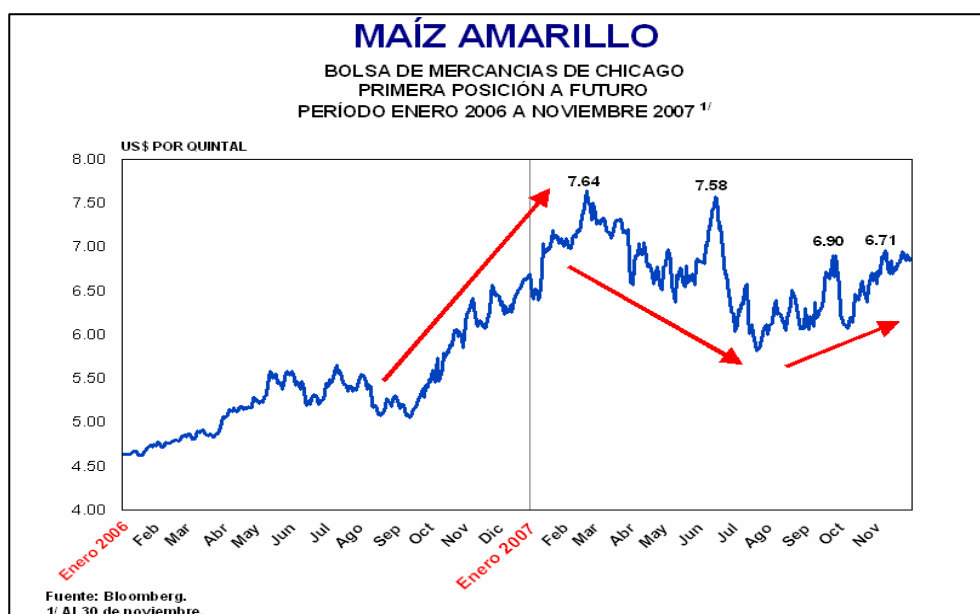
<sup>8</sup> Energy Information Administration, -EIA-.

<sup>9</sup> Report presented in October 2007.



registered since 2006, when the price was at US\$7.64 per quintal. In March and April, the tendency to rise was reverted; however, since May and up to the second week of June, it again registered an increase, showing a tendency to rise up to the third week of July, when again it registered a fall. As of July up to the end of September, the price again registered a rising tendency. The following graph presents the behavior of the international price.

### YELLOW CORN

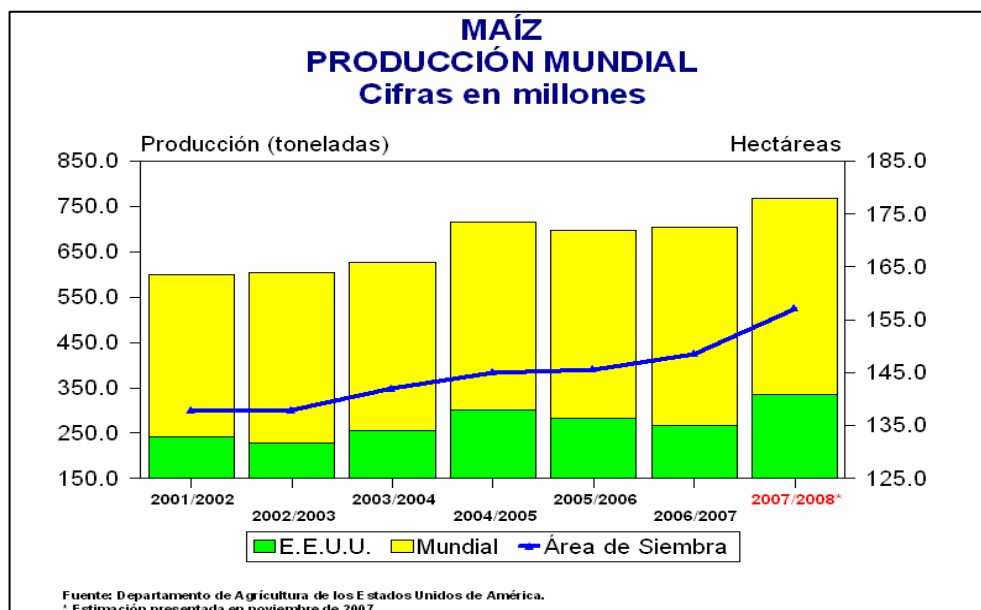


According to the estimations of the United States Department of Agriculture (USDA), it is forecast that the world corn production for the 2007-2008 harvest was at 769.0 million tons (703.4 million tons in the 2006-2007 harvest), the biggest harvest registered in the last years as is shown in the graph. The increase in the world grain production is influenced by the US harvest<sup>10</sup>, country that forecasts reaching a production of 334.5 million tons (267.6 million tons in the 2006-2007 harvest). This production record is associated to the increase of the planted areas destined for corn harvesting, to cover the demand of grain destined for the production of ethanol.

<sup>10</sup>Biggest corn producer in the world.



CORN  
WORLD PRODUCTION (NUMBERS IN MILLIONS)

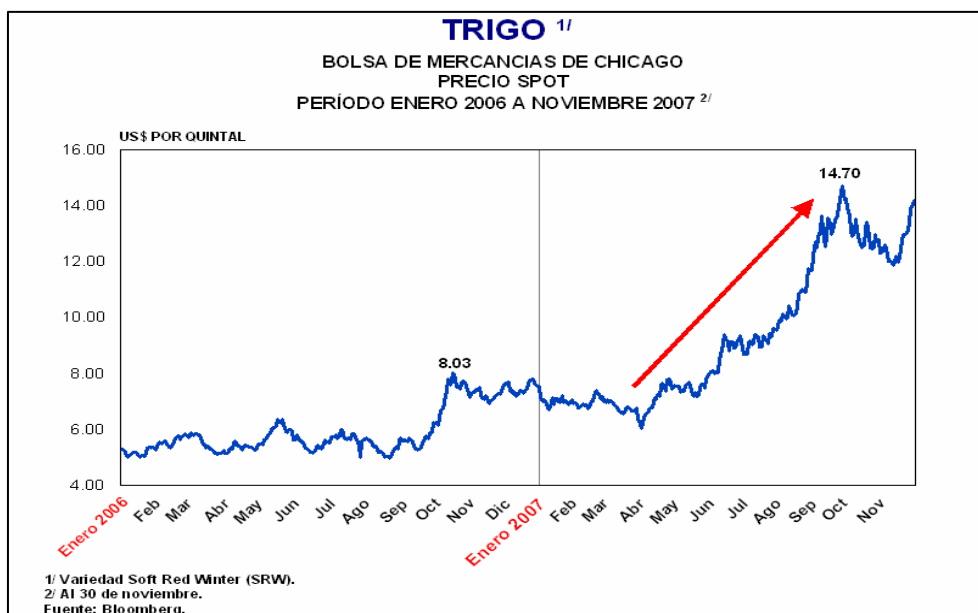


On the other hand, wheat is one of the main cereals that is destined for human consumption and, in less measure, to feeding animals. The price of this grain in the world market has registered a tendency to rise during the last two years, which is attributed to reduction in world supply, derived from occasional damage in production of the last two harvests, due to climatic factors in the main planting areas.

The international price of wheat remained between US\$6.00 and US\$8.10 per quintal since the end of September 2006 up to April 2007, date in which a rise was registered that remained until the end of September 2007, reaching its highest quote on October 1 at US\$14.70 per quintal. This tendency reverted in the middle of November when again they observed a tendency to rise, as is presented in the following graph.



WHEAT  
(CHICAGO COMMODITIES EXCHANGES)

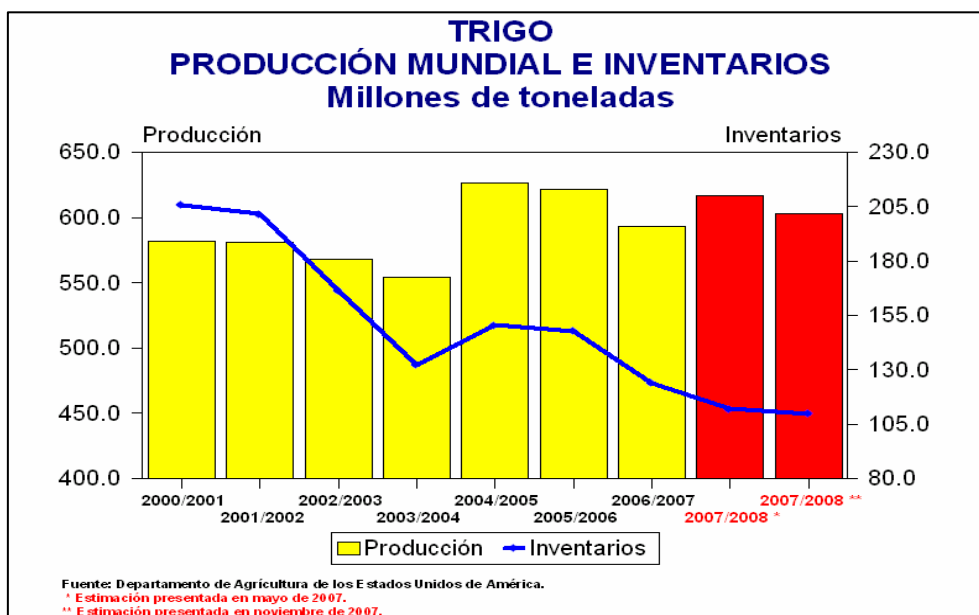


The rise registered in the international price of wheat, which began in May 2007, is the result of the reduction in the production forecast for the 2007-2008 harvest, as well as the decrease registered in the previous harvest (2006-2007). In that regard, according to the USDA, the production volume of wheat for the 2006-2007 harvest located at 593.1 million tons, lower by 28.6 million tons regarding the 2005-2006 harvest, which is located at 621.7 million tons. The referred institution also indicated that the damage caused to the crops due to climatic factors during the present year<sup>11</sup> have provoked the reduction in the production level. In effect, in November 2007, the USDA reported that its world estimation of wheat production was reduced to 603.5 million tons, situation that has caused the recurring use of inventory for the demand of the grain, which has caused the decrease of these and, therefore, an increase in the price.

<sup>11</sup> Strong droughts and intense rain in the main producing countries has affected the present crop. The countries that have been affected by droughts are Canada, Australia, Italy, France (southern region), Romania, Bulgaria, Turkey, Syria and Morocco. The countries affected by intense rain are England, Germany, France (northern region) and in less degree the United States of America.



WHEAT (WORLD PRODUCTION AND INVENTORIES)



As a result of the decrease of wheat inventory worldwide, some producers have considered limiting the grain in order to guarantee their internal supply, such is the case of Russia, country that, although its production volume registered an increase for the present crop at 48.0 million tons (44.9 million tons for the 2006-2007 harvest), they established a tax of 10.0% to wheat exports as of October. In the same manner, Argentina, the fifth world wheat exporter, also modified the wheat exportation tax, increasing it from 20.0% to 28.0%. It is worth indicating that the European Union, block of countries that has historically been a net cereal exporter, suspended the tariffs to the importations of these, among them wheat, as a result of the damage caused to its productions due to climatic factors, which obligates them to find mechanisms to guarantee the internal supply of different cereals that are consumed in the block; said suspension will be current to June 2008.

### 3. Payments Balance estimated to December 2007

#### a) Current account

For 2007 it is estimated that the current account of the payments balance shows a deficit balance of US\$1,696.9 million, greater by US\$104.9 million (6.6%) to the registered the previous year, equivalent to 5.1% of the GDP (5.3% en 2006). Said deficit will be financed with a surplus of the capital



and financial account of US\$1,921.9 million, which would generate an increase in the net international monetary reserves by US\$225.0 million.

The balance of the current account would be the result of the deficit in the commercial balance of US\$6,544.0 million and of the surplus in the services balance for US\$235.5 million as the net current transfers for US\$4,611.6 million.

The balance of the commercial balance, in relation to December 2006, would be determined by an increase in the FOB value of the exportations of US\$973.8 million (16.2%) and an increase in the CIF value of the importations for US\$1,614.6 million (13.5%).

In effect, the FOB value of exportations would be of US\$6,986.8 million, greater by 16.2% to the registered in 2006. In this result the increase of exportations in the Main Products heading would be determinant by US\$315.0 million, which would grow by 24.3%, as well as the Other Products heading, which would increase by 14.0% (US\$658.8 million) regarding 2006.

The dynamism in 2007 of the Main Products heading, would mainly be due to the behavior of the exportations value of coffee, that to December 2007 would be at US\$584.3 million, amount higher by US\$120.7 million (26.0%) to the registered in December 2006, which would be explained by an increase in exported volume, as well as by an increase in the mean price, regarding 2006. In effect, the exported volume in quintals would increase by 15.4%, when going from 4,420.6 thousand in 2006 to 5,099.9 thousand in December 2007. On the other hand, the median exportation price per quintal in 2007 will be of US\$114.57, higher by US\$9.70 to the registered the previous year. The referred behavior will be associated to the increase of the international price of the grain, which, according to Bloomberg, will remain high, due to climate problems in the main coffee zones of Brazil and on the other hand to the weakening of the US dollar, which increased the price of this product in the commodities exchanges. On the other hand, according to the National Coffee Association -ANACAFÉ [For its acronym in Spanish]-, the climate conditions in the country contribute to the increase of national production. Also, the prestige of Guatemalan coffee quality, especially gourmet coffee, has been expanded around the world lately, which has allowed the increase in exported volume.



On the other hand, it is expected that the value of sugar exportations will be at US\$377.9 million, higher by US\$79.3 million (26.6%) to the registered in 2006, situation that is explained by the increase of US\$2.11 (20.5%) in the median price of exportation, as well as by the increase of 5.1% in the exported volume. In effect, the median exportation price per quintal would increase by US\$10.31 in 2006 to US\$12.42 in 2007, mainly as a result of a decrease in the sugar production on behalf of Brazil (greatest producer in the world), due to the use of sugar cane for ethanol production. As to the exported volume, in thousands of quintals, it would increase by 1,478.2 (5.1%), when going from 28,959.6 in 2006 to 30,437.8 in December 2007.

The value of banana exportations to December 2007 was of US\$296.3, amount higher by US\$80.8 million (37.5%) to the registered the year before, which would be explained by the increase to 7,523.0 thousand quintals (35.2%) in exported volume, associated to the greater demand of the United States of America and to the advantage of the access to the European market; whereas at the local level they forecast a recovery of the banana production. On the other hand, it is expected that the median exportation price per quintal would increase slightly, when going from US\$10.09 in 2006 to US\$10.26 in 2007.

The exportations value of cardamom to December 2007 was US\$112.1 million, amount higher by US\$28.7 million (34.4%) to the registered in 2006. This result is explained by the increase of the median exportation price per quintal, which would go from US\$123.10 in 2006 to US\$183.94 in 2007. According to government officials from India, mentioned in the Wall Street Journal, the increase of the price of this product is due to the reduction expected in the cardamom production, derived from climate problems, like the delay in rain generated by the seasonal monsoons and the flooding registered afterward.

The value of oil exportations to December 2007 was of US\$238.7 million; amount higher by US\$5.5 million (2.4%) to the registered the year before. This increase would be held by the exported volume, which would increase by 110.9 thousands of barrels (2.1%) and due to the rise in the median exportation per barrel, which would go from US\$43.53 in 2006 and US\$43.65 in



2007. It is worth indicating that the margin between the median barrel price of exported oil and the international oil price in the international market (which was around US\$67.86 to October 2007) is due to the fact that national oil is of inferior quality regarding that which can be quoted in the international markets, so its final use requires a greater refining process that implies greater costs.

The value of exportations of Other Products was of US\$5,377.5 million, higher by US\$658.8 million (14.0%), to the registered in 2006. This result is due to the increase forecast in the exportations to the Rest of the World (23.6%), in the exports to Central America (20.1%) and in the Multure exports (6.2%). The previous behavior was attributed to the greater demand of Central American countries and to the Free Trade Agreement with the United States of America going into effect.

The CIF value of imports to December 2007 was of US\$13,530.8 million; amount higher by US\$1,614.6 million (13.5%) to the registered the previous year. In this growth, we highlight the increase of the following headings: construction material (29.2%); fuels and lubricants (21.5%); raw material and intermediate products (16.3%); consumer goods (16.2%); and machinery, equipment and tools (12.9%). The increase of imports is due to the dynamism of the national economic activity and to the rise in international prices of some raw material, as well as oil based fuels and lubricants.

On the other hand, the services balance in 2007 held a surplus balance of US\$235.5 million, amount higher by US\$50.8 million (27.5%), higher to the registered the year before. Said result would be determined by the surplus of US\$653.8 million in the non-factorial services and by the deficit of US\$418.3 million in factorial services. The surplus of non-factorial services is due to the greater income of foreign currency from tourism and travel, because of the increased number of tourists, as well as the celebration of world class events, like the Forty-Eighth Annual Meeting of the Assembly of Governors from the Inter-American Development Bank and the Twenty-second Annual Governors Assembly of the Inter-American Investors Corporation; and, the International Olympic Committee Assembly. On the other hand, the deficit of the factorial services is mainly due to the increase in the service of the external debt of the



non-financial public sector and the payment of utilities, royalties and dividends of the private sector.

Regarding the net current transfers, these were a surplus balance of US\$4,611.6 million, which would particularly derive the net income of family remittances, which reached an amount of US\$4,111.6 million, higher by 15.0% to the registered in 2006.

#### **b) Financial and Capital account**

The financial and capital account of the payments balance to December 2007 registered a surplus balance of US\$1,921.9 million; amount higher by US\$51.2 million (2.7%) than that of the previous year.

The balance of the financial and capital account is the result of the surplus balances of the capital transfers; of the official and banking capital account; and, of the private capital account. In effect, the transfers of capital to December 2007 registered a surplus balance of US\$90.0 million, amount lower by US\$159.3 million (63.9%) to the registered the previous year.

The official and banking capital account registered a surplus balance of US\$224.4 million to December 2007, amount higher by US\$34.8 million (18.4%) to the registered in 2006. Said result is fundamentally explained, on behalf of income, by the disbursements of loans to the non-financial public sector by US\$594.0 million and, as to expenditure, by the amortizations of external debt to the non-financial public sector by US\$209.2 million and by the amortization of Treasury Bonds from the Republic of Guatemala with non residents for US\$160.4 million, amount that includes the payments of the Treasury Bonds place in the international market in 1997 for US\$150.0 million.

As to the private capital account, this registers a surplus balance of US\$1,607.5 million, amount higher by US\$175.7 million (12.3%) to the registered in 2006. Said surplus is explained by the income due to direct foreign investment for US\$535.8 million, which would be mainly associated to the improvement of the business climate and to the enforcement of the US Free Trade Agreement; due to the net capital of medium and long terms for



US\$800.0 million; and, by the net income of short term capital for US\$271.7 million.

Due to operations in current account and in the capital and financial account of payments balance, it is estimated, as was indicated, as an increase in the net international monetary reserves for US\$225.0 million (US\$278.7 million in 2006).

**PAYMENTS BALANCE**  
**YEARS 2006 - 2007**  
**-In millions of US dollars-**

CONCEPT	2006 <sup>p/</sup>	2007 <sup>e/</sup>	Variations	
			Absolutes	Relatives
<b>I. CURRENT ACCOUNT (A+B+C) <sup>1/</sup></b>	<b>-1,592.0</b>	<b>-1,696.9</b>	<b>-104.9</b>	<b>6.6</b>
A. COMMERCIAL BALANCE	-5,903.2	-6,544.0	-640.8	10.9
1. Fob Exportations	6,013.0	6,986.8	973.8	16.2
Main Products	1,294.3	1,609.3	315.0	24.3
Other Products	4,718.7	5,377.5	658.8	14.0
2. CIF Importations	11,916.2	13,530.8	1,614.6	13.5
B. SERVICES	184.7	235.5	50.8	27.5
1. Net Factorials	-394.7	-418.3	-23.6	6.0
2. Net Non-factorials	579.4	653.8	74.4	12.8
C. TRANSFERENCIAS CORRIENTES (Netas)	4,126.5	4,611.6	485.1	11.8
<b>II. CURRENT CAPITAL AND FINANCIAL (A+B+C)</b>	<b>1,870.7</b>	<b>1,921.9</b>	<b>51.2</b>	<b>2.7</b>
A. TRANSFER OF CAPITAL	249.3	90.0	-159.3	-63.9
B. CURRENT OFFICAL CAPITAL AND BANKING	189.6	224.4 <sup>2/</sup>	34.8	18.4
C. CURRENT PRIVATE CAPITAL <sup>3/</sup>	1,431.8	1,607.5	175.7	12.3
<b>III. BALANCE OF PAYMENTS BALANCE</b>	<b>278.7</b>	<b>225.0</b>		
<b>Net International Reserves</b> <b>(- increase)</b>	<b>-278.7</b>	<b>-225.0</b>		

<sup>1/</sup> Balance of Current Account/GDP = -5.3% for 2006 and -5.1% for 2007

<sup>2/</sup> Includes the amortization of the Treasury Bonds placed in the international market in 1997 for US\$150.0 million

<sup>3/</sup> Include errors and omissions

<sup>p/</sup> Preliminary numbers

<sup>e/</sup> Estimated numbers for closing



### INSERT 3 DOING BUSINESS 2008

The World Bank and the International Financial Cooperation -CFI- published the *Doing Business 2008* annual report in which they analyze the facility of doing business in 178 countries.

The countries are placed in order from 1 to 178 in function of approachability for business, where number 1 is the best qualified country; in other words, that which has a commercial legislation that is characterized for the ease and efficiency of implementation and which gives privilege to the protection of property rights. Said order is held based on the simple average of the 10 following aspects:

TÓPICOS	DESCRIPCIÓN
1. Apertura de un negocio	Retos para comenzar un negocio.
2. Manejo de licencias	Obtención de licencias, permisos y completar las notificaciones e inspecciones requeridas y la obtención de conexiones a servicios públicos.
3. Contrato de trabajadores	Dificultades que los empleadores encuentran en contrataciones y despidos.
4. Registro de propiedades	Facilidad con la que las empresas pueden asegurar los derechos de propiedad.
5. Obtención de crédito	Divulgación de la información crediticia y los derechos legales de los deudores y los acreedores.
6. Protección de los inversores	Transparencia de las transacciones, responsabilidad por aprovechamiento de beneficio propio y capacidad de los accionistas de enjuiciar a los directores y oficiales por mala conducta.
7. Pago de impuestos	Impuestos que una compañía de tamaño medio debe pagar o retener al año y complicaciones administrativas sobre el pago de impuestos.
8. Comercio transfronterizo	Costos y procedimientos relacionados con la importación y exportación de un embarque estándar de mercancías.
9. Cumplimiento de contratos	Facilidad o dificultad para hacer cumplir contratos comerciales.
10. Cierre de una empresa	Resolución de una situación de bancarrota, debilidades de la ley y dificultades procesales y administrativas durante el proceso de bancarrota.

It is important to point out that each one of the mentioned aspects is considered one of the numbers of the necessary procedures, the average time it takes to implement them, as well as the cost it implies to do it. In that sense, the ordering looks to identify problems in the operability to make business for the governments that can design reformation that improve business climates in each country.

According to the results of the report, the three countries that provide greater ease to do business are, in that order: Singapore, New Zealand and the United States of America. Guatemala is located at 114, which represents a slight improvement regarding the ranking of 2007 (115). It is worth stating that at regional level, Guatemala is positioned below Mexico (44), Belize (59), El Salvador (69) and Nicaragua (93) and slightly over Costa Rica (115) and Honduras (121).

Notwithstanding the referred report considers that Guatemala has implemented significant actions to facilitate a business climate in the country, among which we can highlight the following: i) the introduction of an electronic signature, which has reduced registry time for properties from 37 to 20 days; ii) the establishment of a new system for exchanging electronic data for the customs declarations, have reduced the exportation time to one day; iii) the *Ventanilla Agil* (Agile window) to register businesses, which have reduced the time of opening a business from 30 to 26 days and the number of procedures from 13 to 11; iv) the acceleration in the authorization of the construction projects, which reduced the necessary time from 286 to 235 days; and, v) the opening of the lawsuits in small claims courts, which allow settling lawsuits quickly and efficiently.



## INSERT 4 GUATEMALA: INTERNATIONAL RATING OF SOVEREIGN RISK

### **Standard & Poor's**

In July 2006, Standard & Poor's improved the rating of the long term sovereign debt in foreign currency from BB- to BB and the rating of the long term internal debt from BB to BB+, both ratings have a stable perspective. According to the analysis made by the mentioned company, the improvement in the referred ratings is a reflection of the continuous advance toward the political pluralism, aspect that reduces the uncertainty in terms of economic policy; of a solid payment record of commercial debt; of economic performance improvement; and, of a long history of discipline in fiscal policy.

On March 5, 2007, Standard & Poor's declared that the suspension of operations of the *Banco del Café, S.A.*, and of the *Banco de Comercio, S. A.*, is part of what they visualize as a natural evolution of the financial system in Guatemala. In that context, the process of exclusion of the assets and liable of the suspended banks could contribute to a more solid banking system. Also, said rater indicated that while both suspensions in reference were isolated facts, this is positive for the banking system as a whole.

On July 6, 2007, the mentioned rater confirmed the BB rating of the sovereign long term debt in foreign currency and B in the short term; keeping the long term rating of the debt in BB+ and B in the short term; and, improved the perspective of the sovereign risk of stable to positive. According to said rating, in its report to October 2007, Guatemala has the continued perspective of prudent macroeconomic policies, even though there is the electoral process of 2007. The mentioned qualifier highlighted that the economic growth rate of the country forecast for 2007 is constituted as the highest in the last ten years, pointing out that said situation is associated to a greater trust on behalf of the private sector as to the direction of economic policies in the following years.

### **Moody's Investors Service**

In July 2006, Moody's Investors Service changes the perspective of the rating of sovereign debt in foreign currency from stable to positive, fact that, according to said qualifier, it based on the improvement of the coefficient of external public debt regarding the exportations of goods and services like in the external public debt regarding the GDP, among other aspects.

In June 2007, Moody's Investors Service kept the rating of sovereign debt in long term denominated in foreign currency (Ba2) and ratified the perspective of sovereign rating as positive. In their analysis, the referred international qualifier indicated that it values the strong commitment of the country to keeping macroeconomic stability through the implementation of disciplined monetary and fiscal policies. They also pointed out that with the low tributary charge of the country, the continued responsible actions in fiscal policy, and due to the fact that in the mid term it is expected that the fiscal deficit will be no greater than 2.0% of the GDP. Additionally, it was mentioned that with the external shocks, added to those that have been expressed in the country, the debt indicators have decreased. On the other hand, they highlighted the best external position of the country, as well as the largest income of foreign currency from family remittances, have propitiated vulnerability of the referred position to be reduced.

### **Fitch Ratings**

In February 2006, Fitch Ratings assigned Guatemala the rating of Sovereign BB+ with the stable perspective, applicable to the long term debt placed in the internal market, in foreign as well as national currency, as well as Treasury Bonds negotiated in the international market with maturity in 2007, 2011, 2013 and in 2035. Among the factors that sustained the referred ratings are: 1) The low levels of internal and external public debt of the country; 2) The background of fiscal discipline and moderate inflation; and, 3) The solid background of payment of commercial debt. In that regard, the mentioned agency rater emphasized that the fiscal prudence, combined with a stable, although slow growth of the GDP, have coincided in that the country has one of the lowest indicators of external public debt regarding the GDP, compared to countries with similar characteristics.

It is also important to highlight that on November 9, 2006, Fitch Ratings was pronounced regarding the suspension of operations of the *Banco del Café, S. A.*, declaring that as a result of the quick action of the problem on behalf of the monetary authority, did not see effects that could commit the macroeconomic stability of the country, given that said suspension constituted an orderly exit of the system, according to the current legislation since 2002, reason for which they decided to keep the sovereign rating assigned to Guatemala as invariable.

On March 12, 2007, the referred international rater declared that the banking industry in Guatemala has been immersed in an intense consolidation process, which is expected to continue in the near future. In that sense, the Guatemalan banking system began to evidence greater competition, notwithstanding the wide differential between active and liable interest rates prevalent in the banking system. They also indicated that the expedite suspensions (*Banco del Café, S. A.* and *Banco de Comercio, S. A.*) on behalf of monetary authorities, as well as the support of the main institutions of the



system, allowed safeguarding the interests of account holders and honor 100% of the deposits in the suspended institutions.

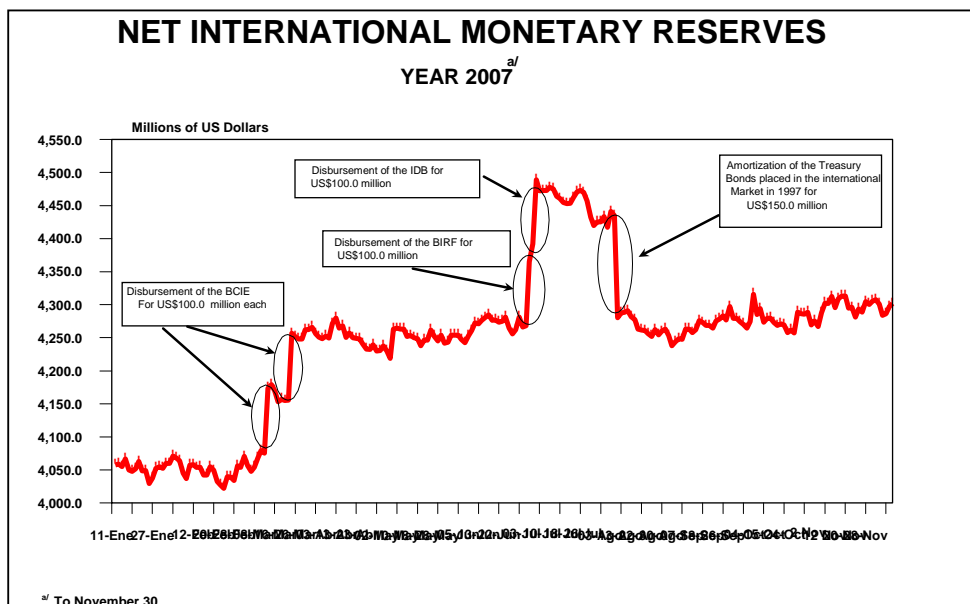
On July 19, 2007 Fitch Ratings kept the sovereign risk rating of BB+ regarding a stable perspective applicable to the long term debt, in foreign currency as well as national currency. According to said rater, keeping the rating is based on low public external and internal debt levels, in the fiscal discipline, in a moderate inflation, as well as a solid repayment background of commercial debt. They also highlighted that the current macroeconomic position of the country has allowed facing internal and external shocks, for example, the operations suspension of two system banks and the natural disasters in the last few years. On the other hand, the rater pointed out that the monetary authorities have appropriately administrated the banking suspensions, minimizing fiscal costs of the same, which constitutes an important factor that bases the current credit ratings of Guatemala.

#### **4. Net International Monetary Reserves**

To November 30, 2007, the Net International Monetary Reserves -RMIN- were located at US\$4,301.8 million, which means an increase of US\$240.7 million regarding the level observed to December 31, 2006. Said increase is the result of foreign currency income for US\$562.7 million, exit of foreign currency for US\$661.2 million and other net income for US\$339.2 million. The income originated by disbursements received by the Non-financial public sector for US\$562.7 million, among which we can highlight, in first place, two disbursements of US\$100.0 million each, corresponding to the loan for the Multi-sector Strengthening Program of Investment, granted by the Central American Bank for Economic Integration –BCIE [For its Acronym in Spanish.]-; in second place, a disbursement for US\$100.0 million, corresponding to the loan for Broad Base Development Policies, granted by the International Reconstruction and Development Bank -BIRF [For its Acronym in Spanish.]-; and in third place, a disbursement of US\$100.0 million, corresponding to a loan for the Public Financial Management Reform Program, granted by the Inter-American Development Bank –IDB-. Regarding the expenditure, payments were made for services of external public debt for US\$320.0 million and payments of capital and interest corresponding to Treasury Bonds expressed in US dollars for US\$341.2 million, amount that includes the amortization of the Treasury Bonds placed in the international market in 1997 for US\$150.0 million. As to other net income, interest perceived on investments of the Net International Monetary Reserves are highlighted abroad for US\$202.6 million, the increase in the legal banking reserve in foreign currency for US\$30.2



million, the income of royalty for oil exploration for US\$87.5 million and other net income for US\$18.9 million<sup>12</sup>.



It is considered that the mentioned level of NIMR is adequate, since the same covers 3.8 months of goods importations. Additionally, if we deduce short term obligations of the Central Government expressed in USD dollars (sensitivity trial), would even then be in the suggested limit for international standards, according to which the amount of NIMR must be enough to finance at least 3.0 months of importation goods, since these would be around 3.0 months.

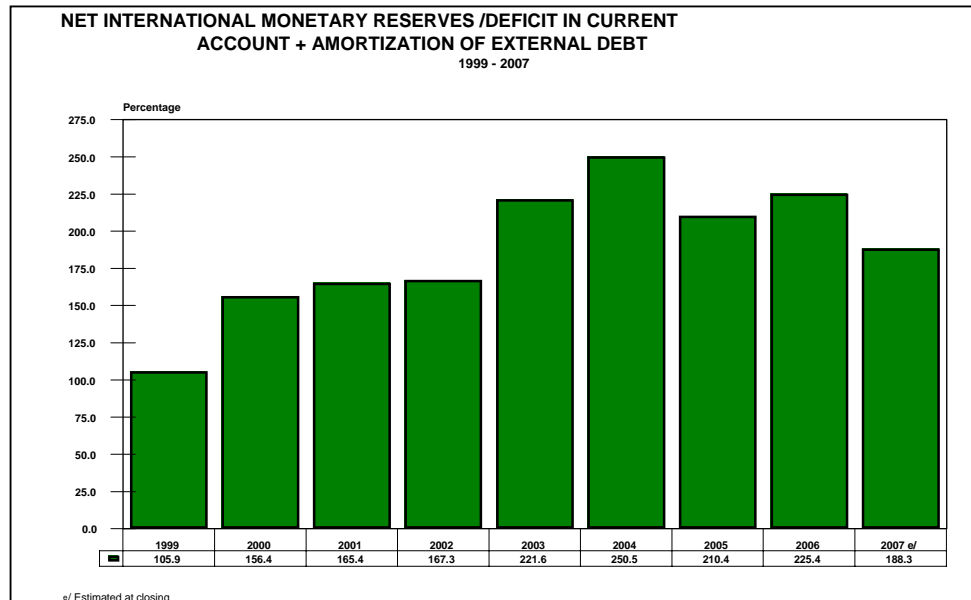
Also, the solidity of the external position of the country can also be measured through the coverage of external public debt. In that sense, to November 30, 2007, the NIMR level is equivalent to 7.3 times the amount of the service of the external public debt for a year.

On the other hand, if we relate the level of the NIMR regarding the sum of the deficit in current account of the payments balance and the payments for a year of external public debt, the result would indicate that with the current level of NIMR could cover up to 1.9 times the referred obligations.

<sup>12</sup> Fundamentally includes the net variation of the international price of gold for US\$32.5 million.



Following we illustrate the behavior of the NIMR regarding the deficit in current account plus the amortization of the external public debt.



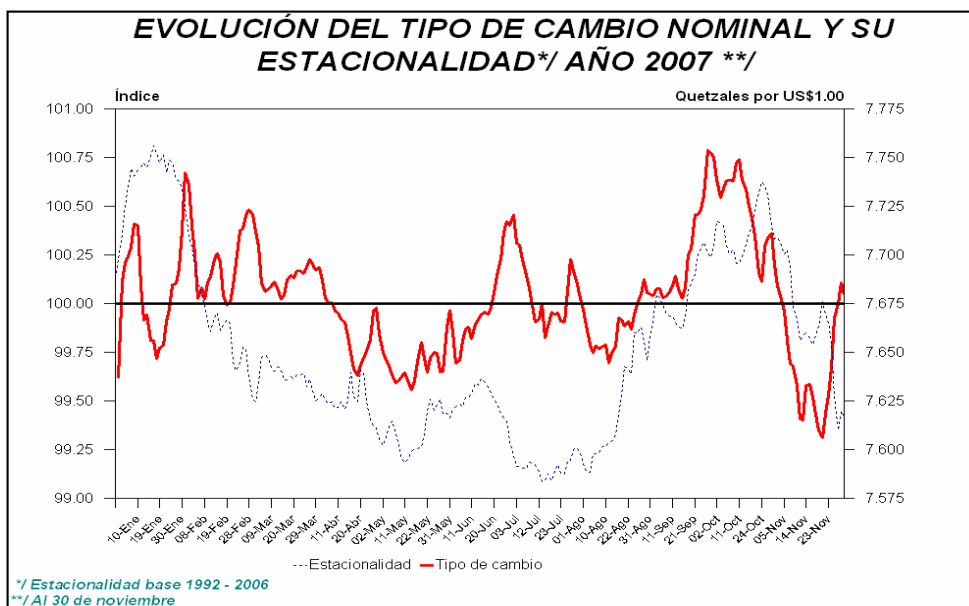
## 5. Nominal Exchange Rate

The weighted average nominal exchange rate in the institutional market of foreign currency registered a depreciation of Q0.05460 (0.72%), when going from Q7.62534 per US\$1.00 to December 29, 2006 to Q7.67994 per US\$1.00 to November 30, 2007.

The nominal exchange rate during 2007 has registered a moderate volatility and, in general, its behavior as is illustrated in the following graph, has been consistent with its seasonality, reason for which the participation rule for the *Banco de Guatemala* has not been activated in the exchange market, through the Electronic System for Foreign Currency Negotiations –SINEDI– contained in the current Monetary, Foreign Exchange Rate and Credit Policy.



## EVOLUTION OF THE NOMINAL EXCHANGE RATE AND ITS SEASONALITY



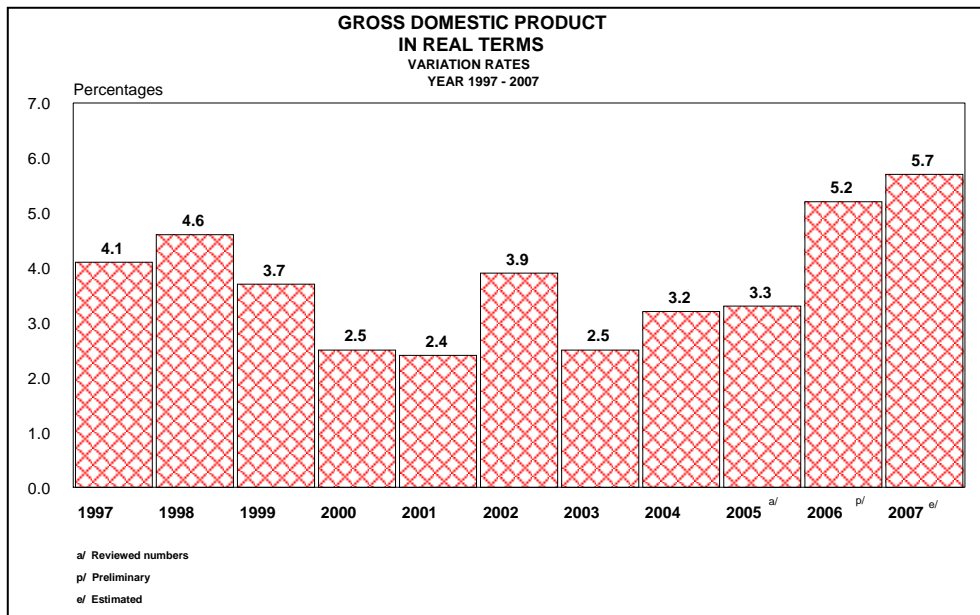
## B. REAL SECTOR

### 1. General Aspects

The national economic activity, as of 2004, has grown in a sustained manner and it is forecast that said behavior is consolidated in 2007, since it is estimated that the Gross Domestic Product –GDP-, in real terms, grew 5.7% (5.2% in 2006)<sup>13</sup>. Said growth rate, for the second consecutive time in the last nine years, would be greater to the highest registered rate in the decade of the nineties (4.6%); also, for the fourth consecutive year the growth of the population has risen (2.5%)<sup>14</sup>, as is illustrated in the following graph. Said dynamism is analyzed from the external point of view as well as the internal.

<sup>13</sup> For 2006 we reviewed the rise in growth rate for the gross domestic product, considering the preliminary results of closing for the SCN93 for said year, mainly influenced, on the one hand, due to greater dynamism shown in the activities of Mines and quarries exploitations; transportation, storage and communications; and, private services and, on the other hand, for a greater dynamism observed in the investment expense by construction. For 2007, we also reviewed the rise of the referred rate, taking into account the latest information available, having equally observed greater dynamism in the activities mentioned for 2006, as well as greater growth in consumer expense of the general government and greater investment in machinery and equipment.

<sup>14</sup> Projection made by the National Statistics Institute -INE- [For its acronym in Spanish.]



In external order, the behavior forecast in the national economic activity is supported by the dynamism of exportations, as well as the benefits generated by the Free Trade Agreement between the United States of America, Central America and the Dominican Republic (DR-CAFTA) <sup>15</sup>.

According to the report “DR-CAFTA one year later”, from the *Ministerio de Economía* [Equivalent to the Department of Commerce.], the DR-CAFTA generated, among others, a direct impact on foreign commerce and an indirect impact on employment. As to external commerce, during the period of July 2006 to March 2007, the treaty propitiated growth of 6.5% in the tendency of exportation of products outside tariff contingency and a growth of 1.9% in importations outside said contingent. In terms of the products composition, 76.8% of the exported products show greater growth.

Additionally, said report analyzes the effect on employment derived from commercial exchange, on one hand, with countries in the region, and on the other, with the United States of America. In that sense, commerce with the

<sup>15</sup> The IMF in the document “Central America: World Integration and Regional Cooperation, Washington, DC, 2005”, estimates that CAFTA could represent economic growth of 0.7 additional percentage points annually for Central American countries to what they would grow in a scenario without the FTA, until reaching a maximum of 1.5 additional percentage points in the long term. As for the World Bank, in the document “CAFTA-RD: Challenges and Opportunities for Central America, 2005”, estimates that it is possible that the FTA might have positive effects in the economic growth of Central America, from between 0.6 and 0.8 additional percentage points to that which it would register in a scenario without the FTA.



countries of the region, during the first nine months of enforcing the treaty generated a reduction of formal agricultural employment from 1% (1500 jobs) and an increase of almost 5.0% in formal industrial employment (9200 jobs). On the other hand, when analyzing commerce with the United States of America, we observed a reduction of 0.38% (700 jobs) in the case of agricultural employment and increase of 1.49% (4,400 jobs) in industrial employment. In net terms, 3700 new jobs generated are equivalent to a reduction of 2.7% of total unemployment in the country.

Regarding the impact that the treaty could have on the real growth rate of the country for 2007, the technical departments of the *Banco de Guatemala*, based on an econometric analysis, estimate that their could be between 0.64 and 0.97 additional percentual points. Of the total impact, in terms of foreign commerce, the effect of exportations would be between 0.10 and 0.22 additional percentual points, while that of the importations would be between 0.17 and 0.39 percentual points.

In the internal order, the expected growth is due to maintaining macroeconomic stability, as a result of the application of monetary and fiscal policies; in the improvement of the expectations of economic agents, founded in a greater aggregate demand; in a better business climate; and, to the impulse coming from greater levels of public and private investment, associated to macroeconomic stability and to other works of infrastructure<sup>16</sup>.

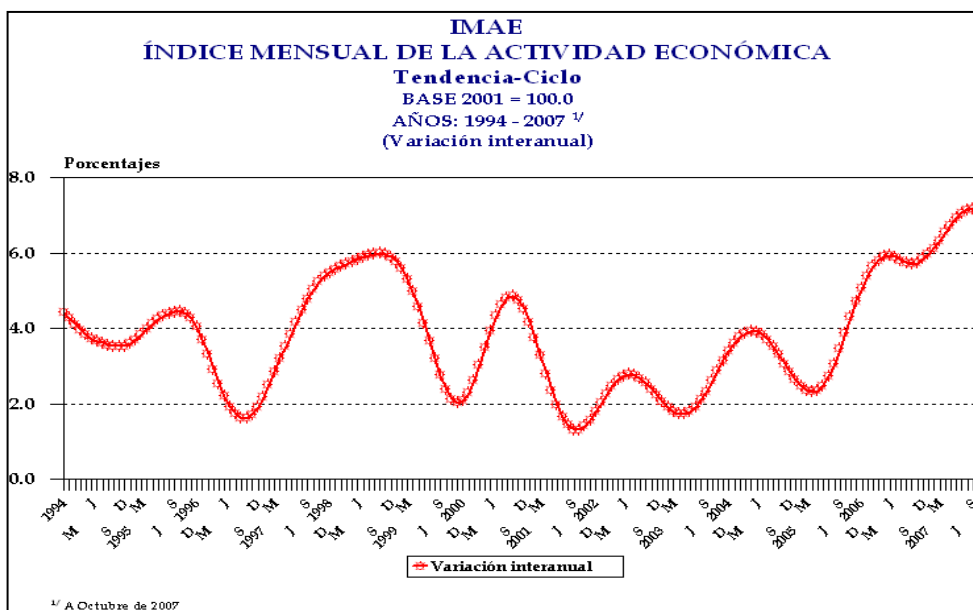
As to the Monthly Economic Activity Index –*IMAE*–, its cycle-tendency, with numbers to October 2007 (latest information available), after showing a growing behavior during 11 consecutive months, in October of the current year showed a tendency change in behavior, reaching an inter-annual variation of 7.10%, higher to the observed in the same month of 2006 (5.71%). It is worth indicating that the level reached by the *IMAE* is congruent with the expected result in the economic activity for this year.

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<sup>16</sup> The *Ministerio de Comunicaciones, Infraestructura y Vivienda* [Equivalent to the Departments of Housing and Transportation.], according to the master plan on remodeling and enlarging airports nationwide by the General Civil Aeronautical Administration, remodeled the International Aurora Airport and the airports of Mundo Maya, Puerto de San José, Coatepeque, San Marcos and Huehuetenango. Also, said ministry did reconstruction on housing, roads and bridges damaged by tropical storm Stan. The Municipality of Guatemala City concluded the works of highway infrastructure for the operation of the *TRANSMETRO*.



Economic Activity of the Monthly Index –IMAE-



According to the expected behavior of economic activity for 2007, and the results of the Business Opinion Survey<sup>17</sup> held in March-April and August-September 2007, on average, 86.3% of the businesses interviewed declared that the production volume of industrial products increased or will be equal to the present year, percentage higher to the evaluation made in 2006 (80.1%).

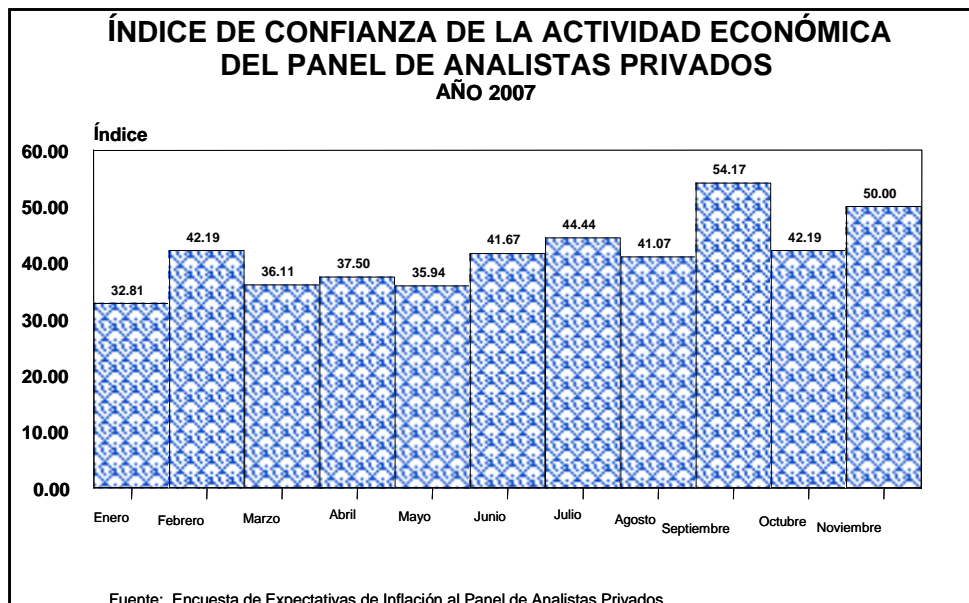
Regarding the Trust Index of the Economic Activity of the Panel of Private Analysts -EEI-<sup>18</sup>, the expectations on the performance of the economic activity presented a conservative scenario during the first quarter of 2007, mainly influenced by a certain degree of uncertainty attributable to factors that affected the national financial system at the end of 2006 and beginning of 2007, as well as the expectations of the economic agents associated to the electoral process. However, as of June, the index presents relative growth, derived from a change in the expectations of the economic agents, situation that gave as a result that the referred index is 50.00 in November 2007, higher to the registered in January 2007 (32.81).

<sup>17</sup> Six month survey directed to the businessmen from the manufacturing industry, whose Broad includes 311 establishments, of which 60% are big (more than 50 employees), 22% are medium (between 20 and 49 employees) and 19% are small (between 5 and 19 employees).

<sup>18</sup> Measures the perception of economic agents, in the current economic situation and the business environment, as well as on the economic evolution for the country in the immediate future. It is worth indicating that the expectations of national and international experts are gathered through the EEI, which the *Banco de Guatemala* has been holding monthly since 2003.



Trust Index of the Economic Activity of the Panel of Private Analysts



## 2. Gross Domestic Product measured by the origin of production

For 2007, it is estimated that all economic activities, due to origin of the production, show positive behavior.

For the activities of *Agriculture, cattle, hunting, forestry and fishing* (with a participation of 13.3% in the GDP), based on information to October provided by associations of producers, trade unions, and public and private entities, a growth of 3.4% is estimated, greater than that of 2006 (0.2%). The greater dynamism would be mainly supported by a recovery in the production of traditional crops (from -1.5% in 2006 to 3.1% in 2007) and to a growth of 4.0% in non-traditional crops (0.7% in 2006).

In the case of coffee production, according to estimations from the National Coffee Association –ANACAFÉ [For its acronym in Spanish]-, the volume of production registered a growth of 3.0% (2.0% in 2006). According to said source, the dynamism is particularly associated to the incentive of more favorable prices for the beans in the international market, due to the average price per quintal going from US\$104.87 in 2006 to US\$114.57 per quintal in December 2007.



As to banana production, according to the Banana Development Company, S.A. –BANDEGUA [For its acronym in Spanish]-, and the Independent Guatemalan Banana Company, S.A. –COBIGUA [For its acronym in Spanish]-, the production volume of the fruit grew 3.6% in 2007 (-5.6% in 2006). Said recovery is based on the widening of 100 hectares in the area planted by BANDEGUA in the Motagua River region (municipium of Los Amates, Izabal); resulting from greater demand from the European market.

The cardamom production is expected to grow 2.0% (-1.5% in 2006). According to the Guatemalan Cardamom Association –CARDEGUA [For its acronym in Spanish]-, the greater dynamism is due to the increase expected from world demand and by the improvement in the international price of cardamom, which, with preliminary information to October 2007, will go from an average of US\$123.10 per quintal in 2006 to US\$183.94 per quintal in 2007.

As to sugar cane production, according to the Guatemalan Sugar Cane Producers Association -ASAZGUA [For its acronym in Spanish]-, for the 2006/2007 harvest a production of 430.7 million quintals is forecast, higher by 63.7 million quintals to the 2005/2006 harvest (17.4%), behavior that contrasts the fall of 5.8% in 2006. This result is associated to the increase of 16,000 planted hectares, derived from the increase in the demand for sugar, as a result of the widening of the quota for exportation forecast in the DR-CAFTA.

In the case of cereal production, according to estimations of the Basic Grains National Producers Coordinator -CONAGRAB [For its acronym in Spanish] - and of the Policy Unit and Strategic Information of the *Ministerio de Agricultura, Ganadería y Alimentación* [Roughly equivalent to the US Department of Agriculture] -UPIE-MAGA [For its acronym in Spanish] - we expect less dynamism in the production volume, when going from a growth of 1.4% in 2006 to 1.0% in 2007. This behavior is explained by the adverse climatic conditions that the country experimented in 2007, so the corn production grew 1.0% (1.6% in 2006).

In the *Exploitation of mines and quarries* (with a participation of 0.7% in the GDP) a growth of 9.0% (17.6% in 2006). In this result we are mainly



contributing to the loss of dynamism forecast in the extraction of stone, sand and clay and other non-metallic minerals, going from 8.4% and 18.9% in 2006, to 7.4% and 2.5%, respectively in 2007.

As to the *Manufacturing Industry* (with a participation of 18.5% in the GDP), expects a growth of 3.3%, percentage higher to that of 2006 (3.1%). This result is explained by the greater dynamism forecast in the manufacturing of food and drinks; and, in the products destined to construction.

In effect, in the *food and drink industry* we forecast the dynamism will remain in the growth rate of internal demand, in congruence with the behavior forecast in private consumption, which, at the same time, would be pushed in good measure by the income of family remittances<sup>19</sup>.

As to *industrial products destined to construction*, it is estimated that the expected levels of investment for public (airports, roads and bridges) as well as private (buildings, homes and shopping centers), stimulate the demand of cement, block, iron and metals.

As to external demand of *diverse industrial products*, they forecast more dynamism than the registered in 2006, particularly in Central America and Mexico. In that regard, according to the Guatemalan Exporters Association – AGEXPORT [For its acronym in Spanish]-, they have a strategy defined for positioning Guatemala as the main supplier of industrial goods in Central American countries, which will help in taking advantage of the DR-CAFTA and to improving commercial exchange with Mexico. In that sense, it is worth highlighting that the exportation data of industrial products destined for Mexico, to October 2007, show a growth of 39.8% (39.1% in the same period of 2006).

For *Electricity supply and water collection* (with a participation of 2.6% in the GDP), we estimate a growth of 5.2% (2.9% in 2006), which is mainly associated to greater demand of electricity, derived from expected growth in activities of *telecommunications, wholesale and retail commerce, manufacturing industry and private services*. In effect, according to information from the Wholesale Market Administrator –AMM [For its acronym in Spanish]-, for 2007

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<sup>19</sup> According to the International Migration Organization –OIM [For its acronym in Spanish]-, estimates that in 2007 49.0% of family remittances that entered the country were destined for final consumption.



estimates an increase in the generation of electricity, when starting to operate two new geo-thermal plants, one by Central General Group, S.A. -GECSA [For its acronym in Spanish]-, located in Chimaltenango and the other by Ortitlán, located in the municipium of Amatitlán.

For *Construction* (with a participation of 4.2% of GDP), is expected to register a growth rate of 12.1% (13.1% in 2006). It is worth highlighting that less dynamism in this activity would be influenced mainly by the deceleration observed in the construction of buildings<sup>20</sup>.

As to buildings, for 2007 there was less dynamism in the construction of buildings for apartments, shopping centers, industrial installations and hotel installations, when going from 26.1% in 2006 to 22.0% in 2007, even so it is considered a growing activity. According to the opinion of the Guatemalan Construction Chamber –CGC [For its acronym in Spanish]-, in 2007 this activity continued developing, but with less dynamism.

The *Wholesale and retail commerce* activity (with the participation of 12.1% in GDP), is estimated that in 2007 it registered a growth rate of 4.1% (3.8% in 2006), mainly explained by the greater dynamism forecast in the *Manufacturing Industries and Agriculture, cattle, hunting, forestry and fishing*, as well as importations. It is worth mentioning that to October 2007, the total importations were increased by 13.5%, lower rate to the registered in the same month the previous year (15.9%).

For *Transportation, storage and communications* activity (with a participation of 9.1% in the GDP), we forecast it registers a growth of 18.8% (18.6% in 2006). Said behavior would mainly result from the expected evolution (30.4%) in the sub-activity of *telecommunications* of which 69.7% are represented by this group, derived of an increase forecast in the investment of the telecommunications businesses, fundamentally for the widening of telephone and Internet services.

As to the *Financial intermediation, insurance and auxiliary activities* activity (with a participation of 4.2% in the GDP), estimates that in 2007 it

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<sup>20</sup> Includes construction of one-family homes, series homes, multi-family homes, commerce, industry, extensions, walls and repairs.



registered a growth rate of 16.0% (16.4% in 2006), mainly associated to a slight reduction in the dynamism of the net result of the banks systems, which to October 2007, registered a variation rate of 20.4% (24.3% in the same period of 2006).

For the activity of *Home rental* (with a relative weight of 10.0% in GDP), we expect a growth rate of 3.9% (2.7% in 2006), due to the dynamism forecast in real rents.

For the economic activity of *Private services* (with a participation of 15.2% in GDP), we forecast a growth rate of 5.4% (5.3% in 2006), associated to the estimated increase in the intermediate demand of industrial activities, agro-industries, commercial activities and telecommunications. In this group of economic activities we highlight the greater impulse of the *hotels and restaurants* sub-activity, whose estimated growth rate is (4.0%), is greater by 0.3 percentual points to the observed the previous year; mainly as a result that in 2007 two international relevance conventions were held: the 48<sup>th</sup> Annual Assembly of Governors of the Inter-American Development Bank and the 22<sup>nd</sup> Annual Reunion of the Assembly of Governors of the Inter-American Investors Corporation and the International Olympic Committee Assembly.

Last, regarding *Public and Defense Administration* activity (with a relative weight of 6.3% in the GDP), estimates that it registers a growth rate of 4.3% (5.3% in 2006), which is mainly explained by the behavior forecast in the remunerations of the Central Government, which to October 2007 present a growth of 8.1% regarding the same period the year before (11.5%)<sup>21</sup>.

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<sup>21</sup> During 2006 there were a greater number of contracts for supernumerary personnel and granting of an only bonus of workers for the Ministries of Education, Work and Social Prevision and Home Office.



**GROSS DOMESTIC PRODUCT MEASURED BY ORIGIN OF THE PRODUCTION  
YEARS 2006 - 2007**

Millions of quetzales constant prices from 2001 <sup>a/</sup>

ECONOMIC ACTIVITIES	2006 <sup>p/</sup>	2007 <sup>e/</sup>	Variation Rates	
			2006	2007
1. Agriculture, cattle, hunting, forestry and fishing	23,821.7	24,637.0	1.2	3.4
2. Exploitation of mines and quarries	1,138.6	1,241.5	17.6	9.0
3. Manufacturing industries	33,274.7	34,358.3	3.1	3.3
4. Supply of electricity and water collection	4,582.6	4,821.1	2.9	5.2
5. Construction	6,935.2	7,774.2	13.1	12.1
6. Wholesale and retail commerce	21,640.9	22,520.8	3.8	4.1
7. Transportation, storage and communications	14,155.2	16,809.7	18.6	18.8
8. Financial intermediation, insurance and auxiliary activities	6,781.9	7,869.2	16.4	16.0
9. Home rental	17,875.6	18,577.9	2.7	3.9
10. Private services	26,833.3	28,274.4	5.3	5.4
11. Public and Defense Administration	11,294.0	11,775.2	5.3	4.3
<b>GROSS DOMESTIC PRODUCT</b>	<b>175,435.9</b>	<b>185,515.8</b>	<b>5.2</b>	<b>5.7</b>

a/ The discrepancy between total and the sum of the components is due to the value of the Financial Intermediation Measures Services Indirectly, to the net taxes of the subventions to products and to the difference of not adding the chained indexes.

p/ Preliminary numbers

e/ Estimated numbers

### 3. Gross domestic product measured by destination of the expense

For 2007 it is estimated that the variables that make up the GDP by destination of the expense, in real terms, register a positive growth rate.

As to internal demand, constituted by consumption, the investment and variation of existence, it is expected to register a growth of 5.3%, less than the observed in 2006 (5.9%).

Private consumption is estimated to register a growth rate of 5.2%, greater by 0.6 percentual points to the observed the year before, associated to



macro-economic stability and the increase observed in family remittances, among other factors.

The expense in general government consumption, that includes the remunerations and the purchase of goods and services, is forecast that in 2007 exhibit growth of 7.4% (6.0% in 2006), mainly associated to a greater budgetary execution in the expense of operation on behalf of the central government.

In matters of investment, the gross formation of fixed capital is estimated to register an increase of 8.9%, lower percentage to the year before (16.7% in 2006), as a result of an increase of 9.8% in the investment in construction (16.9% in 2006) and less dynamism in investment in machinery and equipment, which went from 16.6% in 2006 to 8.2% in 2007, the last one is associated to a deceleration observed in the importations of capital goods to October 2007, in comparison to the same period the previous year. In effect, in said period, the importations of the referred goods for agriculture showed a variation rate of 4.5%; for the industry, telecommunications and construction of 14.4%; and, for transportation presented a decrease of 4.9% (35.9%, 25.4% and 15.1%, respectively to October 2006).

As to external demand, constituted by the exportation of goods and services, it is estimated to register a growth of 10.8% (4.6% in 2006) in real terms. It is worth indicating that external demand would be promoted by a greater demand of goods and services on behalf of the United States of America and of the main commercial partners of the country.

As to external supply, the importations of goods and services is estimated to register a growth of 7.5% in real terms, greater to observed the year before (6.8%), as a result of the dynamism forecast in the economic activity of the present year.



**GROSS DOMESTIC PRODUCT MEASURED BY DESTINATION OF EXPENSE  
YEARS 2006 - 2007**

Millions of quetzales constant to prices from 2001

C O N C E P T	2006 <sup>p/</sup>	2007 <sup>e/</sup>	Variation rates	
			2006	2007
1. Expense in final consumption of homes and non-profit Institutions that serve as homes	149,074.4	156,806.6	4.6	5.2
2. General government consumption expenses	14,642.0	15,718.2	6.0	7.4
3. Gross formation of capital	34,271.8	37,329.0	16.7	8.9
Construction	13,918.7	15,282.4	16.9	9.8
Machinery and Equipment	20,520.2	22,194.6	16.6	8.2
4. Variation of existence	1,254.6	-231.8		
5. Exportation of goods and services	46,007.7	50,963.7	4.6	10.8
6. Importation of goods and services	69,934.4	75,151.6	6.8	7.5
<b>GROSS DOMESTIC PRODUCT</b>	<b>175,435.9</b>	<b>185,515.8</b>	<b>5.2</b>	<b>5.7</b>

a/ The discrepancy between the total and the sum of the components is due to the difference of not adding chained indexes.

p/ Preliminary numbers

e/ Estimated numbers

## C. FISCAL SECTOR

### 1. Analysis of the budgetary execution

According to preliminary numbers from the *Ministerio de Finanzas Públicas* [Roughly equivalent to the US Department of the Treasury], the financial situation of the Central Government (latest information available) registered a fiscal deficit of Q2,754.4 million, amount higher by Q778.7 million (39.4%) to the registered to November 2006. Said deficit is equivalent to 1.1% of the GDP estimated for 2007 (deficit of Q1,975.7 million to November 2006, equivalent to 0.9% of the GDP preliminary for 2006). On the other hand, it is worth indicating that the level of tributary income to November of this year has allowed the tributary charge to position itself at 11.3%, higher by 0.4 percentage points to the registered in the same period of 2006.



The fiscal income, to November 2007, registered an amount of Q30,489.9 million, higher by Q3,942.2 million (14.8%) to the observed in equal period the year before, which represents a readapting of 97.3% regarding the total budget for 2007 (93.8% in 2006). From tributes Q28,979.3 million were obtained, amount higher by Q3,928.3 million (15.7%) to the registered in the same period the year before, which means 100.5% of the programmed tributary collection of the 2007 budget (97.0% in 2006)<sup>22</sup>. Said amount is explained by the higher collection of direct taxes (Q964.6 million) and indirect taxes (Q2,963.7 million). The higher collection of indirect taxes is mainly explained by the increase of the income coming from the Value Added Tax –IVA [For its acronym in Spanish.] In effect, the income from IVA reached Q13,929.3 million, amount higher by Q2,633.3 million (23.3%) to the perceived in the same period of 2006, as a result of the higher collection from IVA on importations and of IVA on goods and services, which were higher by Q1,558.5 million (21.4%) and Q1,074.8 million (26.8%), in its order, regarding November 2006.

As to the increase in income from direct taxes (13.2%), this is fundamentally due to the higher collection of Income Tax -ISR [For its acronym in Spanish.]- for Q1,114.5 million (21.9%).

It is important to indicate that the better tributary collection is associated to the application of Decree Number 20-2006 of the Congress of the Republic, through which they approved “Legal Dispositions for the Strengthening of Tributary Administration” (current as of the second semester of 2006); to the administrative measures adopted by the Superintendence of Tributary Administration -SAT [For its acronym in Spanish.] oriented toward increasing the level of tax income; and, to the higher economic growth that has been observed during 2007.

As to executed expenses to November 2007, they registered an amount of Q33,244.3 million, higher by Q4,720.9 million (16.6%) to the registered in the same period of 2006, which represents an execution of 87.7% regarding the budget for 2007 (in November 2006 the execution registered was of 81.6%). As

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<sup>22</sup> According to the Superintendence of Tributary Administration –SAT [For its acronym in Spanish.], the tributary income collected to November was higher by Q1,498.4 million (5.1%) regarding the programmed.



to the structure of the total expense to November 2007, the operation expenses represented 67.4% of the total (67.9% to November 2006), while the capital expense represented 32.6% of the total (32.1% to November 2006).

The operation expenses were at Q22,402.6 million, amount higher by Q3,028.1 million (15.6%) to the registered in the same period of the year before, which represented a level of execution of 87.8% regarding the total budgeted for 2007 (87.4% to November 2006). This result was determined by the increase of the current transfers for Q1,406.9 million, in the operation expenses for Q935.8 million and in interest payments of public debt for Q685.4 million. As to current transfers to November of this year, they highlight the following: to social security –pensions and retirements- (Q1,826.8 million), to the University of San Carlos of Guatemala (Q841.3 million), to the Judicial Branch (Q777.2 million), to the *Ministerio Público* [Equivalent to the US Department of Justice] (Q591.5 million), to the National Education Self-management Program (Q522.6 million) and to the Congress of the Republic (Q377.9 million). Additionally, it is important to highlight the extraordinary transfer made to the Supreme Electoral Tribunal for Q409.0 million to cover the budget of the general elections of 2007. As to the increase in operation expenses, this is explained, among others, by the salary adjustment granted to the national Teacher's Union and to the workers of the Ministry of Health, which came into effect as of April of this year. Also, it is important to indicate that among the operation expenses, we include the commission payment to fiscal receptors and collectors that, to November 2007 rose to Q557.5 million. As to the increase in the interest payment of public debt, highlights the increase in the interest payment on the external public debt for Q394.1 million.

The capital expenses were at Q10,841.7 million, amount higher by Q1,692.8 million (18.5%) to the registered for the same period of 2006, which represents an execution of 87.5% regarding the expenses budgeted for 2007 (71.5% in 2006). As to the composition of investment expense, to November of this year, direct investment reached Q3,752.6 million, amount higher by Q1,304.5 million (53.3%) in relation to November 2006; while the indirect investment registered Q7,089.1 million, amount higher by Q388.3 million (5.8%)



in relation to the same period the year before. As to direct investment expenses, the most important is the Highway Development Program for Q2,687.7 million, amount higher by Q1,240.2 million, regarding the executed to November 2006. Indirect investment highlights the capital transfers made to the municipalities of the country for Q3,251.6 million, to the urban and rural development councils for Q1,067.1 million, to the Social Investment Fund (in settlement) for Q337.1 million and the contribution to the State Fund for Savings Protection for Q273.6 million.

As a result of regular income and regular expense, to November 2007, a savings in regular account of Q7,806.9 million was generated, amount higher by Q945.0 million (13.8%) to the registered in the same period of 2006. In that sense, the regular savings account registered in the period analyzed allowed financing 72.0% of the investment expense (75.0% in 2006).

As to financing sources for the deficit registered to November, the net external financing was at Q2,060.1 million, result of disbursements of loans for Q4,394.3 million, amortizations to loans for Q1,428.4 million and the amortization to Treasury Bonds placed in the international market in 1997 for Q905.8 million (US\$150.0 million<sup>23</sup>). The loan disbursements mainly came from the Economic Integration Development Bank to partially finance the “Multi-sector Program for Investment Strengthening” for the equivalent of Q1,538.1 million; the International Bank for Reconstruction and Development –BIRF [For its acronym in Spanish]- to finance the “Second Loan for Development Policies of the Broad Base” for the equivalent to Q771.7 million; and, the Inter-American Development Bank to finance the “Public Financial Management Reform Program” for the equivalent to Q771.5 million.

The net internal financing rose to Q3,424.3 million, as a result of public titles negotiations for Q5,308.2 million, maturities for Q1,290.1 million and the amortizations for Q593.8 million to cover the net deficiency of the *Banco de*

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<sup>23</sup> It is important to indicate that the amortization of the Treasury Bonds was registered for an amount of Q905.0 million, taking into consideration that the historic type of exchange rate (current at the date of placement) was of Q6.03486 per US\$1.00, however, the cash payment was of Q1,150.0 million, due to the fact that the type of reference exchange rate when the amortization was made was of Q7.67199 per US\$1.00. This is typical, because the settlement of obligations for external debt is made with the historic value of the same.



Guatemala corresponding to the fiscal year of 2005. Therefore, the fiscal till registered an increase of Q2,730.0 million.

Following is a graph that illustrates public finances to November 2007.

**CENTRAL GOVERNMENT  
SITUATION OF PUBLIC FINANCE TO NOVEMBER  
YEARS 2006-2007  
-In millions de quetzales-**

CONCEPT	2006	2007 <sup>P/</sup>	VARIATIONS	
			ABSOLUTES	RELATIVES
<b>I. Income and donations</b>	<b>26,547.7</b>	<b>30,489.9</b>	<b>3,942.2</b>	<b>14.8</b>
A. Income s	26,271.7	30,214.2	3,942.5	15.0
1. Regular income	26,236.4	30,209.5	3,973.1	15.1
a. Tributary	25,051.0	28,979.3	3,928.3	15.7
b. Non Tributary	1,185.4	1,230.2	44.8	3.8
2. Capital income	35.3	4.7	-30.6	-86.7
B. Donations	276.0	275.7	-0.3	-0.1
<b>II. Total Expenses</b>	<b>28,523.4</b>	<b>33,244.3</b>	<b>4,720.9</b>	<b>16.6</b>
A. Operation	19,374.5	22,402.6	3,028.1	15.6
B. Capital	9,148.9	10,841.7	1,692.8	18.5
<b>III. Fiscal Deficit or Surplus</b>	<b>-1,975.7</b>	<b>-2,754.4</b>	<b>-778.7</b>	<b>39.4</b>
<b>IV. Savings in regular account</b>	<b>6,861.9</b>	<b>7,806.9</b>	<b>945.0</b>	<b>13.8</b>
<b>V. Financing</b>	<b>1,975.7</b>	<b>2,754.4</b>	<b>778.7</b>	<b>39.4</b>
A. Net External Financing	2,480.1	2,060.1	-420.0	-16.9
B. Net Internal Financing	2,603.8	3,424.3	820.5	31.5
C. Till variation (-Increase + Decrease)	-3,108.2	-2,730.0	378.2	-12.2

SOURCE: *Ministerio de Finanzas Públicas* (Equivalent to the US Department of the Treasury.) .

<sup>P/</sup> Preliminary numbers



## INSERT 5 PUBLIC FINANCE AND ECONOMIC GROWTH

The fiscal policy can affect the aggregate supply of the economy through two inter-related channels: 1) for its contribution to savings and investment and, therefore, to the growth rate in the long term of the product; and, 2) for its effects on the efficiency with which the resources are assigned that compete among themselves and, therefore, on the level of the product and future economic growth.

The application of an expansive fiscal policy can backfire on an increase of the product in the short term, especially in periods of economic recession. In these circumstances, it is likely that the manipulation margin to apply an expansive fiscal policy is greater in countries that have previously adopted a conservative fiscal strategy. However, the effectiveness of an expansive fiscal policy has the following limitations: a) the sparse reaction of internal supply and b) the impossibility of sustaining an elevated level of payment balance deficit. As a matter of fact, it is likely that an excessively expansive fiscal policy may generate distortion in the economy and, in the long term, reduce economic growth, due to excess demand, as a result of an expansive fiscal policy, which is usually the cause of adjustment problems, inflation and sustainable economic growth.

In a study made by Baldacci, Clements and Gupta (2003), for a sample of 39 countries, they examined the effect of the fiscal policies on the growth of the real GDP per capita during the nineties, concluding that when there is freeing of encumbrances of public finance, there is a more positive effect on economic growth. The authors point out that the fiscal adjustments that are mainly based on the cutback of subsidies, transfers and public sector remunerations, the longer they last, the more they contribute to strengthening macroeconomic stability in the measure in which investors have certainty that neither taxes nor interest rates will be raised to finance future fiscal imbalances. In contrast, a slight fiscal adjustment is less likely to generate economic growth, since public finances can not remain and said adjustment could revert in the mid-term. In that context, a slight fiscal adjustment in the majority of case studies had negative consequences for the fiscal viability and economic growth. In the study, they point out that when there is greater displacement of public spending in favor of capital investment in detriment of regular expenses, the fiscal adjustment lasts longer; in other words, the composition of public expense influences economic growth with more intensity. The authors also indicated that the low income countries contemplated in the study that accelerated tributary collection- whether it improved tributary administration, eliminating exemptions, fighting evasion or raising imposed rates – registering reductions of the more persistent deficit. In that sense, the fiscal adjustment held in lower income countries, gave way to higher economic growth rates, especially through the increase in productivity of the factors. Another important aspect in the study is that when public funds are not used efficiently and the productivity of the public sector declines, the better composition of expense can be an incentive to economic growth.

The study indicates that countries that enjoy macroeconomic stability can allow increasing some expenses, as long as they have access to low expense financing and the resources destined to generating greater economic income, like the expansion of infrastructure and poverty reduction programs. Last, given the impact of government management and the importance of increasing total productivity of the factors that promote economic growth, the institutional reforms that facilitate good government management are crucial to achieving sustained growth. The fiscal and prudent macroeconomic policies can help improve said management, but the expense reform has to be made in an adequate sequence to guarantee that the policies help a more rapid growth.

SOURCE: Ideas for Fiscal Adjustment. Department of Public Finance, Series of pamphlets. No. 49. IMF 1995  
Use of fiscal policy to stimulate growth. Finance and development. Volume 40, number 4. IMF 2003.



## 2. Public Debt

### a) Internal

The balance of internal public debt, according to preliminary numbers to October, was at Q24,245.5 million, amount higher by Q4,056.9 million (20.1%) to the amount observed in December 2006. This increase is mainly due to the increase in the holding of Treasury Bonds on behalf of the non-banking private sector, the banking sector, the public sector and of the *Banco de Guatemala*, which increased by Q1,299.5 million, Q1,271.3 million, Q973.6 million and Q593.8 million, in the same order. In contrast, the non-resident sector reduced the holding of public values in Q81.3 million. It is important to indicate that to October 2007, the *Banco de Guatemala* registered greater holding of Treasury Bonds, which is from a decree contained in the Organic Law of the *Banco de Guatemala*, the State of Guatemala, through the *Ministerio de Finanzas Públicas* [Roughly equivalent to the US Department of the Treasury], who is in charge of covering the net deficiencies that the Central Bank registers. On this, on August 28, 2007 the *Ministerio de Finanzas Públicas* [Roughly equivalent to the US Department of the Treasury] fulfilled said legal mandate on the third occasion, transferring the Treasury Bonds of the Republic of Guatemala to the *Banco de Guatemala* for Q593.8 million to cover the net deficiency corresponding to the fiscal year of 2005.

As to the structure of the holder of the balance of internal public debt, the same varied due to greater placements made with the public sector and to the increase of holdings of Treasury Bonds on behalf of the *Banco de Guatemala*. In effect, to December 31, 2006, the participation of said sectors regarding the total was of 18.5% and 12.9% of the total, respectively; while to October of this year, it was at 19.4% and 13.2%, in that order. In contrast, the non-banking private sector, the banking sector and the non resident sector decreased their relative participation from December 2006 to October 2007, when going from 40.6%, 26.6% and 1.4% to 39.2%, 27.4% and 0.8%, in the same order.



Evaluation of the Monetary, Foreign Exchange Rate  
and Credit Policy to November 2007



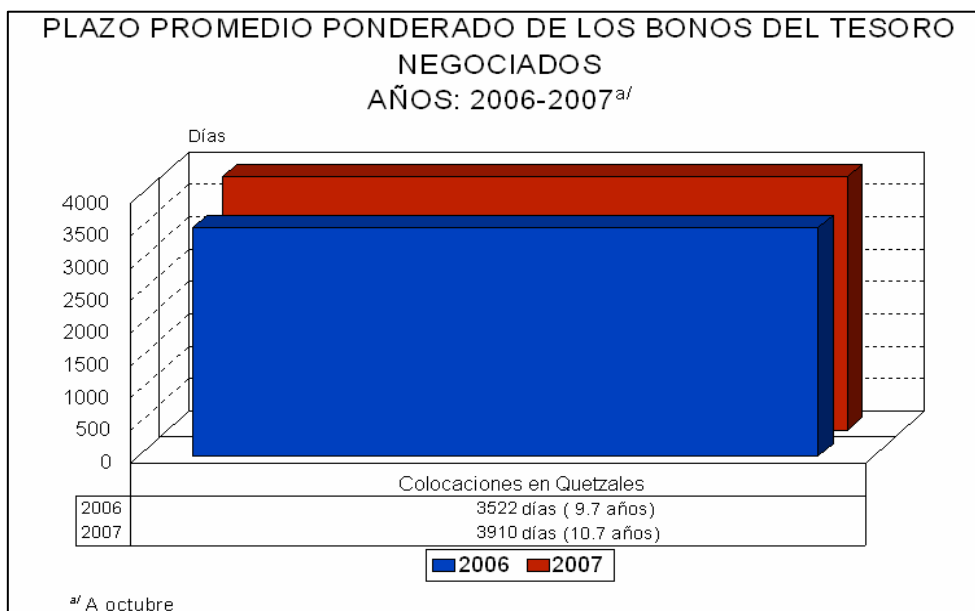
Central Government  
Balance of the Internal Public Debt  
Years 2006 - 2007  
(millions of quetzales)

Holder	TO 31/12/2006	Structure	TO 31/10/2007	Structure	Variation	
					Absolute	Relative
TOTAL	20,188.6	100.0	24,245.5	100.0	4,056.9	20.1
<i>Banco de Guatemala</i>	2,597.8	12.9	3,191.6	13.2	593.8	22.9
Private Banking Sector	5,369.8	26.6	6,641.1	27.4	1,271.3	23.7
Public Sector	3,740.6	18.5	4,714.2	19.4	973.6	26.0
Nonresident Sector	286.9	1.4	205.6	0.8	-81.3	-28.3
Private non banking Sector	8,193.5	40.6	9,493.0	39.2	1,299.5	15.9

SOURCE: *Banco de Guatemala*.

As to the placement term of internal debt, it is important to indicate that in 2006 the weighted average of placements in quetzales was of 3,522 days (9.7 years), while to October 2007 it was at 3,910 days (10.7 years). It is worth pointing out that in both years there were only placements of public value expressed in quetzales, through the mechanisms of bidding and of auction.

*Weighted average term of the negotiated Treasury Bonds*

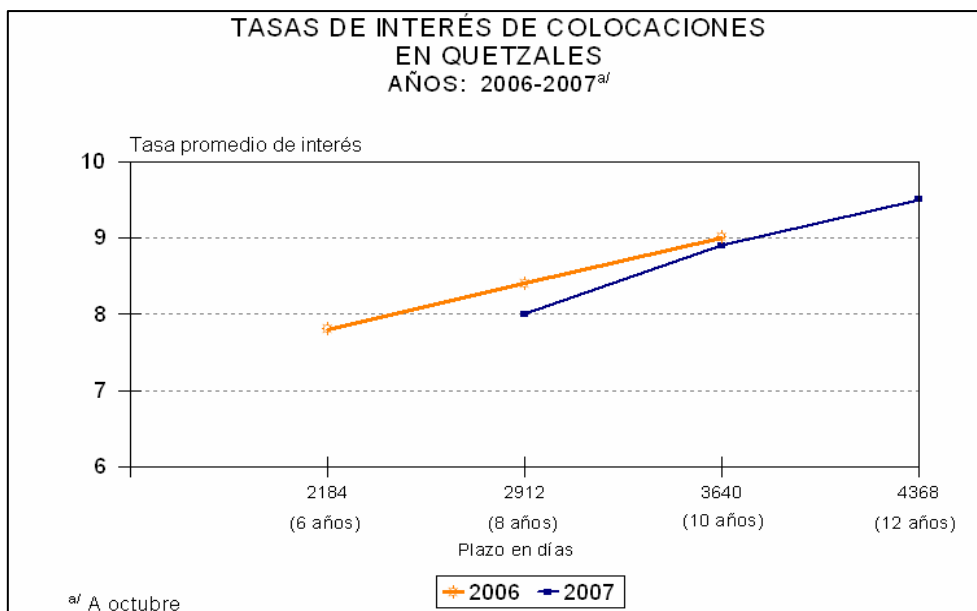


As to the weighted average interest rate of placements of the Central Government expressed in quetzales, this was at 9.03%, slightly higher than that of 2006 (8.90%). Said increase, is the result that in 2007 they made placements



for 4,368 days (12 years) at 9.5%, which reflects an average term for the placements.

### INTEREST RATE OF PLACEMENTS IN QUETZALES



#### b) External

According to preliminary numbers to October 2007, the balance of the external public debt was at US\$4,237.8 million; amount higher by US\$379.5 million to the balance registered to December 31, 2006. Said increase is mainly the result of disbursements for US\$565.1 million and amortizations for US\$315.0 million; therefore, the net transfer of resources, understood as the result of the difference between disbursed resources and the amortization of capital was positive by US\$250.1 million.

Regarding the disbursements for loans received by the Central Government, to October 2007 highlights the following<sup>24</sup>: US\$237.0 million<sup>25</sup> of the Central American Bank for Economic Integration –BCIE [For its acronym in Spanish.]; US\$190.9 million<sup>26</sup> of the Inter-American Development Bank –IDB

<sup>24</sup> The sector loans are highlighted, which are characterized for having more favorable interest rates and terms. This type of loans constitutes a new modality for obtaining financial resources at relatively low costs than the placement of Treasury Bonds in international markets. The financial conditions in which the sector type loans are hired, allow certain discretion for the lending entity; in the sense that the resources obtained are perceived in the quality of budget support, so that the hiring country assigns the funds for its own priorities of expenses.

<sup>25</sup> They highlight that they destined US\$200.0 million to finance the Multi-sector Program of Investment Strengthening.

<sup>26</sup> They destined US\$100.0 million for financing the Reform Program of Public Financial Management, US\$20.0 million for the Improvement of Quality of Social Expense Program and the Rehabilitation and Highway Modernization II Program for US\$17.2 million stand out.



[For its acronym in Spanish]-; and US\$128.9 million<sup>27</sup> of the International Bank for Reconstruction and Development –BIRF [For its acronym in Spanish]-.

As to the amortizations on capital, it is important to indicate that in August of this year, they amortized Treasury Bonds negotiated in the international market in 1997 for US\$150.0 million. The amortizations made to the IDB for US\$47.6 million and to the CABIE for US\$47.3 million, also stand out.

#### **a) Estimation of closing for December 2007**

According to the estimations of the *Ministerio de Finanzas Públicas* [Roughly equivalent to the US Department of the Treasury], the fiscal closing for 2007 contemplates that the fiscal deficit will more or less reach 1.8% of the GDP, slightly below the registered in 2006 (1.9%), while the tributary load will be around 11.9%, equal to the registered in 2006.

It is worth highlighting that in 2007 the monetary policy was supported by the fiscal policy, in a framework of coordination of both policies. In effect, said support is reflected in a minor associated fiscal deficit, on the one hand, and a greater tributary collection and, on the other hand, discipline in public expense, said situation allows the maintenance of deposits from the Central Government in the *Banco de Guatemala* over the programmed.

### **D. FINANCIAL SECTOR**

#### **1. Banking Liquidity**

##### **a) In national currency**

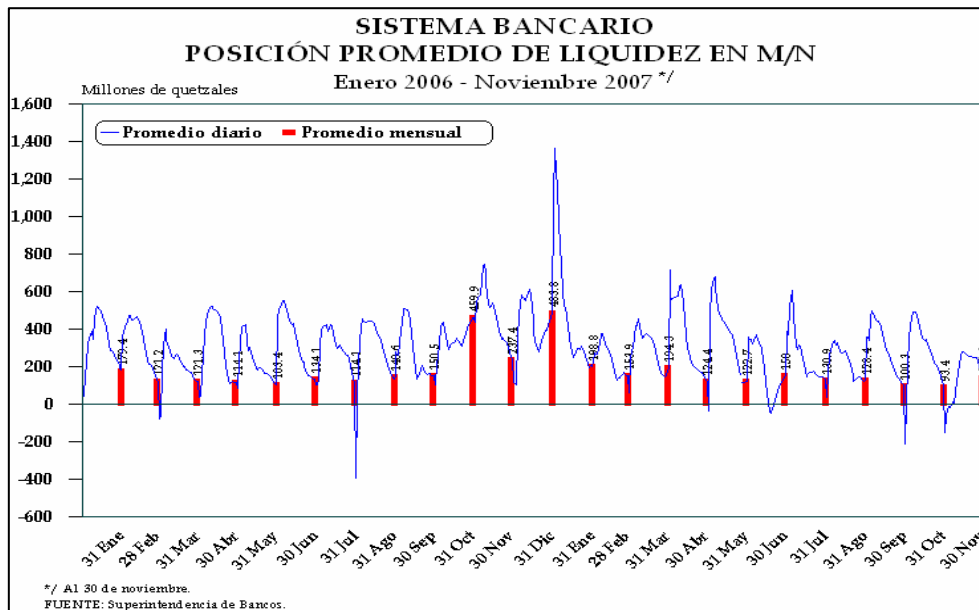
The banking liquidity, through the excess or deficiencies of legal reserve, is an indicator of the level of financial resources available in the banking system. During the period of January to November 2007, the banking system showed positive level of liquidity on average.

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<sup>27</sup> The second loan for Development of Broad Base Policies for US\$100.0 million also stands out.

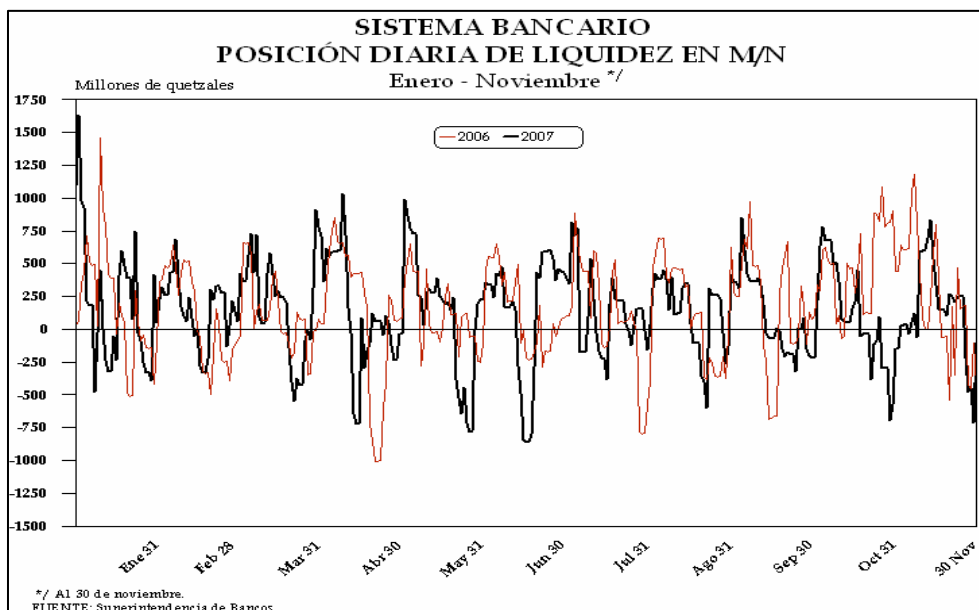


*Banking system; Average liquidity position in M/N*



Daily liquidity that banks registered from January to December 2007, showed similar stability to the observed in an equal period during 2006. On this, between January and November of this year, the daily liquidity registered its maximum point to January 2, when it was at Q1,636.3 million and its lowest level was on June 17, at –Q859.7 million. To November 30, the daily balance of banking liquidity was at –Q108.9 million.

*Banking system; Daily liquidity position in M/N*





It is important to comment that the behavior of the banking liquidity in the mentioned period is associated, among other factors, to the modifications to the Banking Legal Reserve Regulations<sup>28</sup>. In effect, the banks in the system were allowed to include, as part of the computable legal reserve, the investment in Term Deposit Certificates issued by the Central Bank, Treasury Bonds from the Republic of Guatemala and mortgage documents with FHA guarantees and/or mortgage bonds, initially up to Q100.0 million for each banking institution, reducing it gradually to Q50.0 million in June and to Q25.0 million in July 2007. They also authorized the banks to keep, as part of the computable legal reserve, in cash funds for up to 75% of the legal reserve required, later in March it was reduced to 50% until it returned to 25% on August 1, 2007. The referred decisions allowed, in the first place, that the banking institutions count on greater liquidity<sup>29</sup> and, second, that they have greater flexibility in the management of the availability for the effects of legal banking reserve. Additionally, the mentioned modifications included the elimination of the inter-banking deposits of the calculation of legal reserve required, during the period between January 23 and May 31, which meant a decrease in legal reserve required for an amount of Q232.1 million. It is worth indicating that this last decision was no longer in effect as of June 1, 2007.

#### **b) In foreign currency**

During the period of January to November 2007, the average banking liquidity in foreign currency; measured by the sum of the excess and deficiencies of legal reserve, showed positive behavior.

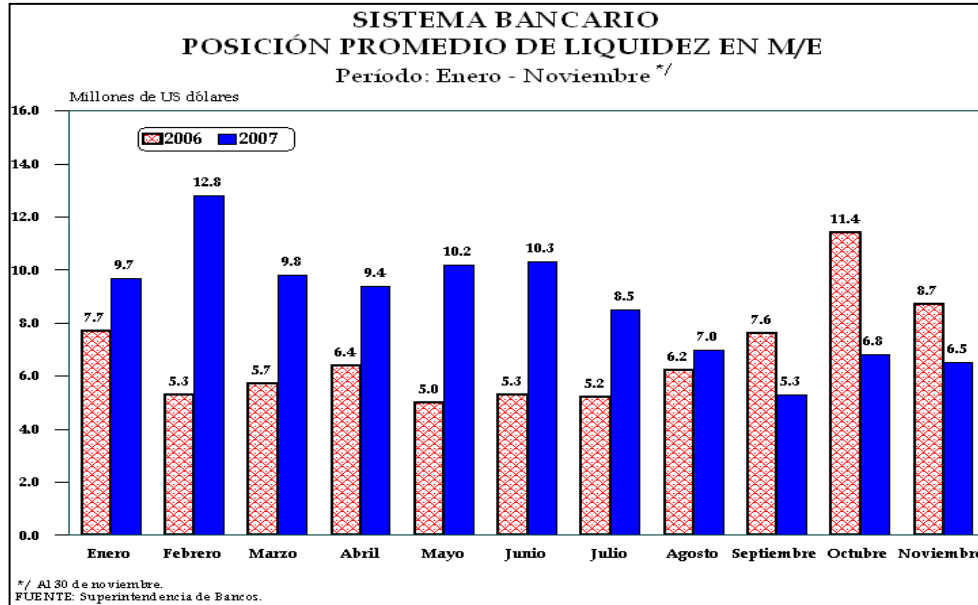
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<sup>28</sup> The Monetary Board, through resolution JM-20-2007 temporarily modified and had the Regulation of Legal Banking Reserve in effect to March 31, 2007. In March it extended said measure to May 31 of this year with some variations regarding the modifications from January. Finally in resolution JM-111-2007 the procedure to gradually reestablish the full enforcing of the Legal Banking Reserve Regulation in Resolution JM-177-2002 and its modifications, as of August 1, 2007 was defined.

<sup>29</sup> In effect, to July 31, 2007, the measures implemented allowed a decrease of deposits in the Central Bank for Q197.8 million, the increase of cash in the tills of the banks for Q385.3 million and the registry of Term Deposits Certificates issued, by the Central Bank, of Treasury Bonds from the Republic of Guatemala, of mortgage documents with FHA guarantees and mortgage documents with guarantee of bonds, as a part of the legal reserve tally, for an amount of Q136.5 million.

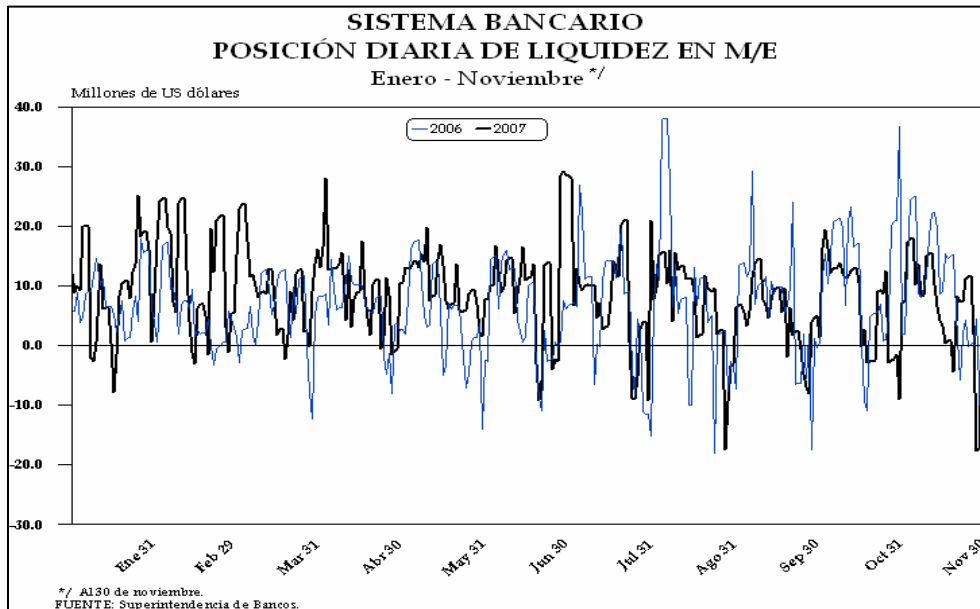


*Banking system; Average position of liquidity in M/E*



As to daily liquidity in foreign currency, it showed a relatively stable behavior, similar to the observed in the same period of the year before.

*Banking system; Daily position of liquidity in M/E*





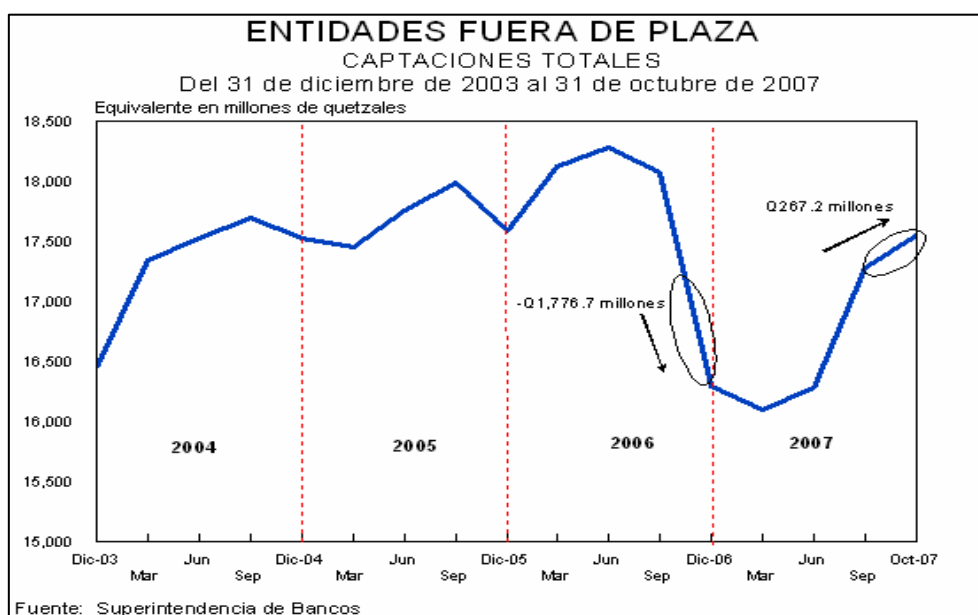
## 2. Offshore entities

The available data to October 2007 generally allows making a disaggregate analysis of the operations of offshore entities, particularly of fund-raising and of credit to the private sector.

### a) Fund Raising

The total fund-raising (including financial obligations) of the offshore entities registered, to October 31, 2007, a balance for the equivalent of Q17,558.9 million, amount lower by Q2,385.0 million (12.0%) to the registered October 31, 2006, but higher by Q1,258.0 million (7.7%) to the registered on December 31, 2006. This particularly influenced the operations closing of *Bancafe Internacional Bank, Ltd*<sup>30</sup>, an offshore entity, member of the *Bancafé Grupo Financiero del País* (Financial Group of the Country), member that to September 30, 2006 registered fund-raising for the equivalent of Q1,257.3 million in quetzales (7.0% of the total fund-raising of offshore entities).

#### *Offshore entities (Total Fund-raising)*



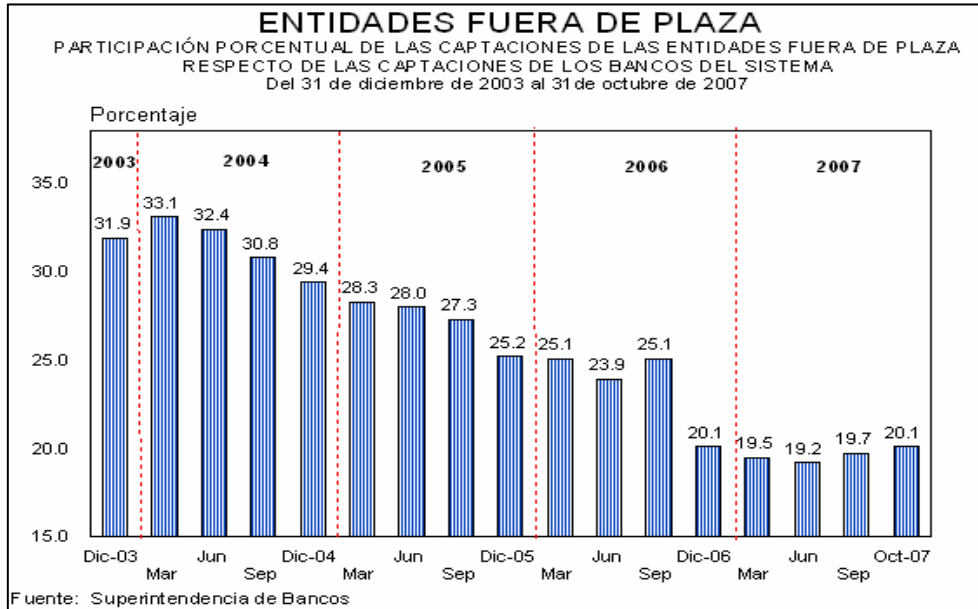
To October 31, 2007, the total fund-raising of the offshore entities represented 20.1% of the total fund-raising of the national banking system,

<sup>30</sup> Through resolution JM-122-2006, modified by resolution JM-125-2006, the Monetary Board resolved to revoke the authorization of the conformation of the *Grupo Financiero "Bancafé Grupo Financiero del País* (Financial Group "Bancafé, Financial Group of the Country)", that included Bancafe Internacional Bank, Ltd.



percentage that is equal to the observed at the end of 2006, situation that modifies the falling tendency observed since 2004, as is shown in the following graph.

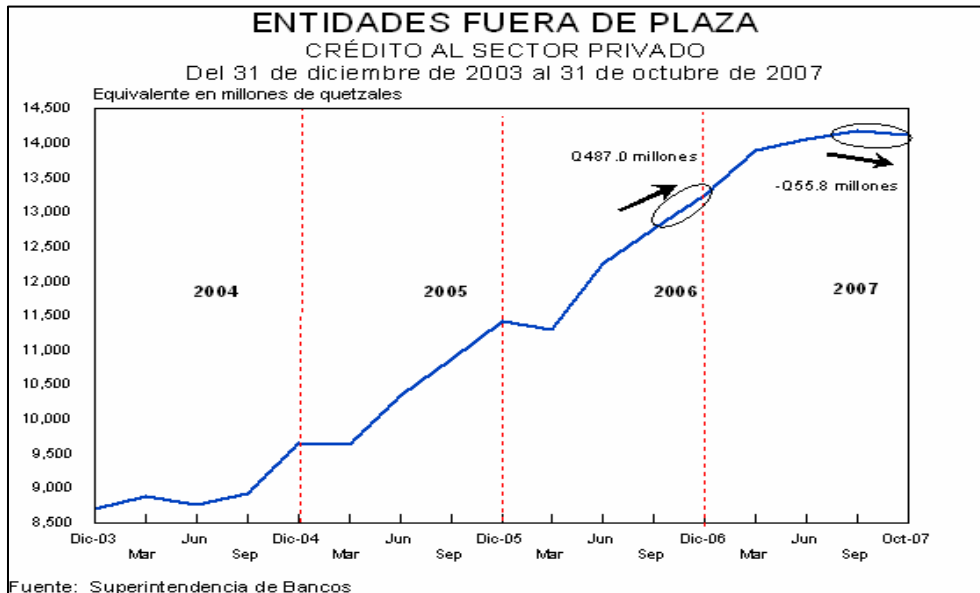
*Offshore entities (Percent Participation of Fund-raising regarding the Fund-raising from Banks in the system)*



**b) Credit to the private sector**

The credit granted to the private sector by offshore entities, to October 31, 2007, registered a balance for the equivalent to Q14,116.8 million, amount higher by Q1,455.1 million (11.5%) to the observed to October 31, 2006 and higher by Q867.1 million (6.5%) to the registered December 31, 2006.

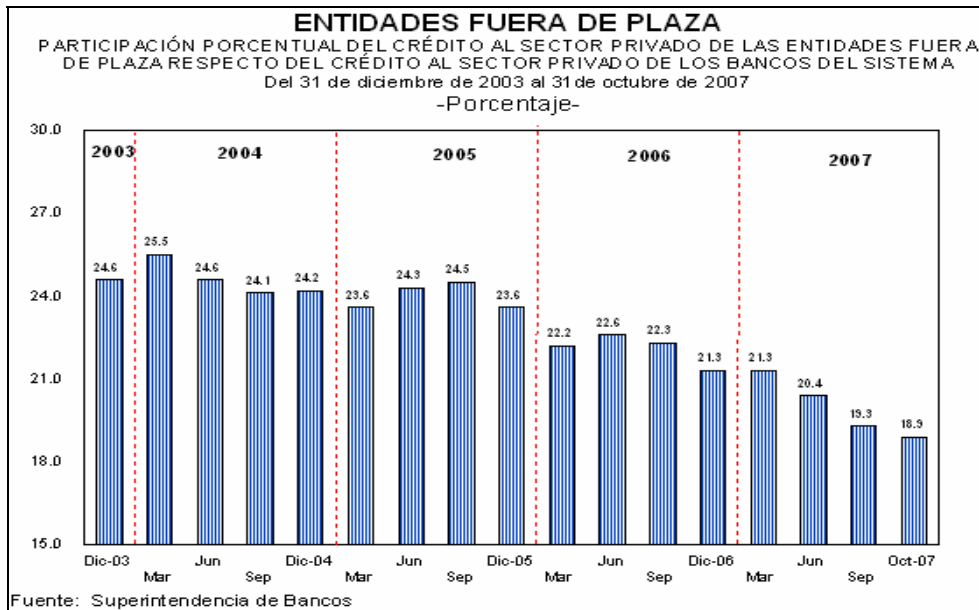
*Offshore Entities (Credit to the Private Sector)*





At the end of 2006 the credit granted by offshore entities to the private sector represented 21.3% of the total granted by the national banking system, while to October 31, 2007 they had a participation of 18.9% of the total, as is illustrated in the following graph.

*Offshore entities (Percent Participation of Credit to the Private Sector regarding Credit from the private sector from Banks in the system)*



### III. EVOLUTION OF THE MONETARY POLICY VARIABLES

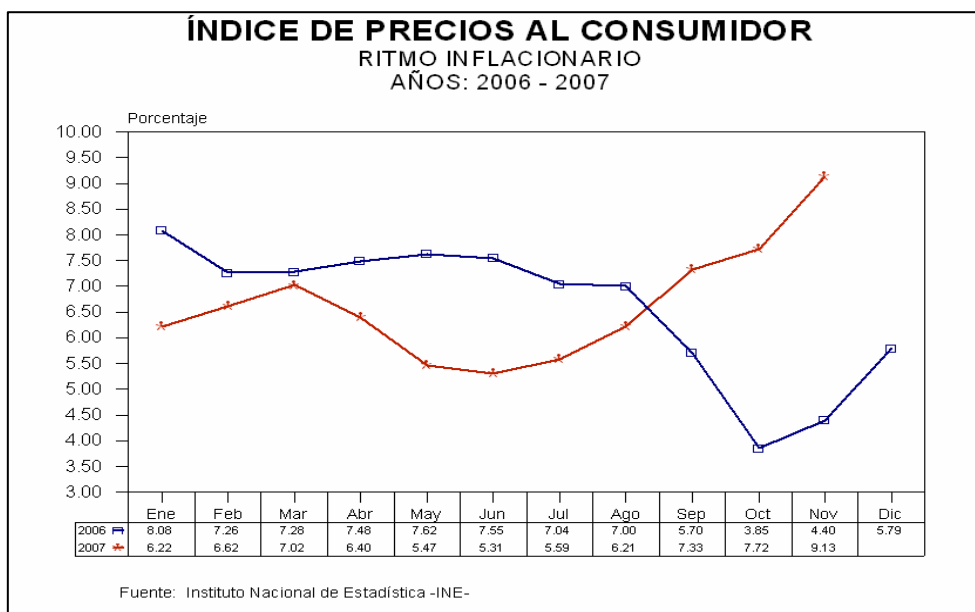
#### A. INFLATION TARGET

##### 1. Consumer Price Index -CPI-

According to the CPI, made by the National Statistics Institute –INE [For its acronym in Spanish], to November 30, 2007, in the whole country, they registered an inflationary rhythm of 9.13%, percentage that is over the target of the end of the year established by the Monetary, Foreign Exchange rate and Credit Policy (5.0% +/- 1 percentual point) and higher by 4.73 percentual points to the observed in November 2006 (4.40%).



### Consumer price index (Inflationary Rhythm)



The observed behavior in inter-annual inflation to November 2007 mainly reflects the increase that was registered by the expense division of **Food, non-alcoholic beverages and take out food** (weighting 38.75%), with an inter-annual variation of 14.00%, that explains 66.74% of the inter-annual variation of the CPI. Due to their participation, we can highlight the inter-annual increase in the index of the expense groups of *Bread and cereals* (25.96%); *Oils and fats* (22.90%); *Orchard products, legumes and tubercles* (17.57%); *Milk, milk-derived products and eggs* (13.66%); *Meats* (6.81%); and, *Take out foods and snacks* (5.51%), that together explain 91.41% of the inter-annual variation of said expense division. At the level of basic expenses, those that register greater hikes at the inter-annual level are: *tomato* (74.10%); *bread* (32.30%); *tortilla products* (22.32%); *gasoline* (21.32%); and, *fresh liquid milk, non-fat milk, pasteurized or sterilized* (19.54%) that together represented 44.44% of the total of inflation to November 2007.

The expense division of **Transportation and communications** (weighting 10.92%), registered an inter-annual growth of 7.28% and represented 7.88% of the inflationary rhythm. Said behavior was especially influenced by the median price of *gasoline* (21.32%) and *automobiles* (19.41%).

The expense division for **Housing, water, electricity, gas and other fuels** (weighting 10.00%), registered an inter-annual growth of 6.54% and



represented 6.60% of the total inflationary rhythm. It is worth highlighting that said behavior to the increase of *expenses derived from manufactured and natural gas and liquid gases from petroleum* (20.10%); from *real rents for housing* (5.16%); and, the *electricity service* (4.97%).

The expense division for **Recreation and culture** (weighting 6.83%), registered an inter-annual growth of 7.68% and explained 5.53% of the total inflationary rhythm. Said behavior was mainly influenced by the increase in the median prices of expenses for *travel and/or recreation outside the country* (24.54%); and, in the *expenses for income of different places, cultural, social and recreation events* (17.90%); and, in the *expenses for subscription and/or purchase of magazines, newspapers and similar* (17.51%).

The behavior of the four divisions of expense mentioned, explained jointly, 86.75% of the observed inflationary rhythm to November 2007.

CONSUMER PRICE INDEX  
(BASE: DECEMBER 2000 = 100.0)  
INFLATIONARY RHYTHM  
AT REPUBLIC LEVEL  
November 2007

EXPENSE DIVISION	WEIGHTING FOR EXPENSE	INFLATIONARY RHYTHM 1/	PARTICIPATION IN INFLATIONARY RHYTHM 2/	PARTICIPATION IN THE INFLATIONARY RHYTHM AS A % 3/
	100.00	9.13	9.13	100.00
1. Food, non-alcoholic beverages and take out foods	38.75	14.00	6.09	66.74
2. Clothing and shoes	7.94	2.88	0.19	2.12
3. Housing, water, electricity, gas and other fuels	10.00	6.54	0.60	6.60
4. Mobile, housing equipment and routine household maintenance	7.95	5.35	0.39	4.27
5. Health	5.48	3.84	0.20	2.18
6. Transportation and communications	10.92	7.28	0.72	7.88
7. Recreation and cultural events	6.83	7.68	0.51	5.53
8. Education	5.60	3.46	0.19	2.09
9. Goods and diverse services	6.53	3.90	0.24	2.59

Source: National Statistics Institute -INE- [For Spanish acronym]

1/ Variation rate of the month examined regarding the same month the previous year.

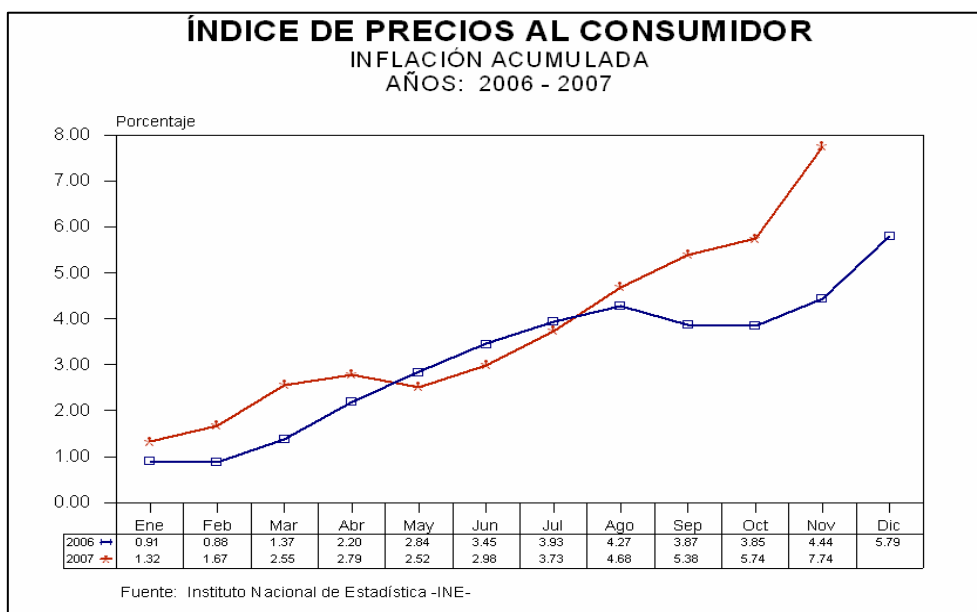
2/ Incidence in variation.

3/ Participation in the variation: (Incidence / Total variation) \* 100.

The accumulated inflation to November of this year, in the country, reached a variation of 7.74%, higher by 3.30 percentual points to the registered in the same month the year before (4.44%).

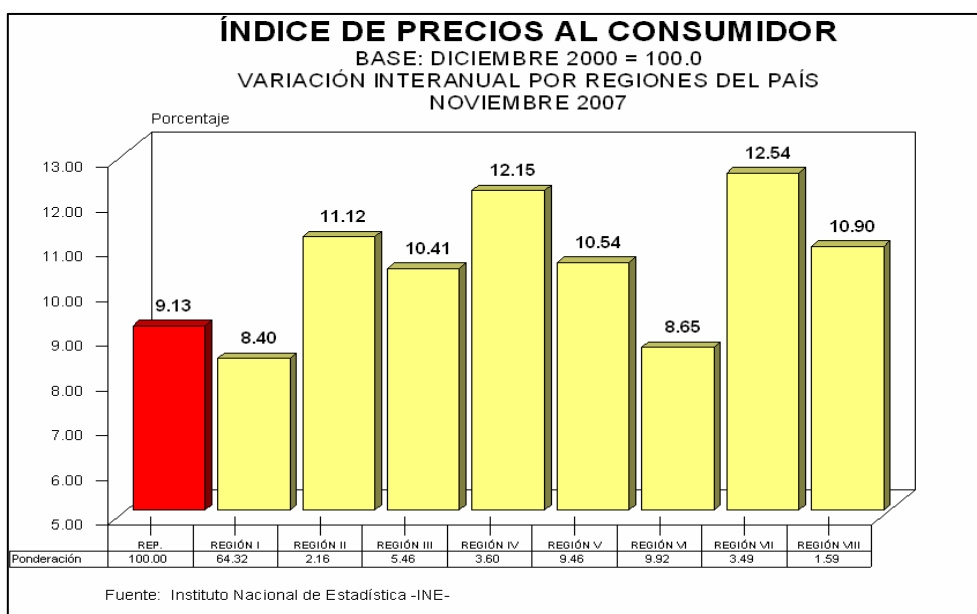


Consumer Price Index (Accumulated Inflation)



Among the regions<sup>31</sup>, Region VII registered the highest inflationary rhythm of 12.54%; Region IV exhibited an inter-annual variation of 12.15%; and, Region II registered a variation of 11.12%. As to Region I, it has a weighting of 64.32% in total CPI, observing an inflationary rhythm of 8.40%, lower by 0.73 percentage points to the weighted average of the country (9.13%).

Consumer Price Index (Inter-annual variation per region in the country)



<sup>31</sup> Region I, Metropolitan (Guatemala); Region II, North (Alta Verapaz and Baja Verapaz); Region III, Northeast (El Progreso, Zacapa, Izabal and Chiquimula); Region IV, Southeast (Santa Rosa, Jalapa and Jutiapa); Region V, Central (Chimaltenango, Sacatepéquez and Escuintla); Region VI, Southwest (San Marcos, Quetzaltenango, Totonicapán, Retalhuleu, Suchitepéquez and Sololá); Region VII, Northwest (Huehuetenango and Quiché); and, Region VIII, Petén.



In Region VII, with a weighting of 3.49% within the structure of regions, the observed behavior is mainly explained by the rise in the median price of *tomato* (74.29%). On the other hand, *bread* registered a variation of 63.30%; *corn* 22.20%; *fresh poultry meat, refrigerated or frozen* 14.14%; and, *breakfast (or dinner)* registered a variation of 10.35%. It is worth indicating that the increase mentioned is explained, jointly, by 60.61% of the inter-annual variation of said region.

The increase observed in Region IV, with a weighting of 3.60%, is particularly due to the rise registered in the median price of *bread* (56.77%); of *tomato* (50.36%); of *other vegetables and orchard produce* (30.92%); of *fresh or dried fish* (29.50%); of *tortilla products* (23.94%); and, of *fresh poultry meat* (12.51%) headings that together represent 73.58% of the variation of said region.

The increase observed in Region II, with a weighting of 2.16%, is mainly due to the hike registered in the median price of *tomato* (130.38%); of *tortilla products* (42.48%); of *other fresh fruit* (25.57%) and of *gasoline* (23.23%). The referred basic expenses, together explained 50.36% of variation for said region.

The inter-annual variation registered in Region I, with a weighting of 64.32%, is mainly explained by the increase observed in the median price of *tomato* (75.83%); *bread* (26.98%); *gasoline* (21.44%); *fresh liquid milk* (21.74%); *tortilla products* (20.72%); *automobiles* (19.42%); and, *fresh, frozen and refrigerated poultry meats* (14.32%). The mentioned products represented 48.33% of the total variation registered.

## 2. Subjacent Inflation

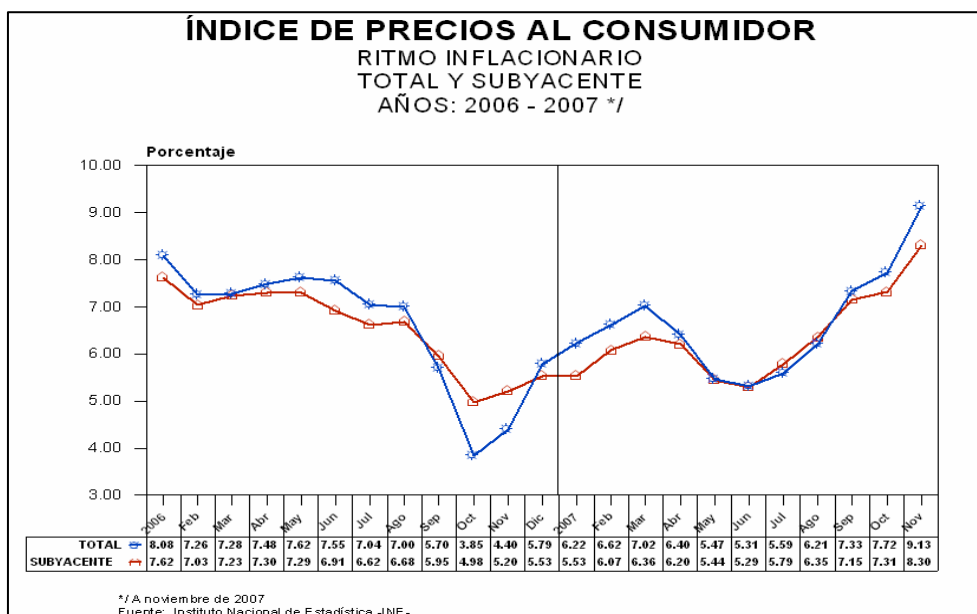
Subjacent inflation is the growth rate of a price index that, in order to eliminate distortion from the calculation, excludes the price indexes of some goods and services that are highly volatile or are subject to shocks. In that regard, for Guatemala, the indexes of the following expense groups are excluded: *fresh, dry and conserved fruit; orchards, legumes and tubercles; manufactured and natural gas and liquefied petroleum gases; and, gasoline,*



whose weightings within the CPI are 1.28%, 3.77%, 1.09% and 2.04%, respectively, for a total of 8.18%.

Subjacent inflation in the country registered an inter-annual variation of 8.30% to November 2007 (5.20% to November 2006), lower by 0.83 percentage points of total inflation (9.13%).

### Consumer Price Index; Total and Subjacent Inflationary Rhythm



In the behavior of the inflationary subjacent rhythm the evolution of the price of *bread, tortilla products and of fresh, refrigerated or frozen poultry meats* were determinant, and together explain 39.56% of the subjacent inflation to November 2007.

### 3. Imported inflation

Since 2004 the behavior of the inflationary rhythm has been significantly influenced by imported inflation, which at the same time mainly responds to the rise in the international price of oil and its derivatives.

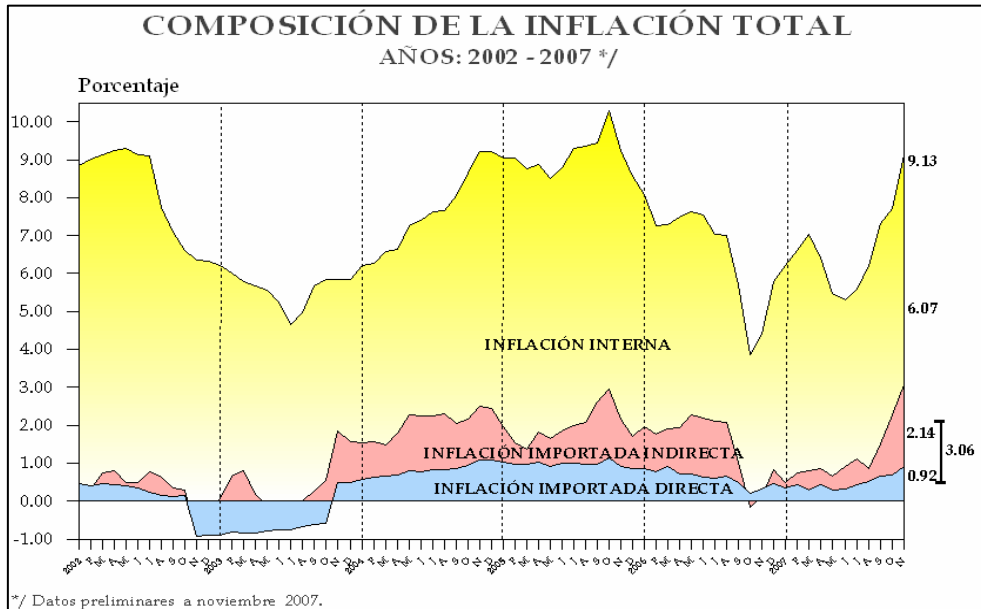
It is worth pointing out that as of 2006, imported inflation has also been influenced by the behavior of the rise in the prices of corn and wheat worldwide.

To November 2007, imported inflation explains 3.06 percentage points of the inflationary rhythm (9.13%), of which 0.92 percentage points correspond to

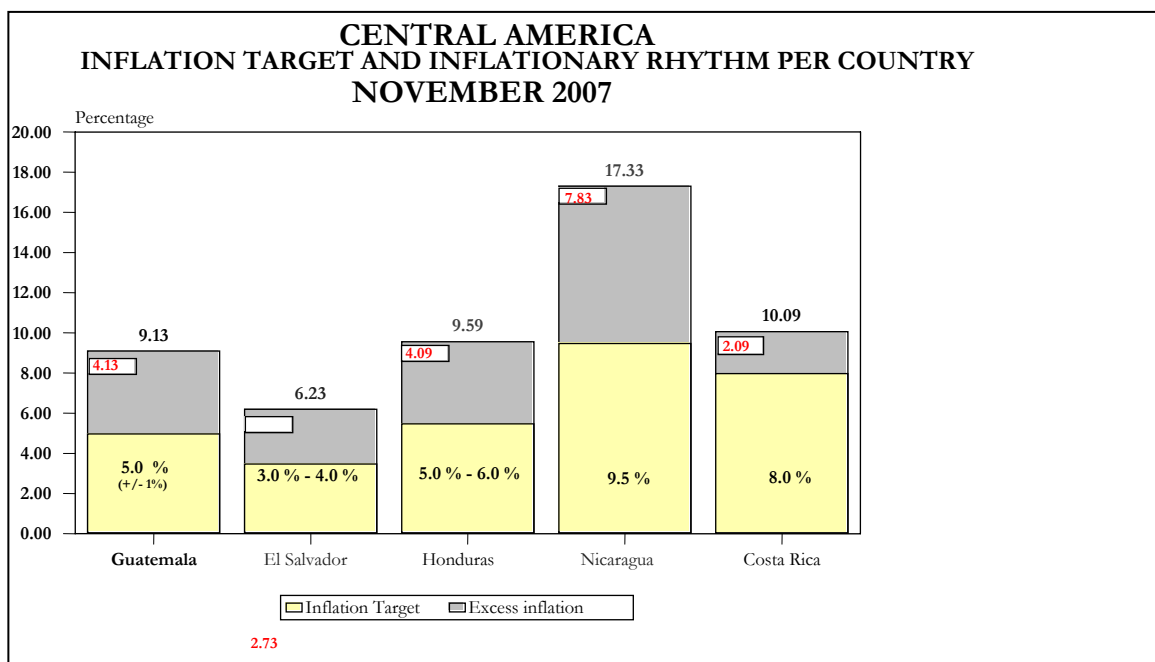


direct imported inflation and 2.14 percentage points to indirect imported inflation, as is illustrated in the following graph.

*Composition of Total Inflation*



Last, it is worth indicating that in Central America, the inflationary rhythm is located over the punctual target forecast for 2007, location associated, in part, to the effect coming from imported inflation.





#### **4. Econometric Projection of inflation for December 2007 and for December 2008**

According to the econometric projections made by the technical groups of the Central Bank, based on information to November 2007 and keeping the monetary conditions invariable, as well as intensifying the presence of supply factors associated to external shocks, for December of this year the inflationary rhythm is at 8.49%, over the fixed inflation target by the monetary authority for 2007 (5.0% +/- percent point). On the other hand, for the end of 2008 an inflationary rhythm of 6.62% is projected, also over the fixed monetary policy target for this year (4.5% +/- percent point). In that sense it is important to highlight the fundamental importance that continues making efforts in matter of monetary policy, duly supported by the fiscal policy for the fulfillment of the inflation target.

#### **5. Forecast in the Mid-term, Semi-structural Macroeconomic Model –MMS [For its acronym in Spanish]-**

In that paragraph, through the fan diagrams, are the forecasts of mid-term generated by the Semi-structural Macroeconomic Model –MMS [For its acronym in Spanish], in its running corresponding to the fourth quarter of 2007 and is presented in the risks balance implied in said forecasts.

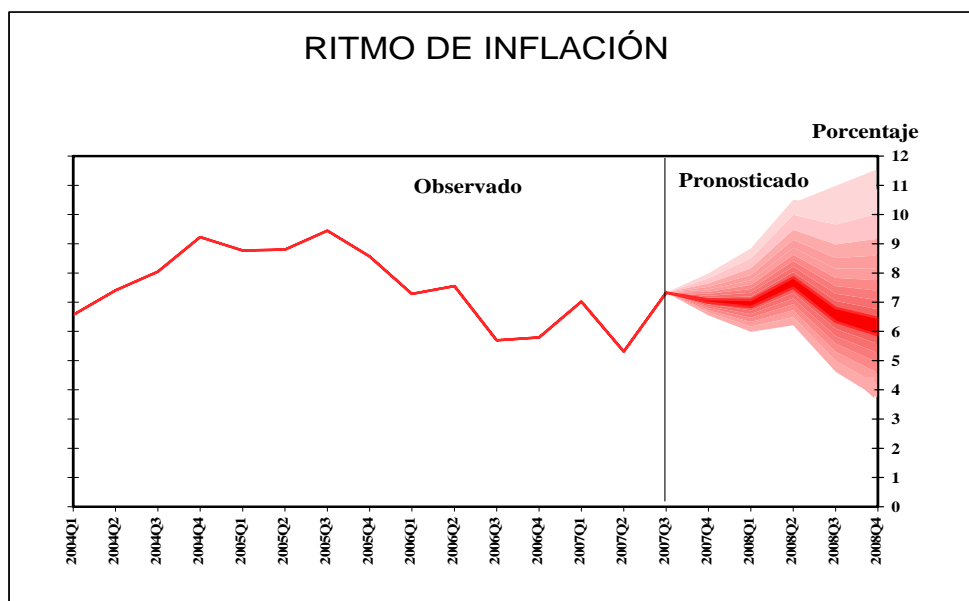
##### **a) Fan Diagram**

The inflation forecasts can be illustrated by a “fan diagram”, which represents the function of the probabilities (or the density) of the futures variables, conditioned by the information known currently.

The following fan diagram illustrates the inflation forecast for the period from the fourth quarter of 2007 up to the fourth quarter of 2008, generated by the fourth running of the MMS in 2007. It is important to highlight that the dispersion in the density function of the inflation forecast increases as the horizon of the forecast widens. The modal inflation forecast for the fourth quarter of 2007 is of 7.04%; while for the fourth quarter of 2008 is of 6.16%.



### *Inflation Rhythm*



There are certain subjective elements necessary for the construction of a fan diagram and they are mainly related to the external variables forecast models. In the present forecast exercise, the subjective probability assigned to the event that the future value of each external variable is greater than its punctual forecast of 50%, except the price of diesel, for which said probability was fixed at 75%. This implies that the distribution of the inflation forecast probability is asymmetric, as is illustrated in the previous fan diagram.

#### **b) Risks Balance**

The following graph shows the risks balance for the inflation forecast; in other words, the probability that futures inflation is found over the modal forecast, as well as the probability that it is found within a certain range of values.



Risks Balance for the Fourth Quarter of 2007				Risks Balance for Fourth Quarter of 2008			
Target		5%		Target		4.5%	
Tolerance Margin		± 1%		Tolerance Margin		± 1%	
Forecast in				Forecast in			
	2007Q3	2007Q4	Difference		2007Q3	2007Q4	Difference
	(A)	(B)	(C) = (B) - (A)		(A)	(B)	(C) = (B) - (A)
Modal Forecast	6.06%	7.04%	0.98%	Modal Forecast	5.78%	6.16%	0.38%
P( $\pi >$ Modal forecast)	50%	61.35%	11.35%	P( $\pi >$ Modal forecast)	50%	69.92%	19.92%
Probability that the futures inflation is found within the values range				Probability that the futures inflation is found within the values range			
Forecast in				Forecast in			
	2007Q3	2007Q4	Difference		2007Q3	2007Q4	Difference
	(A)	(B)	(C) = (B) - (A)		(A)	(B)	(C) = (B) - (A)
P( $\pi \in [4\%, 6\%]$ )	44.41%	1.04%	-43.37%	P( $\pi \in [3.5\%, 5.5\%]$ )	26.20%	20.91%	-5.29%
P( $\pi \geq 6\%$ )	52.27%	98.96%	46.69%	P( $\pi \geq 5.5\%$ )	53.21%	69.77%	16.56%
P( $\pi < 4\%$ )	3.32%	0.00%	-3.32%	P( $\pi < 3.5\%$ )	20.59%	9.32%	-11.27%

As we can see in the left part of the above graph, the inflation target for 2007 is 5.0% +/- 1 percent point. According to the forecast generated in the third running of 2007, there is a 44.41% probability that the inter-annual inflation rate is found within the mentioned inflation target, a 52.27% probability that it be over the target and a 3.32% probability that it be below the referred target of the monetary policy. In contrast, according to the generated forecast in the fourth running of 2007, there is a 1.04% probability that the inter-annual inflation is within the monetary policy target for December, 2007, a 98.96% probability that it be over the target and no probability that it be below the monetary policy target.

As to the right quadrant, it shows a risks balance of the inflation rhythm forecast for the fourth quarter of 2008. As we can see in said quadrant, the inflation target for 2008 is of 4.5% +/- 1 percent point. According to the forecast generated in the third running of 2007, there is a 26.20% probability that the inter-annual inflation is found within the inflation target, a 53.21% probability that it will be over the target and a 20.59% probability that it will be below the referred target. In contrast, according to the forecast generated in the fourth running of 2007, there is a 20.91% probability that the inter-annual inflation is found within the monetary policy target for December 2008, a 69.77% probability that it be over the target and a 9.32% probability that it be below the monetary policy target.



## B. INTEREST RATES

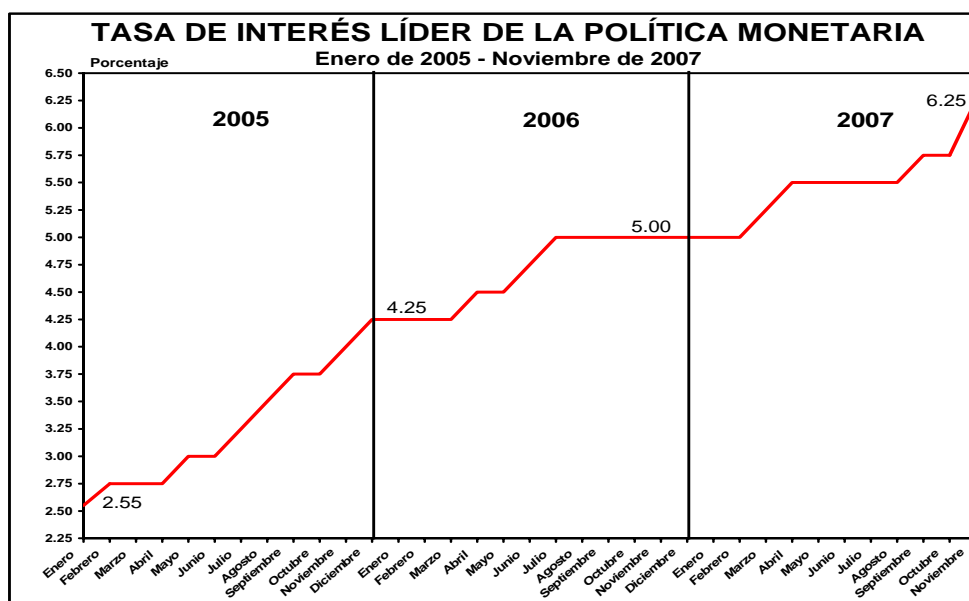
### 1. Of Monetary Stabilization Operations -MSO-

#### a) In national currency

##### i. Per term

During the period between January and November 2007, in the Monetary Stabilization Operations in the short term that are held in the Electronic Money Banking Table and in the Commodities Exchange, the interest rate of the Term Deposit in the 7 day term (leading interest rate of the monetary policy) increased on March 29 from 5.00% to 5.25%, on April 26 from 5.25% to 5.50%, on September 27 from 5.50% to 5.75%, on November 2 from 5.75% to 6.00% and on November 29 from 6.00% to 6.25%, after the Monetary Board knew the inflation balance risk, the orientation of indicative variables and the inflation forecast presented by the technical departments of the *Banco de Guatemala*, were for 2007 as well as for 2008, which were over the target established for each one of those years. With the indicated increase of the leading interest rate, they hope to moderate the inflation expectations of the economic agents, strengthen the commitment of the Central Bank as to the stability in the general level of prices and consolidate the credibility of the monetary policy. It is pertinent to mention that the increases in the leading interest rate also propitiate that these be less negative in real terms, which will begin to gradually elevate the efficiency in the transmission of the monetary policy.

#### *Leading interest rate of the monetary policy*





Above is a graph that illustrates the behavior of the leading interest rate of the monetary policy in the last few years.

As to the interest rates of the MSO in the bidding mechanism they were determined by the market conditions, reflected in the bids received. The Execution Committee of the *Banco de Guatemala* continued applying the maximum limits (quotas) for each one of those years until last year, which were fixed taking into account the information that provides the estimated monetization flow and the established regulation for said effect, which, at the same time, is founded in a term structure with its recent historic behavior and in an environment that will gradually propitiate the balance reduction of the MSO in the very short term (7 days).

The Execution Committee, taking into account the agreed in matters of coordination with the fiscal policy for the participation in the money market, agreed that, as of January, the *Banco de Guatemala* will convene bidding on Mondays for 91, 182 and 364 day terms, with pre-established quotas; while on Tuesdays and Thursdays for 1092 (3 year), 1820 (5 year) and 2548 (7 year) day terms without pre-established quotas. Also, said licensed body determined that the biddings on Mondays will be made alternately for the 91 and 182 day terms; in other words, 91 and 364 day terms one week and 182 and 364 day terms the following week.

Later, due to the participation of the *Ministerio de Finanzas Públicas* [Equivalent to the US Department of the Treasury] in the money market in the long term, the Execution Committee decided that the *Banco de Guatemala* should, as of February 5, suspend the biddings for Term Deposits longer than a year (3, 5 and 7 years).

Taking into account that there is still an excess of liquidity prevalent of a structural nature that could be sterilized, the Execution Committee deemed it convenient that the *Banco de Guatemala* make new operations of said nature through the longer than one year term deposits. In that sense, said Committee, agreed that as of September 13 they will convene bidding for Term Deposits for 3 and 5 years and, on the other hand, that as of November 9 will convene bidding for Term Deposits to 8 years. Said convening will be made weekly,



adopting the modality applied for the beginning of 2007 and that is also used by the *Ministerio de Finanzas Públicas* [Equivalent to the US Department of the Treasury]; in other words, per term, without pre-established quotas and that the interest rates be determined by the market conditions.

In the following table are the weighted average monthly interest rates for the terms convened.

WEIGHTED AVERAGE INTEREST RATES OF OPERATIONS  
OF MONETARY STABILIZATION IN BIDDING  
FROM JANUARY TO NOVEMBER 2007  
- In Percentages -

TERM IN DAYS	JANUARY	FEBRUARY	MARC	APRIL	MAY	JUNE	JULY	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER
91	-	5.25	5.25	-	-	-	5.77	5.77	-	-	-
182	5.50	-	5.50	-	-	-	6.05	6.05	-	-	-
364	6.20	6.20	6.20	6.38	6.56	6.65	6.65	6.65	6.65	6.65	-
1,092	6.80	-	-	-	-	-	-	-	7.00	7.00	7.01
2,548	8.00	-	-	-	-	-	-	-	-	-	-
2,912	-	-	-	-	-	-	-	-	-	-	8.10

The *Banco de Guatemala* no longer convened the bidding for 91, 182 and 364 day terms, as of October 5, due to the decision of the Execution Committee of receiving Term Deposits for maturity dates, instead of making them per terms, according to the decisions made by the Monetary Board.

## ii. Per due date

The Monetary Board, in resolution JM-154-2007 dated September 5, 2007, approved the Regulation for Term Deposit Reception in national currency, to be constituted in the *Banco de Guatemala*, which came into effect on October 8, 2007. Said regulation establishes, among other decisions, that the *Banco de Guatemala* could receive Term Deposits according to the date they are due. Attending said decision, the Execution Committee agreed that as of the date of the enforcing of the referred legal instrument, the biddings in term deposits will be made according to maturity date, through commodities exchanges, on Mondays each week and for the effect established fund-raising quotas based on the estimated value of the liquidity amounts to neutralize, which are determined based on the programmed maturity dates of term deposits placed in bidding and in the excess liquidity added estimated according to the monetary program for the corresponding quarter. In that sense, the bids are awarded according to



price and standardized nominal values, for the raised term deposits through biddings, for Q100.0 thousand, Q1.0 million and of Q10.0 million.

The Execution Committee received term deposits per due dates, with the purpose of reducing the fragmenting of the market of public financial instruments, of promoting development and strengthening the secondary market of said instruments and of propitiating the formation of a term deposit yield curve, aspects relevant to advancing in an operational framework of monetary stabilization operations, congruent with a scheme of explicit inflation targets that allows improving the monetary policy transmission.

The following due dates were established: December 10, 2007; March 10, 2007; June 9, 2008; September 8, 2008. Said dates were determined according to the monetary spaces that the monetary program indicates.

On the other hand, regarding the direct term deposits biddings with public entities, the Execution Committee established to convene biddings weekly, on the day of greater concentration of deposit maturities constituted by said entities, per due dates, without pre-established quotas, without standardized nominal values and per price. The awarding prices will be determined according to the market conditions, reflected in the bids received, considering the reference prices established by the technical departments.

In the following table are the average yields in bidding, calculated based on awarding prices, for the established maturity dates.

### AVERAGE MONETARY STABLIZATION YIELDS IN BIDDING

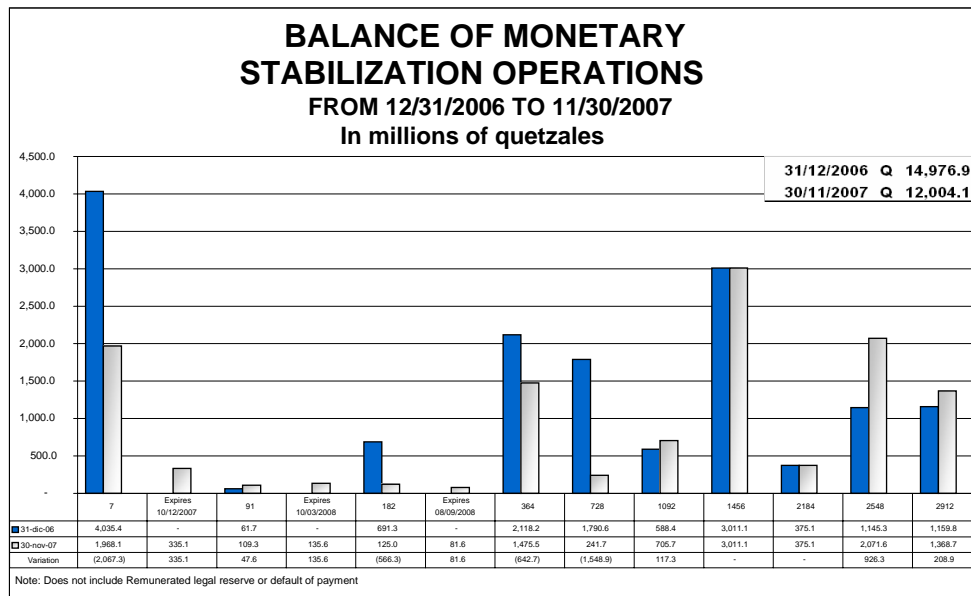
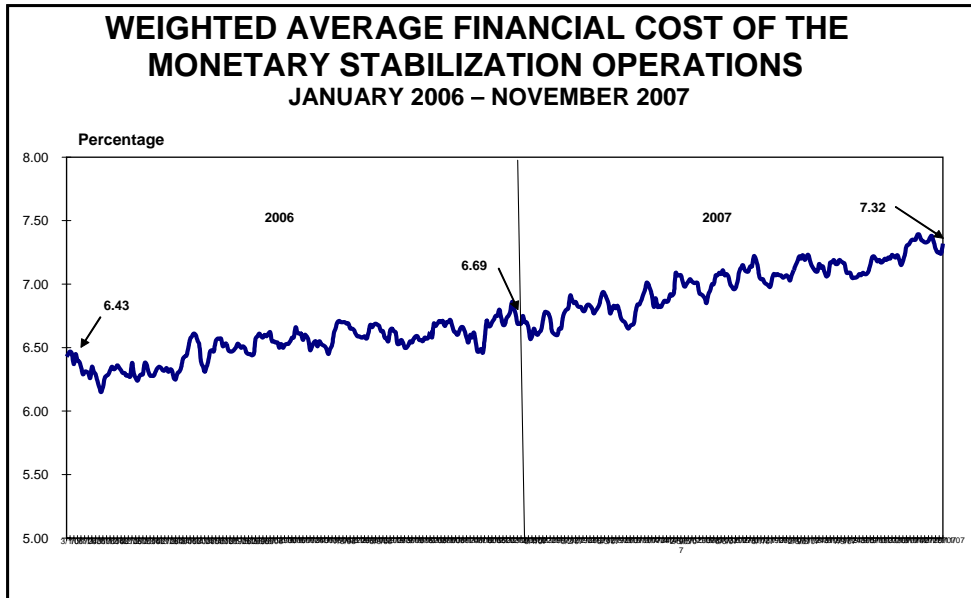
From October to November 2007  
- In percentages -

MATURITY DATES	OCTUBRE		NOVIEMBRE	
	Through the Stock Exchanges	Directly	Through the Stock Exchanges	Directly
12/10/2007	-	5.94	-	6.12
03/10/2008	6.35	6.33	-	-
06/09/2008	-	-	-	-
09/08/2008	6.65	6.61	6.71	6.84

The average weighted financial cost of the balance of the MSO during the December 31, 2006 to November 30, 2007 period showed a tendency to rise, when going from 6.69% to 7.32%, due to the placement of MSO in 1092



day (3 year), 2548 day (7 year) and of 2912 day (8 year) terms; as well as the decrease in the short term balance. In the following graphs we show the behavior of the weighted average financial cost from January 2006 to November 30, 2007 and, on the other hand, compare the MSO between December 31, 2006 and November 30, 2007.

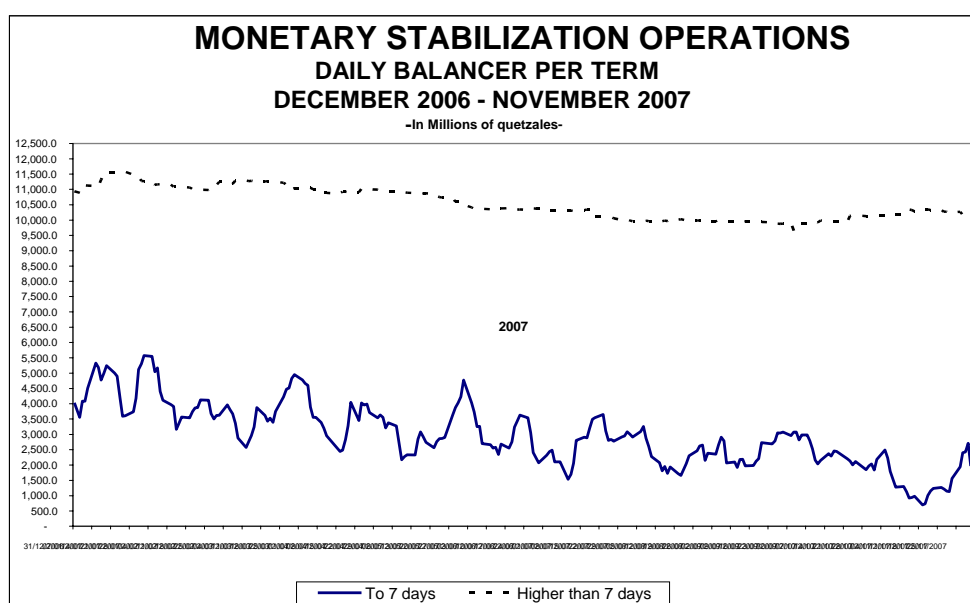


When analyzing the balance of MSO per fund-raising term, these can be divided in 7 day operations (associated to the leading interest rate of the



monetary policy) and in greater term operations. As we can observe in the following graph, during the analyzed period said operations are mainly concentrated in terms greater than 7 days, reaching a minimum balance of Q9,646.5 million to September 25, 2007 and a maximum of Q11,576.2 million to January 19, 2007.

As to the 7 day operations, these registered a maximum balance of Q5,577.9 million to January 26, 2007 and a minimum of Q700.5 million to November 12, 2007. The total balance of MSO registered to November 30, 2007 reached Q12,004.1 million, of which Q1,968.1 million (16.4%) correspond to 7 day terms.



On the other hand, in the framework for the monetary stabilization operations, contained in the Monetary, Foreign Exchange Rate and Credit Policy for 2007, they established that the *Banco de Guatemala* could participate in the Electronic Money Banking Table -MEBD- or in the commodities exchanges, injecting or withdrawing liquidity.

In that context, the Execution Committee agreed to keep the supply bids for 7 day term liquidity, receiving only public titles for said operations as a guarantee.



The Execution Committee also agreed that as of January 22, 2007, it was necessary to count on preventive measures to provide liquidity to the banking system. In that sense, they considered that it was proceeding to widen the terms for the liquidity giving operations temporarily until March 31, 2007, for which they decided that the *Banco de Guatemala* make said operations for the 7, 14 and 28 day interest rates for 6.50%, 6.60% and 6.75%, respectively. The guarantee of said operations would be constituted by only receiving public titles, expressed in quetzales or US dollars.

In the described context, it is worth mentioning that the choice of interest rates indicated was founded in that the gap between the liable and asset interest rate, on the one hand, converge to a level that does not allow arbitrage and, on the other hand, that it is not too high that it takes away incentive to the access of Central Bank resources.

The Execution Committee agreed, on March 30, 2007, to extend the liquidity giving operations for 7, 14 and 28 day terms till May 31, 2007, in order that, if necessary, the banking institutions could access a mechanism that will allow providing liquidity coming from the Central Bank. For the determination of the interest rates to apply, the Committee agreed that the *Banco de Guatemala* make the liquidity giving operations an interest rate that keep the current margin on the leading interest rate of the monetary policy; in other words, of 1.50 percentage points for the 7 day term; of 1.60 percentage points for the 14 day term; and of 1.75 percentage points for the 28 day term. The Execution Committee also decided to continue accepting said operations for public titles in quetzales or US dollars as a guarantee.

On May 25, 2007, the Execution Committee agreed that as of June 1 said liquidity giving operations will be made only for the 7 day term and that the interest rate to apply will keep the margin of 1.50 percentage points regarding the leading interest rate of the monetary policy. Due to the last increase decided by the Monetary Board to the leading interest rate of the Monetary Policy, as of November 29 the liquidity giving rate for 7 days is at 7.75%.

From January to November 2007 they held liquidity giving operations in the following terms: for the 7 day term, Q1,163.8 million (Q36.4 million in net



terms); for the 14 day term Q38.1 million (Q0.0 million in net terms); and, for the 28 day term, Q261.4 million (Q0.0 million in net terms). The balance for said operations to November 30 was of Q36.4 million.

### **b) In foreign currency**

The Execution Committee, taking into account that during the January to November 2007 period there was no evidence of exchange pressures nor did they anticipate significant maturities of Treasury Bonds expressed in US dollars negotiated with residents, they estimated it unnecessary to convene a long-term bidding in the mentioned currency.

The Execution Committee agreed to continue accepting the constitution of term deposits to public entities in US dollars directly at the window in 91, 182 and 364 day terms and that for the interest rate they apply and take as a reference the interest rate of the US Treasury Letters in similar terms.

The Execution Committee agreed that the *Banco de Guatemala*, as of March 26, continue accepting the constitution of term deposits in US dollars directly at the window from public institutions at the terms they deem convenient. For the effect they established that the interest rate to apply will be determined by a commission in which the Presidency, the Management and the Department of Monetary Stabilization Operations, from the *Banco de Guatemala* will participate, for which it can take as a reference the leading interest rate of the US Treasury Letters in similar terms or the investment yield rate of the international monetary reserves.

It is worth mentioning that as of November 30, 2007, the balance of MSO in US dollars was of US\$46.7 million.

## **2. Parameter Interest Rate**

The parameter interest rate is an indicator based on the “Taylor Rule”<sup>32</sup> and incorporates adjustments on the base rate (or neutral) in inflation differentials, of aggregate demand and of the nominal exchange rate; its result

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<sup>32</sup> Indicator used by many central banks to orient the participation decisions in the monetary market, since the same reflect the adjustments in the interest rate due to inflation and by excess demand that result compatible with the fundamental objective of the monetary policy. In the case of Guatemala it has been considered convenient to add an adjustment for exchange movements, reason for which it has been called the parameter rate.

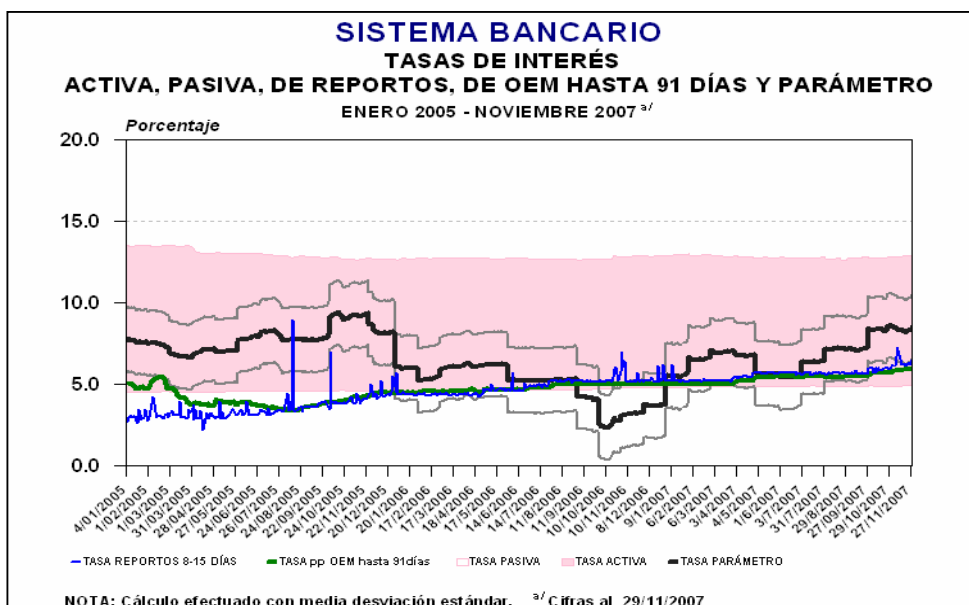


indicates the interest rate levels that should prevail in the market to be compatible with the existing inflation level. The Monetary, Foreign Exchange Rate and Credit Policy for 2007 establishes that the parameter interest rate will be compared to the weighted average interest rate of the repurchase agreements operations of between 8 and 15 days, as well as the weighted average interest rate of the monetary stabilization operations for up to 91 day terms.

To November 29, 2007, the parameter interest rate is located at 8.52% and its upper and lower limits (calculated with a standard median deviation) in 10.50% and 6.55%, respectively. The repurchase agreements interest rate for the 8 and 15 day terms, as well as the interest rate for the monetary stabilization operations for the 91 day terms remained below the tolerance margins of the parameter rates. To November 30 said rates were at 6.50% and 6.02% respectively; which indicates that the monetary policy to the referred date must be restrictive.

### Banking System

Asset, Liable, Repurchase agreement, of MSO to 91 days and Parameter Interest Rates



### 3. Parity liable interest rate

The external competitiveness of the internal liable interest rate in national currency can be evaluated if it is compared with the parity liable interest rate.



This last one is defined as the sum of three elements: i) comparable international interest rates; ii) a risk exchange premium; and, iii) a country risk premium.

For effects of measurement, in the present analysis the interest rate for deposits for 6 month terms in the United States of America, as a comparable external liable interest rate with the internal liable interest rate in national currency (weighted average interest rate of the national banking system for term deposits). Also, to estimate the exchange risk Premium, the difference between the average nominal exchange rate (purchase and sale) observed in the Foreign Currency Institutional Market and the average nominal exchange rate (purchase and sale) of bids in the Guatemalan Futures Market is used. At the same time, to estimate the country premium risk, the difference between the return rates of the Treasury Bonds of the Republic of Guatemala placed in the international financial market<sup>33</sup> and the return rate of the US Treasury Bonds for a 10 year term is calculated.

During the January to October 2007 period a weighted average interest rate of term deposits (internal liable rate), was observed, with the exception of August and the first half of September, was higher to the parity liable interest rate. In effect, to November 29, the weighted average term deposit interest rate was at 7.28%; whereas, that the parity liable interest rate was of 7.13%. Without taking into account the transaction costs, said situation would advise the economic agents that to November 2007 it would be more favorable to save internally.

As to the monetary policy orientation that offers the mentioned variable, it was observed that when comparing the interest rate for term deposits with tolerance margins for the parity liable interest rate<sup>34</sup>, this was at, within said margin, during the four periods: the first, from January to the middle of May 2007; the second, from the last week of July to August 2007; the third, from the

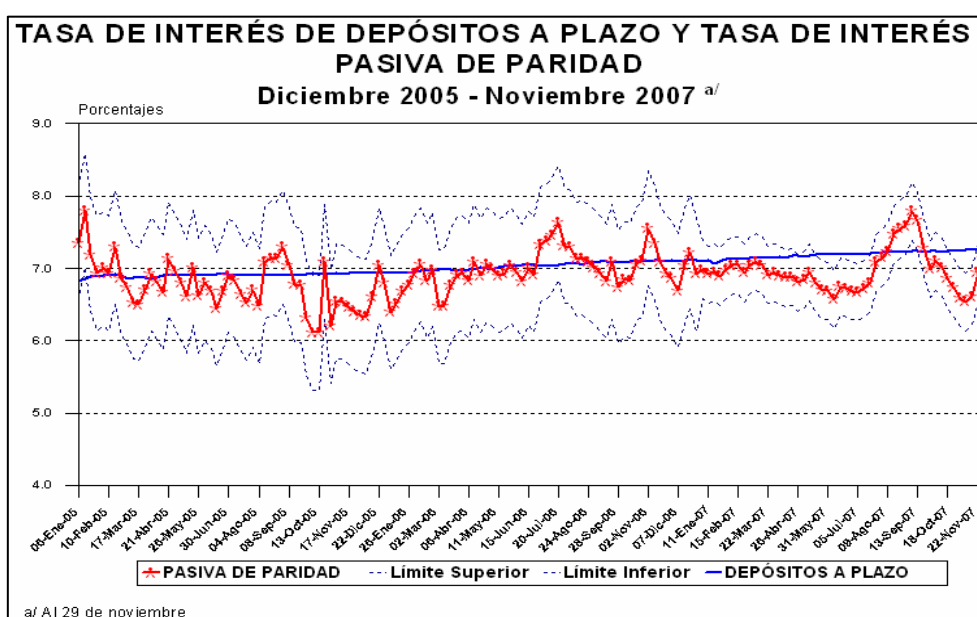
<sup>33</sup> To August 2, 2007 they used the weighted average yield rate of issues for 1997, 2001 and 2003. As of August 3, 2007, said weighting only included issues for 2001 and 2003, due to the fact that the 1997 issue is amortized in its totality on the referred date.

<sup>34</sup> The Monetary Board in resolution JM-168-2006 dated December 28, 2006, decided that the parity liable rate be included in a tolerance margin of +/- the standard median deviation.



third week of September to the first half of October 2007; and the fourth, in the last two weeks of November, suggesting an invariable monetary policy orientation. It is worth mentioning that as of the third week of May to the third week of July and from the last week of October to the second week of November, the referred variable was over the upper limit of the tolerance margin, which advises relaxing the monetary conditions. However, during the first half of September, said variable was below the lower fluctuation margin, which suggests restricting the monetary policy.

#### Term Deposit and Liable Parity Interest Rates



#### 4. Weighted Average Asset and Liable Interest Rates for the Banking System <sup>35</sup>

##### a) In national currency

From January to November 2007, the weighted average interest rates continue to be stable and have a slight tendency to decline in the case of the asset rate and toward the rise in the case of the liable rate. In effect, the asset interest rate, weighted average, to November 29 was at 12.89%, lower by 0.01 percentage points regarding the observed at the end of December 2006

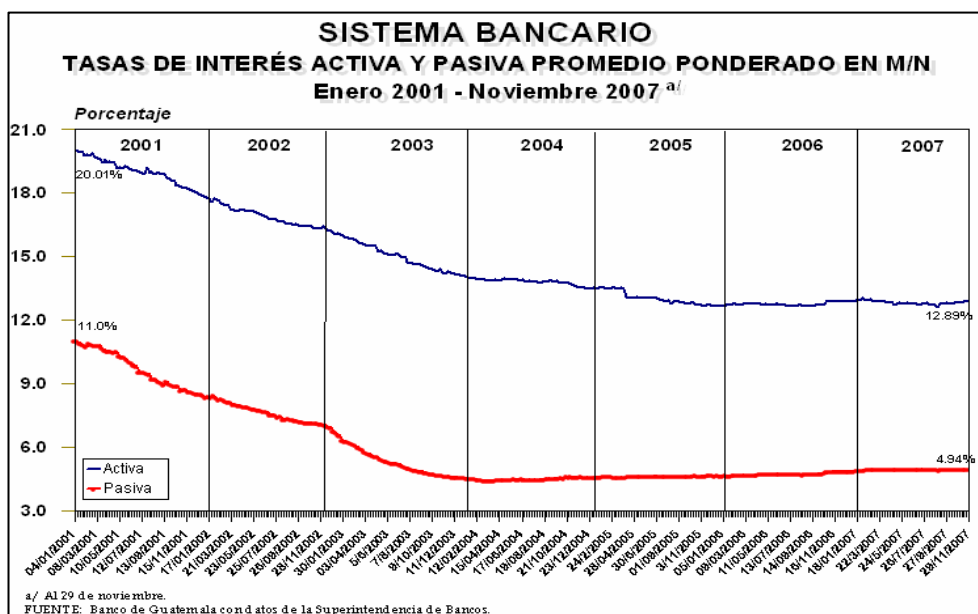
<sup>35</sup> Corresponds to the methodology used by the *Banco de Guatemala*, which differs regarding the used by the Superintendencia of Banks. In effect, in the calculation of the weighted average asset interest rate, the *Banco de Guatemala* does not include data corresponding to the heading of financing with credit cards, while the Superintendencia of Banks does not incorporate the data corresponding to loans with zero interest rates. In the calculation of the weighted average liable interest rates, the *Banco de Guatemala* does not include the data corresponding to the deposits at sight.



(12.88%)<sup>36</sup>; while the weighted average liable rate was at 4.94%, higher by 0.10 percentage points to the registered on December 31, 2006 (4.84%)<sup>37</sup>.

*Banking System*

*Weighted Average Asset and Liabe Interest Rates in M/N*



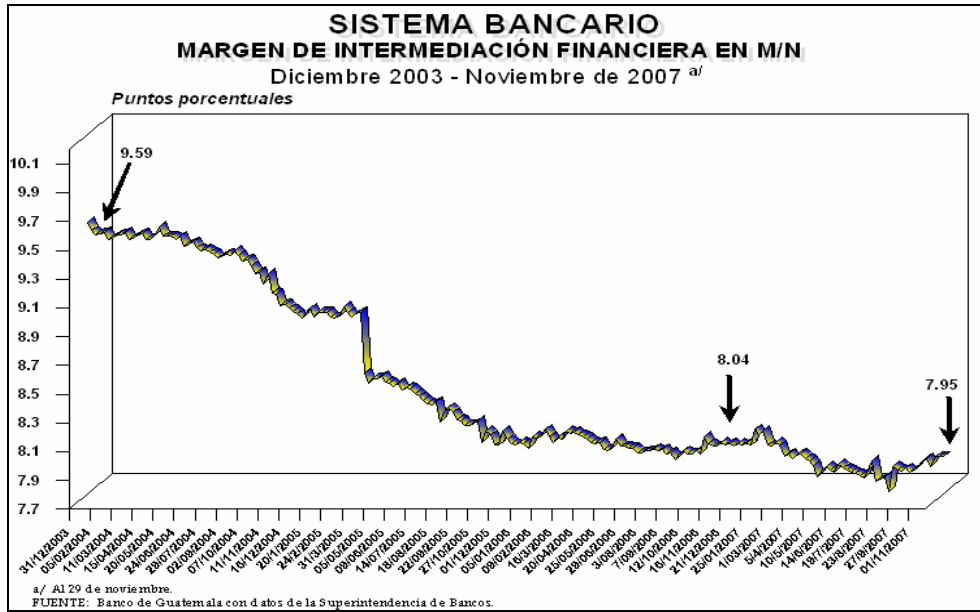
Due to the tendency that the weighted average asset and liable interest rate have, the financial intermediation margin was at 7.95 percentage points, lower by 0.09 percentage points to the observed at the end of December 2006 (8.04 percentage points).

<sup>36</sup> When evaluating the behavior of the asset interest rate in national currency per group of banks, we observe that the relative to the group of large banks to December 31, 2006 registered a level of 11.79%, while to November 29, 2007 was of 11.92%. As to the asset interest rate of the group of medium banks, this to December 31, 2006 was of 13.23%, whereas to November 29, 2007 was at 12.62%. In the case of small banks, the asset interest rate registered to December 31, 2006 was at 15.80%, while to November 29 it was at 21.48%.

<sup>37</sup> When evaluating the behavior of the liable interest rate in national currency per group of banks, we observe that in the group of large banks to December 31, 2006 it registered a level of 4.63%, while to November 29, 2007 was at 4.66%. As to the liable interest rate of medium banks, to December 31, 2006 it was 4.76%, whereas to November 29, 2007 it was at 5.16%. In the case of small banks, the asset interest rate registered to December 31, 2006 was of 6.00%, while to November 29 it was at 6.50%.



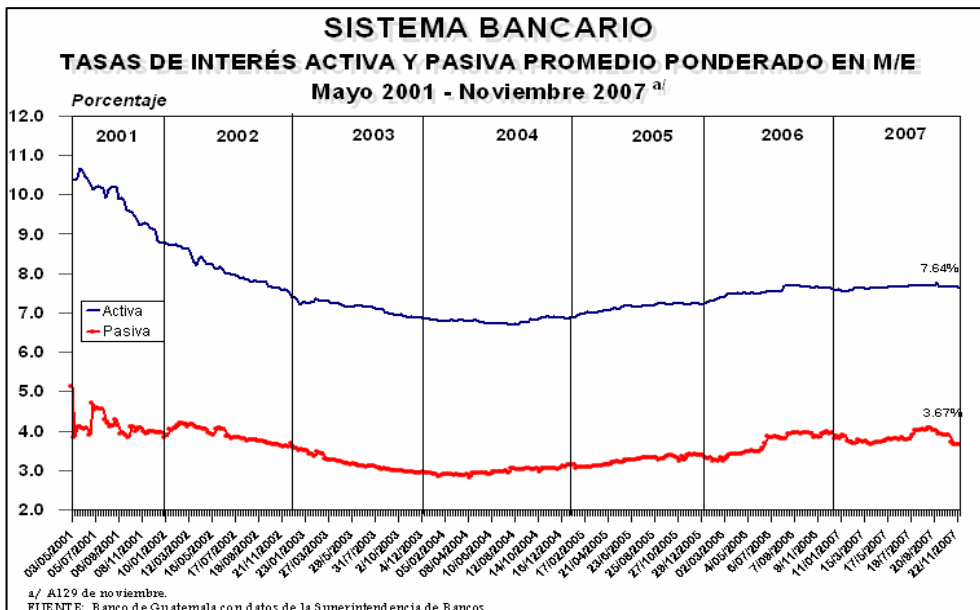
Banking System: Financial Intermediation Margin in M/N



b) In foreign currency

The weighted average asset liability interest rates during the January-November 2007 exhibited stable behavior. In effect, the asset interest rate, on November 29 was at 7.64%, higher by 0.07 percentage points to the observed on December 31, 2006 (7.57%). As to liable interest rates, they showed a decrease when going from 3.81% in December 2006 to 3.67% on November 29, 2007.

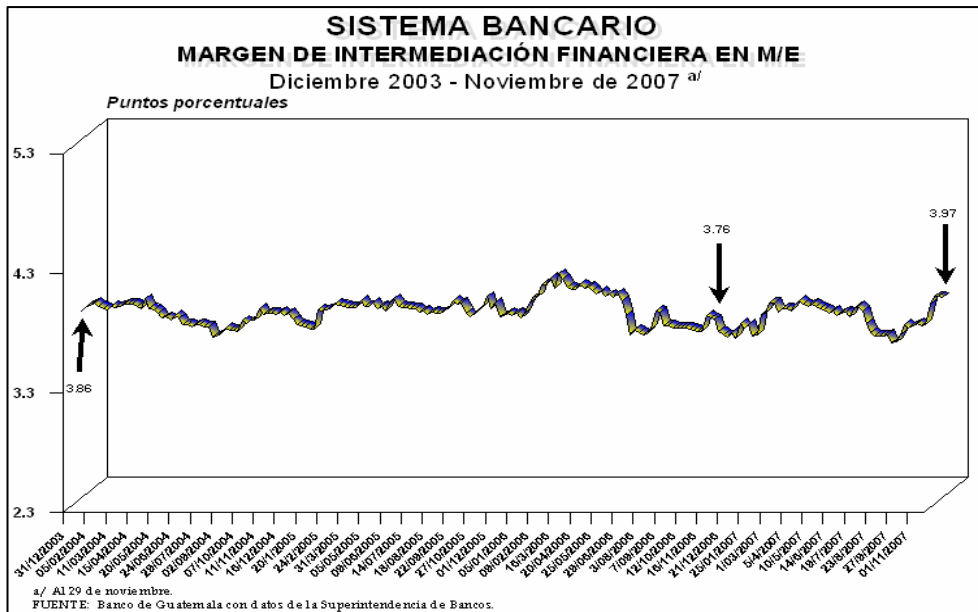
Banking System: Weighted Average Asset and Liabe Interest Rate in M/E





As a result of the behavior of the weighted average asset and liable interest rates, the financial intermediation margin increased 0.21 percentage points, when going from 3.76 percentage points in December 2006 to 3.97 percentage points on November 29, 2007.

*Banking System: Financial Intermediation Margin in M/E*



### C. STATEMENT ANALYSIS OF THE ACCOUNTS OF THE *BANCO DE GUATEMALA*

In the Monetary, Foreign Exchange Rate and Credit Policy for 2007, among other aspects, they determined the quarterly monetary program that contains the estimated behavior of the main accounts of the balance of the Central Bank. In said program, it was estimated that the demand of monetary issue would grow around 11.2% regarding the level observed at the end of 2006; however, due to the fact that in the first quarter there were events that were not contemplated in the original approved monetary program, making it necessary to review it.

The revision of the monetary program was heard by the Monetary Board during the Monetary Policy report to March 2007 and therefore derived adjustments on the change in the fiscal projections for 2007 provided by the *Ministerio de Finanzas Públicas* [Equivalent to the US Department of the



Treasury] and, on the other hand, of the need to again estimate the position of the banks in the system with the *Banco de Guatemala*, as a result of the exchange observed in the banking liquidity behavior, after the events that occurred with a lack of numerary experimented by the national economy and by the uncertainty it generated in the banking system before the operations suspension of a bank system in 2007.

Following is a revised monetary program that incorporates the observed information to the third quarter of 2007.

MONETARY PROGRAM OF THE BANCO DE GUATEMALA 2007  
FLOWS FROM DECEMBER 31, 2006 TO SEPTEMBER 30, 2007  
- Millions of quetzales -

CONCEPT	ACCUMULATED		
	PROGRAMMED	OBSERVED	DEVIATION
I. NET INTERNATIONAL MONETARY RESERVES	2190	1708	-482
US\$	274	214	-60
II. NET INTERNAL ASSETS	-2123	-1641	482
1. Position with the Consolidated Public Sector	1179	-2449	-3628
1.1. Central Government	1744	-2304	-4047
1.2. Rest of the public sector	-564	-145	419
2. Position with banks and financial companies	887	1151	264
2.1. Credit to banks and financial companies	-1	-2	-2
2.2. Remunerated and non-remunerated banking legal reserve	888	1154	266
3. Other net assets	207	59	-148
3.1. Expenses and products [(-) = Products]	21	-155	-175
3.2. Non-classified net assets	187	214	27
4. Monetary Stabilization Operations	419	1596	1176
5. EXCESS (-) ÓR LACKING (+) LIQUIDITY	-4816	-1998	2818
III. MONETARY ISSUE DEMAND	67	67	0
Note: MSO totals	-4330	1958	6288

The behaviors of each one of the factors that influence the supply of monetary issue are commented in the following.

### 1. External Monetization

In the monetary program, it was forecast that to September 30, 2007 the level of NIMR would increase by Q2,190.0 million (US\$274.0 million); however, at the end of said month said reserves exhibited an increase of Q1,708.0 million (US\$214.0 million) regarding the observed level at the end of the previous year, amount lower by Q482.0 million (US\$60.0 million) to the programmed. Said result is mainly associated to the fact that there were no



placements for Treasury Bonds expressed in US dollars for US\$150.0 million, which had been forecast, according to the monetary program; notwithstanding, this result was partially counteracted by a greater income of foreign currency for the IMR yields, regarding the programmed, by around US\$75.0 million.

## **2. Net Internal Assets -NIA-**

### **a) Position with the public sector**

From January to September of this year the Central Government increased its deposits in the *Banco de Guatemala* by Q2,304.0 million, amount higher by Q4,047.0 million regarding the forecast in the monetary program for said period, which is mainly explained by the lesser use of the deposits from the Central Government, associated to greater income and to less execution of public expense regarding the programmed.

As to the position of the rest of the public sector, it registered a demonetization for Q145.0 million, lower by Q419.0 million, regarding the programmed. This result is fundamentally explained by the lower amount of investments in CDP, regarding the programmed for Q428.0 million.

### **b) Position with banks and financial companies**

According to the monetary program, to September 30 the banks in the system registered a monetizing flow for Q887.0 million, derived of the decrease of the balance of legal reserve accounts in the *Banco de Guatemala*, due to the lesser dynamism of bank fund-raising. However, the observed behavior regarding the banking legal reserve up to the third quarter was monetizing by Q1,154.0 million, which represented a deviation of Q266.0 million regarding the programmed. It is worth indicating that said behavior can be associated to two fundamental factors: the first, regarding the temporary measures of flexibilization of the legal banking reserve, adopted by the Monetary Board in resolutions JM-20-2007, JM-75-2007 and JM-111-2007 (current to the months of March, May and July of 2007, in that order), which allows the banking entities, for the computable legal reserve effects, to increase the participation percentage of cash funds kept in their tills and include Term Certificates of Deposit issued by the Central Bank, Treasury Bonds of the Republic of



Guatemala, mortgages guaranteed by the FHA and/or mortgages guaranteed by guarantors. The second factor is related to the decrease of deposits of the banking system in the Central Bank, which, at the same time, is linked to less dynamism, observed in the banking fund-raising to date in the year.

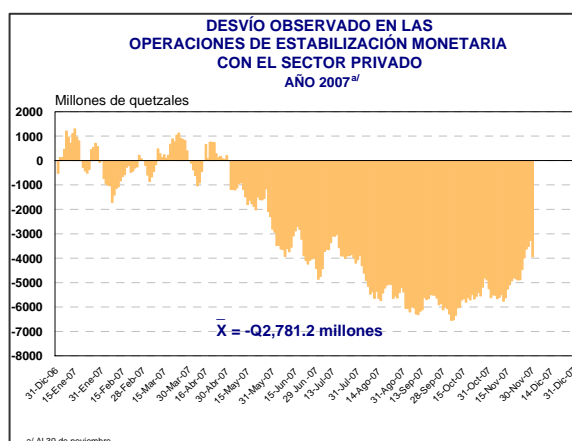
### c) Expenses and products

The net result of expenses and products of the *Banco de Guatemala* to end the third quarter was demonetizing by Q155.0 million, which meant a deviation of Q175.0 million regarding the programmed. Said deviation is mainly due to the fact that the increases from yield of IMR investments were higher to the payment of interests from MSO.

### d) Monetary Stabilization Operations

The monetary program had forecast that to September 30, 2007 they would make MSO for Q4,330.0 million to neutralize the excess of primary liquidity in the economy. At the end of said month, the total MSO balance registered a decrease of Q1,958.0 million regarding the level observed to December 31, 2006, which generated a deviation in said variable for Q6,288.0 million. Said deviation is mainly explained by less MSO in national currency with the private sector and with banks in the system for Q5,993.0 million.

It is worth stating that in the course of the year, the increase of deposits by the Central Government in the *Banco de Guatemala* over the programmed has partially compensated the decrease in monetary stabilization operations regarding the programmed, as is illustrated in the following.





### e) Estimation of monetary program closing 2007

The Monetary, Foreign Exchange Rate and Credit Policy for 2007 contemplated that the monetary issue demand increase by 11.2% regarding the observed level at the end of 2006, compatible with an economic activity growth rate of 5.1% and with an inflation target of 5.0% +/- 1 percentage point; however, due to the new growth estimation made for the GDP of 5.7% for 2007, it was necessary to revise the estimation of the monetary issue demand for the end of that year. In that context, the new estimation of the monetary issue demand forecasts an inter-annual increase of said variable for around 11.8%, which is congruent with the behavior of the monetary variables to November, with the estimation of the performance of the real and external sectors, as well as the closing estimation of the fiscal variables.

Following is a presentation of the estimation of monetary program for the last quarter of 2007 and year closing, considering that the first three quarters correspond to the observed numbers.

MONETARY PROGRAM 2007  
FLOW IN MILLIONS OF QUETZALES

CONCEPT	QUARTERS OF 2007				Total 2007
	I	II	III	IV	
<b>I. NET INTERNATIONAL MONETARY RESERVES</b>	1507	1918	-1717	92	1800
US\$	188	240	-215	12	225
<b>II. NET INTERNAL ASSETS</b>	-1624	-1637	1680	1643	63
<b>1. Position with the Consolidated Public Sector</b>	-1838	-3050	2438	1466	-983
1.1. Central Government	-1249	-3475	2420	1629	-674
1.2. Rest of the public sector	-589	426	19	-164	-309
<b>2. Position with banks and financial companies</b>	1740	-852	263	-1479	-328
2.1. Credit to banks and financial companies	0	-2	0	0	-2
2.2. Remunerated and non-remunerated Legal Reserve	1741	-850	263	-1479	-326
<b>3. Other net assets</b>	400	10	-350	-8	52
3.1. Expenses and products [(-) = Net Products]	5	-17	-142	-49	-204
3.2. Non-classified Net Assets	395	27	-208	41	256
<b>4. Monetary Stabilization Operations</b>	394	1638	-437	1145	2741
<b>5. Excess (-) or lacking (+) liquidity</b>	-2320	617	-234	519	-1418
<b>III. DEMAND OF MONETARY ISSUE</b>	-116	281	-36	1735	1863



As we can see in the above graph, it would be expected that in the fourth quarter the net international monetary reserves show an increase of US\$12.0 million, mainly derived of the products from the investment of the IMR. Taking into account the information available to November, it is estimated that at the end of the year the NIMR show an increase of around US\$225.0 million, amount that will allow continuing consolidating the position of the external sector of the country.

Consistent with the behavior of the NIMR and of the monetary issue demand, in the fourth quarter of the NIA of the *Banco de Guatemala* will monetize by Q1,643.0 million, while at the closing of 2007 would expect to monetize by Q63.0 million.

Considering the balance of deposits from the Central Government in the *Banco de Guatemala* to November 2007, as well as the closing of public finances, would estimate that in the fourth quarter the Central Government will decrease its deposits in the *Banco de Guatemala* by Q1,629.0 million. Of that account, at the end of 2007 the demonetization generated by the Central Government would be of Q674.0 million. It would be expected that in the fourth quarter the rest of the public entities increase their deposits and investments in CDP by Q164.0 million, so at the end of the year it is estimated that said entities demonetize by around Q309.0 million, so that the demonetization generated by the non-financial public sector would consolidate for Q983.0 million.

As to the position of banks and financial companies, it would be expected that at the end of the fourth quarter said entities increase their deposits in the central bank by Q1,479.0 million, fundamentally because of the increase expected from banking fund-raising during the last quarter. Due to the above, it is estimated that at the end of 2007 said position generate a demonetization for Q328.0 million.

Taking into consideration the estimations of expense derived from the monetary stabilization operations, as well as the products derived from the investment in IMR, during the fourth quarter the net cost of the monetary, exchange rate and credit policy would register a surplus for Q49.0 million, so to



end the year it would be expected that for the first time since 1984, net products for around Q204.0 million will be observed.

In the fourth quarter of 2007, consistent with the monetary issue demand for Q1,735.0 million and with an external origin monetization for the equivalent to Q92.0 million, the headings that makes up the NIA of the *Banco de Guatemala*, would be monetizing by Q1,643.0 million.

#### **D. PRIMARY LIQUIDITY**

The Monetary Board in resolution JM-64-2006 decided, among other aspects, to complement the follow up of the primary liquidity, that is made through the monetary issue, with an indicator that incorporates the behavior of the legal banking reserve and of the MSO that are incidental in the banking liquidity, named the Broad monetary base.

Following is the behavior of each one of the components of primary liquidity to November 29, 2007.

##### **1. Monetary Issue**

According to the monetary program approved by the Monetary Board for 2007, it is estimated that the demand of monetary issue would grow, in inter-annual terms, by around 11.2%<sup>38</sup>, compatible increase with an expected rate of economic activity growth of 5.1% with an inflation target of (5% +/- 1 percentage point).

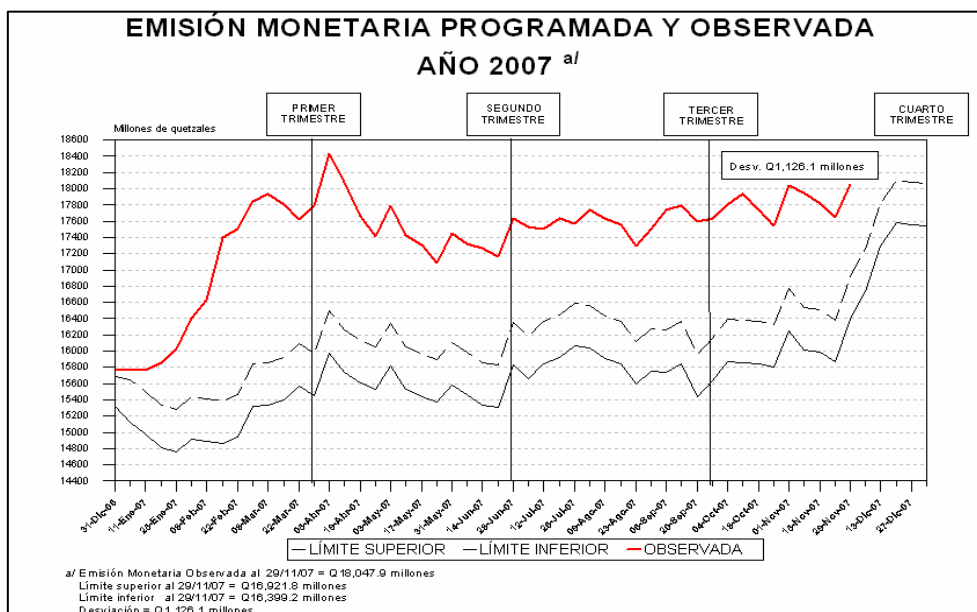
One of the characteristics of the monetary issue demand is that its seasonality and tendency allow reasonable prediction, which facilitates programming its behavior according to a runner that incorporates possible transitory fluctuations of liquidity.

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<sup>38</sup> It is important to highlight that according to the estimation of the closing of the monetary program for 2007, it is forecast that the monetary issue register an inter-annual increase of around 11.8%, congruent with the new growth estimation of the GDP of 5.7% for 2007.



### Programmed and Observed Monetary Issue



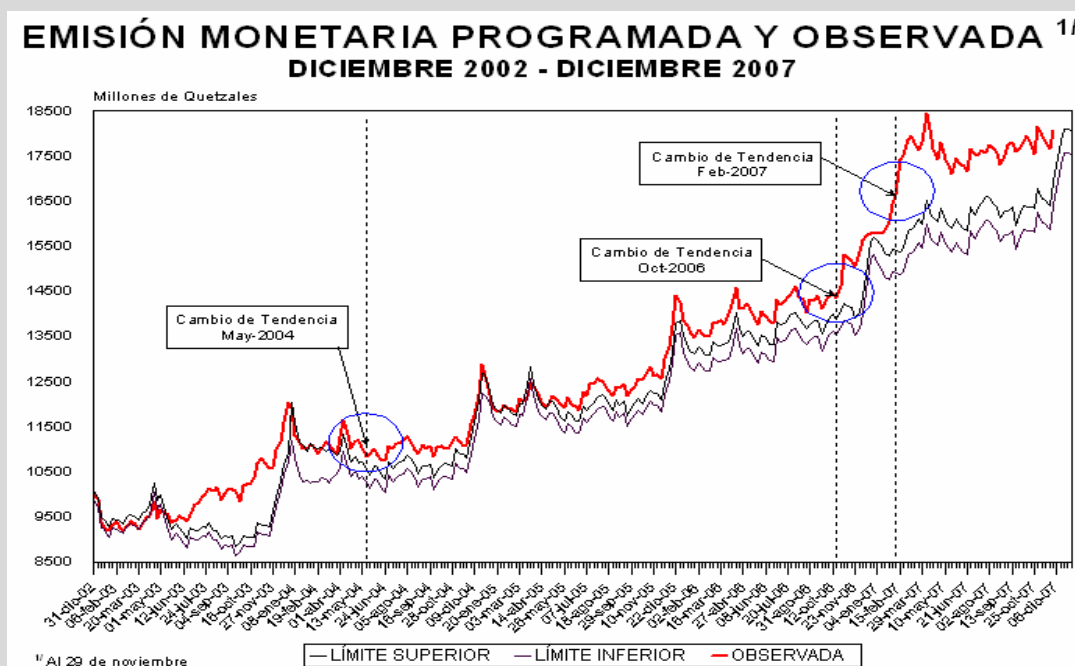
To November 29, 2007, the trajectory of monetary issue remained over the upper limit of the programmed runner, to that date, registering a deviation of Q1,126.1 million<sup>39</sup>. Said excess of issue is explained mainly because in the mentioned period the balance of MSO was less by approximately Q2,053.0 million regarding the forecast in the current monetary program, on behalf of supply.

<sup>39</sup> It is forecast that at the end of 2007, the deviation of monetary issue regarding the upper limit of the programmed runner, rises to Q1,200.0 million. According to the analysis of the technical departments, as to the referred deviation around Q500.0 million would not generate inflationary pressure, so the remainder of Q700.0 million must be neutralized in 2008, value that incorporates in the programmed runner for said year.



## INSERT 6 ANALYSIS OF THE MONETARY ISSUE BEHAVIOR

During the last years it has been observed that the monetary issue has registered values for over its programmed level, so the monetary authorities requested the make up of an analysis that allows identifying the factors that have provided one of the greater demands of monetary issue, as well as the impact of excess primary liquidity on the general level of prices. For said effect, the technical departments of the *Banco de Guatemala* held an econometric analysis for the 2002-2007 period, through which they were able to determine that the monetary issue has experimented three significant changes toward a rise in its tendency behavior, particularly in May 2004, in October 2006 and in February 2007, as is illustrated in the following graph.



The first structural change, registered in May 2004, is associated to the transaction, as a result of the increase of the economic activity that began during this year. In effect, the inter-annual variation of the cycle tendency of the Economic Activity Monthly Index –*IMAE* [For its acronym in Spanish] registered its highest level in May 2004 (3.92%).

As to econometric analysis, it identified that the second structural change of the monetary issue was registered in October 2006, due to two extraordinary events that were registered during the fourth quarter of said year. The first refers to the suspension of operations for the *Banco del Café, S.A.*, and the second is associated to the unfounded rumors about the liquidity problems in a bank within the system. Said events, associated to precaution, caused the monetary issue demand to increase significantly on the indicated date.

The last structural change of the monetary issue was in February 2007, after the scarcity of numerary registered at the end of 2006 and to the suspension of operations of the *Banco de Comercio, S.A.* in January 2007. It is worth stating that when the referred scarcity was corrected, in February of said year, a considerable amount of monetary issue demand was observed.

Another factor that has influenced in the increase of monetary issue is the increase in the cash average that supplies ATMs, which is part of the banks' till.



Additionally, through an econometric estimation, they were able to determine that the mentioned structural changes of monetary issue influenced the behavior of the Consumer Price Index. In effect, in the period understood between 2001 and 2005 an increase of 1% in the monetary issue generated an increase of 0.52% in the CPI, with a 12 month delay. Notwithstanding, if the analysis period is opened to November 2007, the increase in the CPI is of 55.0%, while the significant delay remains at 12 months. It is worth indicating that said variables deduct the effect of the CPI coming from the variations in the international price of oil and its derivatives, wheat and corn.

Summarizing, it was determined that the monetary issue has experimented three structural changes; the first is associated to an increase in the economic activity; the second, is produced after the suspension of the operations of the *Banco del Café, S.A.* and the speculative attack on a bank belonging to the system; and, the third originated due to the scarcity of numerary lived in the economy at the end of 2006, from the suspension of operations of the *Banco de Comercio, S.A.* in January 2007, and of the increase in the demand for cash for the supply of automated teller machines. Finally, through the regression analysis, they determined that the excess of primary liquidity has influenced the general level of prices.

## 2. Broad Monetary Base

The monetary base is a fundamental concept in macroeconomic theory as well as monetary theory that consists of the quantity of money in public power (numerary) plus the banking reserves. Its importance radiates in that it represents the basic monetary aggregate that can be controlled directly by the monetary authority, besides possessing a monetary supply multiplying effect. For this reason, in the monetary theory it is also known as high power money.

In that sense, the Broad monetary base is calculated through the sum of circulating numerary, of the legal banking reserve and the balance of the MSO in short term with the banking sector (with maturity for up to 91 days)<sup>40</sup>.

Just as in the case of monetary issue, given that the inflation target has a tolerance margin, the follow up of the Broad monetary base can be made through a runner that is consistent with said range and that incorporates possible transitory fluctuations of liquidity.

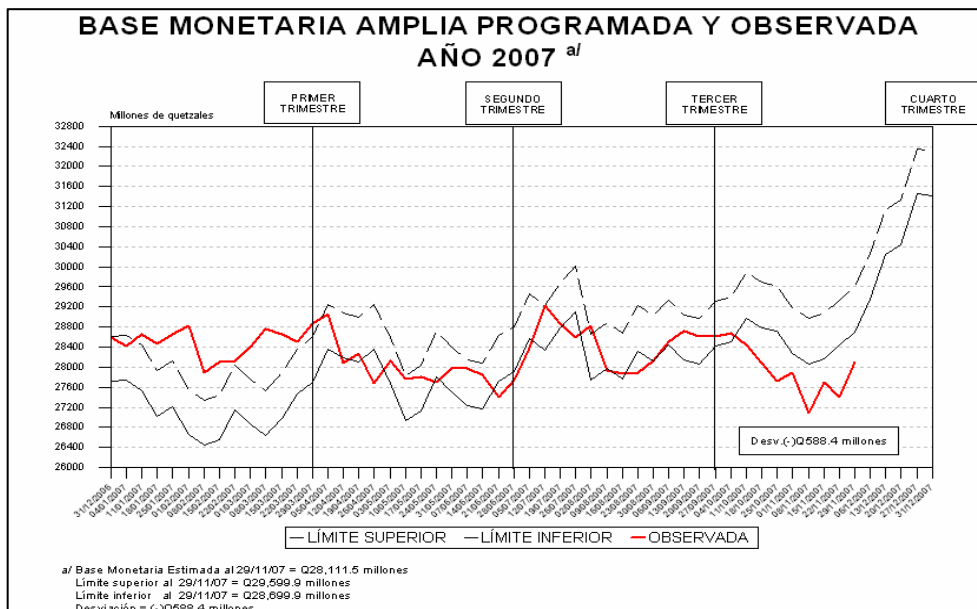
It is worth indicating that the tolerance margin of the referred runner was established as a standard deviation.

<sup>40</sup> This Broad version of the monetary base is consistent with the forecast in the Monetary Statistics and Financial Manual (2000 Edition) of the International Monetary Fund. It is worth indicating that the restricted version of the mentioned variable is only integrated by circulating numerary and the legal banking reserve.



In the described context, it is estimated that at the end of the year, the Broad monetary base grew by 13.0% regarding the level observed to December 31, 2006, which represents an increase of Q3,701.8 million.

*Programmed and observed broad monetary base*



During the first quarter of 2007, the referred variable showed an average deviation of Q569.0 million over the upper limit of the programmed runner, behavior that is basically associated to the greater demand of numerary on behalf of the economic agents.

Throughout the second and third quarters of the year, the trajectory of the balance of the Broad monetary base registered a very close tendency toward its seasonal behavior, registering during said period an average deviation of Q214.0 million below the lower limit of the programmed runner. It is worth indicating that as of the fourth quarter, the Broad monetary base began to register an important reduction, and on November 29, it was at Q588.4 million, below the lower limit of the programmed runner, which implies an average deviation during October and November of Q711.6 million below said limit. Such behavior is mainly explained by the decrease in the legal banking reserve.



As to the orientation that offers primary liquidity, as an indicative variable of the monetary policy, it is obtained through the weighting of the deviation of the monetary issue as well as the Broad monetary base, considering for the effect the 50% deviation of each one of said variables<sup>41</sup>. In that sense, as was indicated, to November 29, 2007, the monetary issue was at Q1,126.1 million over the upper limit of the programmed runner, whereas the Broad monetary base was at Q588.4 million below the lower limit of the programmed runner. In weighting terms the deviation would be of Q268.9 million, which would suggest a restrictive monetary policy.

### **E. TOTAL PAYMENT MEANS**

In the Monetary, Foreign Exchange Rate and Credit Policy for 2007 it was considered that in order to be congruent with the growth of economic activity, with the inflation target and with the circulation speed of money, the total payment means (M2) would grow between 15% and 17%, in inter-annual terms for the end of the year. To November 29, 2007, the inter-annual variation of M2 was of 10.8%, which is below the lower limit of the tolerance margin estimated for said date (15.1% - 17.1%).

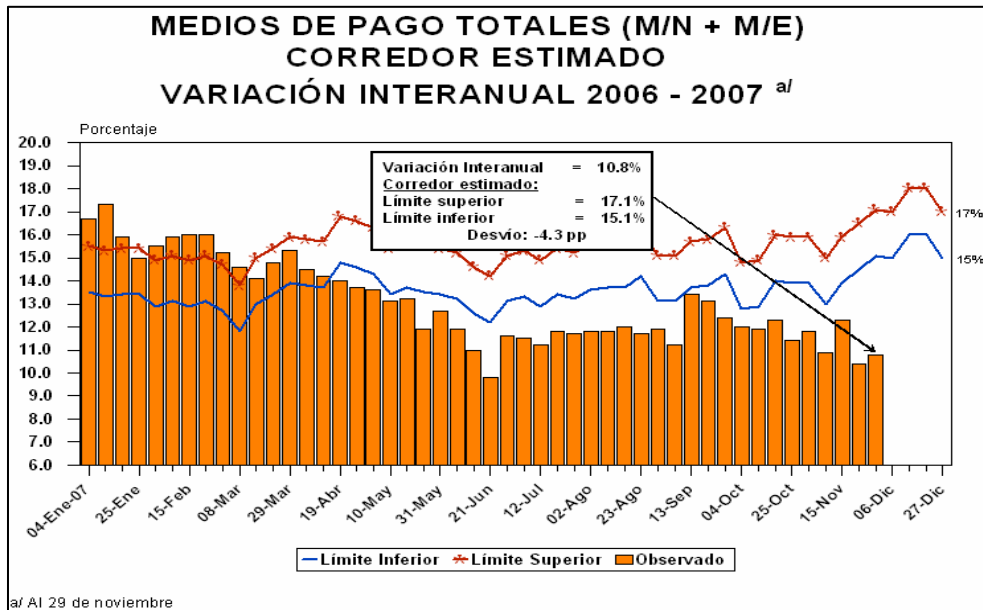
Added to considering the estimated runner, in the analysis of this variable we take into account an econometric estimation of the inter-annual growth rate for December 2007, whose calculation incorporates the seasonal behavior of the payment means for the 1998-2006 period, as well as the information observed periodically, as is illustrated in the following graph.

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<sup>41</sup> A value over the upper limit of the programmed runner for each one of said variables suggests a restrictive monetary policy, a deviation below the lower limit advises a relaxed monetary policy, while a value within the referred runner indicates an invariable monetary policy.

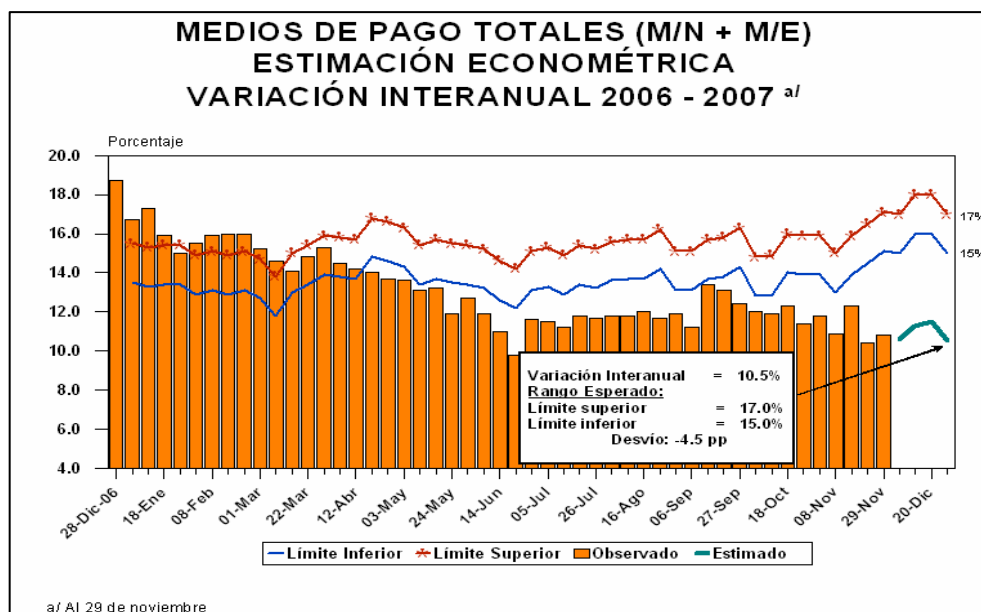


TOTAL PAYMENT MEANS; ESTIMATED RUNNER



Based on the information to November 29, 2007 the econometric estimation of the inter-annual variation of the total payment means for the end of the year would be at 10.5%, which is located below the lower limit of the expected range for December 2007 (15.0% - 17.0%), as is illustrated in the following graph.

TOTAL PAYMENT MEANS; ECONOMETRIC ESTIMATION





The orientation that the total payment means offers, like the indicative variable of the monetary policy, we obtain an average deviation of the estimated runner as well as that of the econometric estimation<sup>42</sup>. To November 29, 2007, the weighted orientation presented a negative value of 4.40 percentage points, which suggest a relaxed monetary policy<sup>43</sup>.

## **F. TOTAL BANKING CREDIT TO THE PRIVATE SECTOR**

### **1. Growth rate**

In the Monetary, Foreign Exchange Rate and Credit Policy for 2007 it was estimated that the banking credit to the private sector would reach an inter-annual growth rate of between 21.0% and 23.0%, consistent with the growth of the total payment means, with an inflation target and with an expected economic growth.

To November 29, 2007, the inter-annual variation of total banking credit to the private sector was at 26.2%<sup>44</sup>, over the upper limit of the estimated runner for that date (20.9% - 22.9%), as is illustrated in the following graph.

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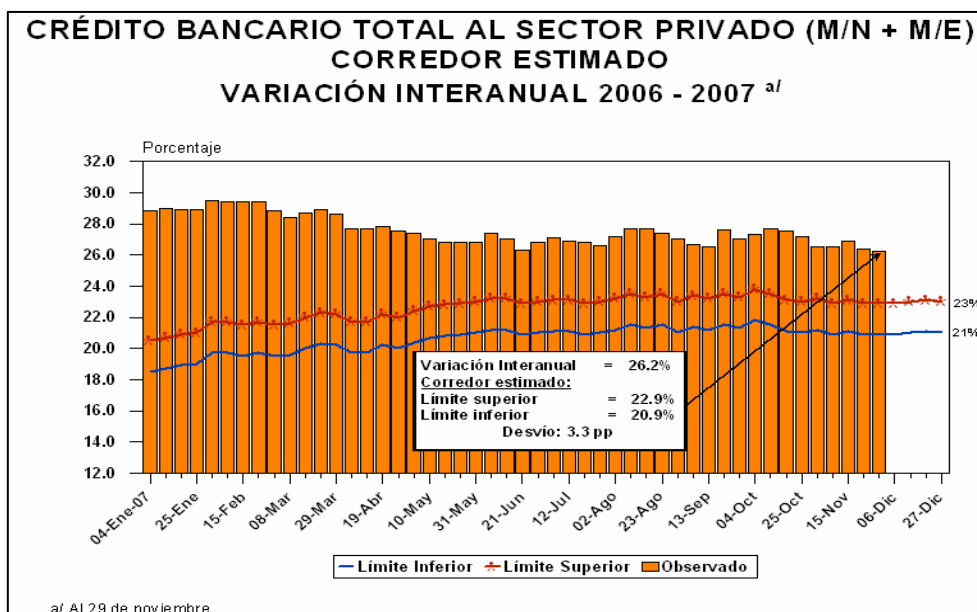
<sup>42</sup> For the follow up of total payment means, a weighting was taken into consideration that includes a 50% deviation based on the estimated runner; in other words, the difference between the observed inter-annual variations on the date of the analysis regarding the estimated value for the referred runner to date. In the same manner, it was considered that 50% of the deviation of the econometric estimation, which is calculated with a difference between the inter-annual variation of the total payment means for 2007, estimated econometrically, and the expected range in the monetary policy for December 2007 (15.0%-17.0%).

<sup>43</sup> A deviation over the upper limit of each one of the estimations suggest a restrictive monetary policy; on the other hand, a deviation below the lower limit advises a relaxed monetary policy, while a value within the margin indicates an invariable monetary policy.

<sup>44</sup> If we add the credit granted to the private sector by the banks in the system to the financial entities and offshore banks, the inter-annual variation would be of 23.0%, lower to the registered in the same period in 2006 (25.0%).



TOTAL BANKING CREDIT TO THE PRIVATE SECTOR



Just like the total payment means, the interpretation of this variable also incorporates an econometric estimation of the inter-annual growth rate of the banking credit to the private sector for December 2007<sup>45</sup>, whose calculation included the seasonal behavior of the banking credit to the private sector in the 1998-2006 period, as well as the information observed periodically.

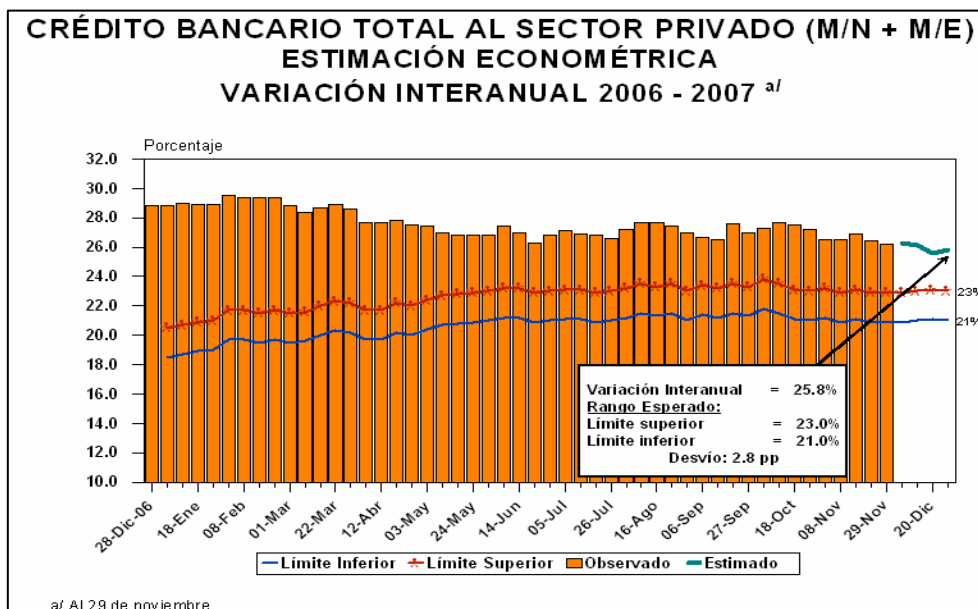
Based on the information to November 29, 2007, the econometric estimation of the inter-annual variation of the banking credit to the private sector for the end of the year would be 25.8%, which would be over the upper limit of the estimated range for December 2007 (21.0% - 23.0%). On this, it is worth pointing out that, if the inter-annual growth rate of the banking credit to the private sector in national currency has been decelerating (of 28.4% to December 31, 2006 to 20.3% on November 29, 2007), the growth rate in foreign currency has grown significantly (from 29.9% on December 31, 2006 to 43.0% on November 29, 2007), situation that advises analyzing the nature in the ambit of risk administration for credit in said currency with caution, aspect that will contribute to decelerating the banking credit to the private sector in foreign

<sup>45</sup> The follow up of the estimated runner for the banking credit to the private sector is complemented with an estimation that incorporates the dynamic of the referred variable during the year, consistent with an econometric estimation that includes the seasonal behavior for several years and that adjusts periodically with information updated weekly.



currency, which helps to mitigate the monetary effects that are derived of the current expansion.

*TOTAL BANKING CREDIT TO THE PRIVATE SECTOR*



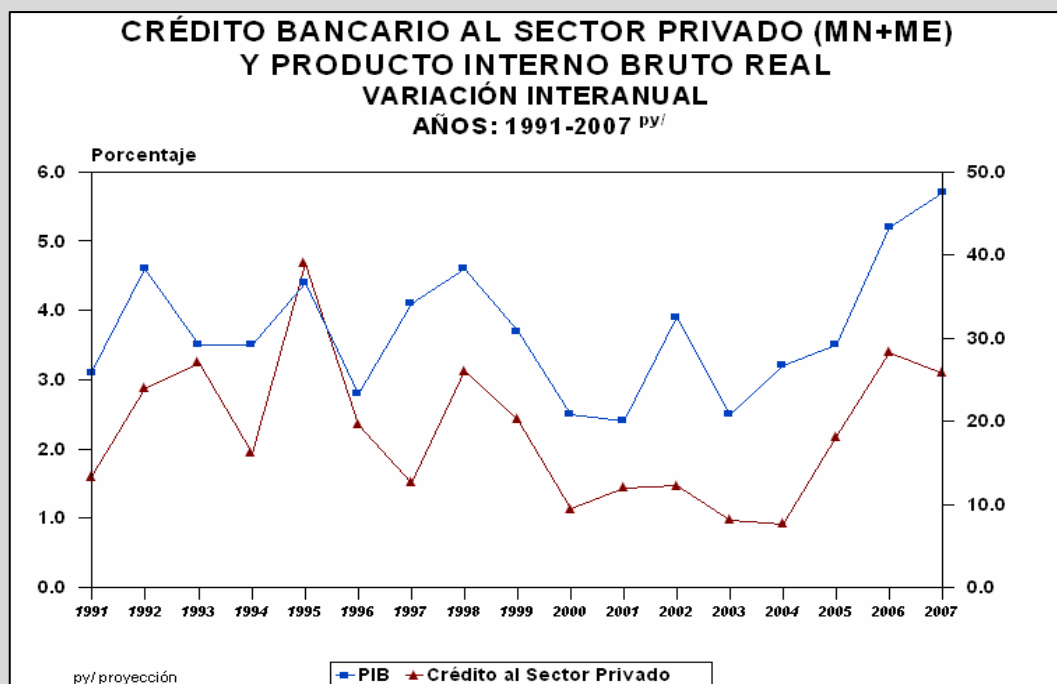
Analogous to the total payment means, the orientation of the banking credit to the private sector, as an indicative variable of the monetary policy, is obtained through the weighting of deviation for the estimated runner as well as for the econometric projection, considering for said effect the 50% deviation of each one of said estimations. In that sense, to November 29, 2007 the weighted orientation presented a positive value of 3.05 percent points, which suggests a restrictive monetary policy<sup>46</sup>.

<sup>46</sup> A deviation over the upper limit for each one of the estimations suggests a restrictive monetary policy; however, a deviation below the lower limit advises a relaxed monetary policy, while a value within the tolerance margin indicates an invariable monetary policy.



### INSERT 7 ANALYSIS OF THE BEHAVIOR OF THE BANKING CREDIT TO THE PRIVATE SECTOR

During the last few years an increase in the growth rate of the banking credit to the private sector has registered an increase over the programmed levels, so an analysis was made of the impact of said growth rate in the productive activity of the country and in the general level of prices. On this, it is worth highlighting that the economic activity of the country has registered greater dynamism as of 2004, which could have induced greater credit demand on behalf of economic agents. Therefore, to confirm the previous hypothesis there was an econometric analysis of the statistic casualty between both variables based on annual information that covers the 1991-2006 period.



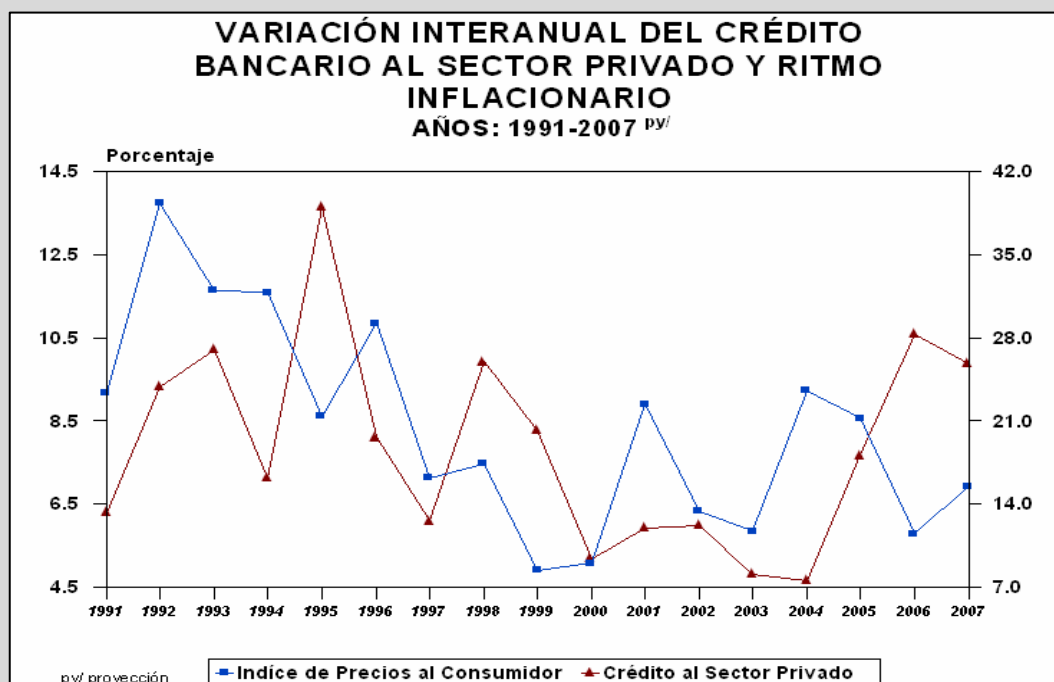
For said effect, the Granger Casualty Test<sup>1</sup>, was used, which results show what changes in the growth rate of the GDP caused changes in the growth rate of the banking credit to the private sector, with a 1 year delay. However, this trial does not discard the possibility of an inverse causality; in other words, if changes in the growth rate of banking credit to the private sector generate variations in the growth rate of the economic activity. The results obtained, use a series of data for the 1990-2006 period that allow concluding that a 1% increase in the growth rate of the GDP generate an increase in the growth rate of the banking credit to the private sector of 4.63%, with a 1 year delay.

The second part of the analysis consisted of determining if the increase in credit demand, caused by an increase in economic activity, has had repercussions in the general level of prices, based on a regression model with monthly observations for the January 2001 to September 2007 period, determined that a 1% increase in the banking credit to the private sector generated an increase of 0.57% in the inflation, with a 12 month delay.

<sup>1</sup> Consists in determining if fluctuations in variable A cause changes in the behavior of variable B.



This graph illustrates the existing relation between the inter-annual variation of the banking credit to the private sector and the inflationary rhythm, where we observe that there is an important relation between both variables.



Summarizing, it was effectively determined that changes in the growth rate of the GDP generate variations in the same direction of the growth rate of the banking credit to the private sector. Also, an increase of the banking credit to the private sector generates an increase in the general level of prices, through stimulation produced in aggregate demand. It is worth underlining that, the growth of the banking credit to the private sector does not generate inflationary pressure, if it is consistent with the inflation target and with the supposed economic growth forecast in the monetary program, not requiring monetary restriction measures, situation that does not currently observe, as mentioned, the inter-annual growth rate of the inter-annual banking credit to the private sector in 2007, which has been over the programmed runner.

## 2. Credit Portfolio per economic activity

The credit portfolio of the banking system, according to information from the general consolidated balance to October 31, 2007, was at Q69,496.6 million, amount higher by Q14,679.7 million (26.8%)<sup>47</sup> to the registered in the same month the previous year. To the referred date, the credit portfolio per economic activity concentrated on the following branches: consumption, transfers and others, 28.1%; commerce, 22.1%; construction, 13.7%; manufacturing industry, 11.2%; and, financial establishments, real estate and services rendered by businesses, 10.8%.

<sup>47</sup> Does not include the amount of the credit portfolio of two institutions suspended by the Monetary Board.



As to the variation in the credit portfolio per economic activity, from October 2006-October 2007, this has been distributed in the following manner:

**BANKING SYSTEM**  
**TOTAL CREDIT PORTFOLIO PER ECONOMIC ACTIVITY**  
**YEARS 2006 - 2007**

- Millions of quetzales and percentages -

ACTIVITY	A October 2006	A October 2007	INTER-ANNUAL VARIATION		STRUCTURE	
			ABSOLUTE	RELATIVE	2006	2007
PORTFOLIO BALANCE (I +II+III)	54,816.9	69,496.6	14,679.7	26.8		
I. Sub-Total <sup>1/</sup>	45,618.7	63,461.2	17,842.5	39.1	100.0	100.0
Agriculture, cattle, forestry, hunting and fishing	2,896.4	3,511.2	614.8	21.2	6.4	5.4
Exploitation of mines and quarries	105.3	111.6	6.3	6.0	0.2	0.2
Manufacturing Industries	5,541.6	7,092.2	1,550.6	28.0	12.1	11.2
Electricity, gas and water	1,683.9	2,154.5	470.6	27.9	3.7	3.4
Construction	6,154.0	8,723.7	2,569.7	41.8	13.5	13.7
Commerce	9,778.5	14,055.0	4,276.5	43.7	21.4	22.1
Transportation and storage	647.0	867.9	220.9	34.1	1.4	1.4
Financial establishments, real estate and services rendered by businesses	4,454.4	6,859.8	2,405.4	54.0	9.8	10.8
Communal, social and persona Services I	1,920.4	2,265.2	344.8	18.0	4.2	3.6
Consumption, transfers and others	12,437.2	17,820.1	5,382.9	43.3	27.3	28.1
II. Portfolio balance, according to banks balance that did not present information per economic activity	3,170.8	2,982.8	-188.0	-5.9		
III. Portfolio balance of credit portfolio of institutions suspended by the Monetary Board	6,027.4	3,052.6	-2,974.8	-49.4		

<sup>1/</sup> the disaggregate numbers of the portfolio; do not include two institutions that did not present information.  
SOURCE: Superintendencia de Bancos.

Given the importance in the credit portfolio of consumption, transfers and others; commerce; manufacturing industry; and construction sectors in the credit portfolio, they proceeded to use separation taking into account their main components.

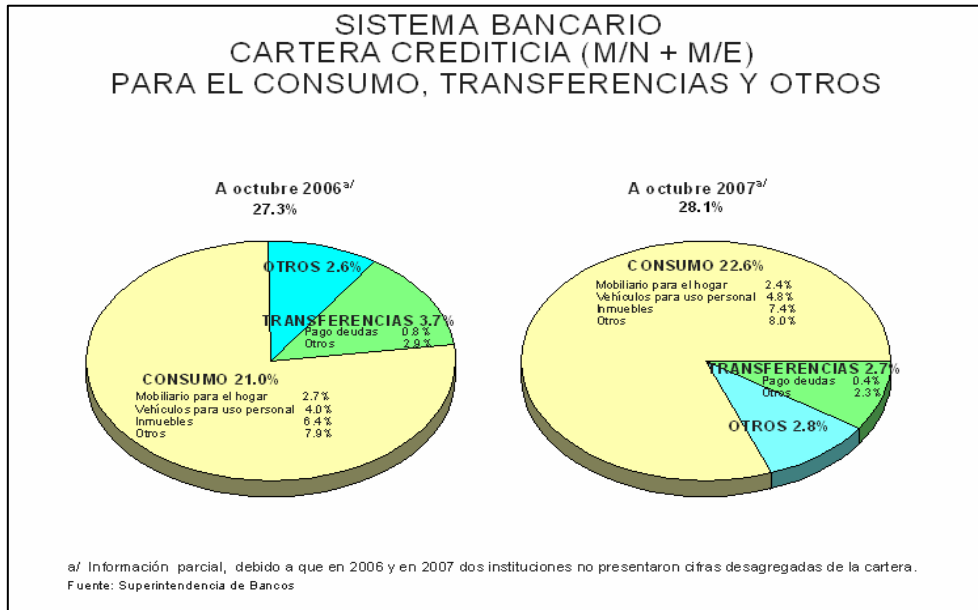
**a) Credit granted by consumption, transfers and others**

The credit portfolio destined to this activity, to October 31, 2007, represented 28.1% financing from the banking system (27.3% to October 2006).

It is worth indicating that of the total credit portfolio, consumption represented 22.6%, transfers 2.7% and the heading for others 2.8%. Taking into account the relative importance of this branch of economic activity, they took off the most relevant components, which are illustrated in the following graph:



Banking System: Credit Portfolio for consumptions, transfers and others



In credit growth for consumption we observe that to October 2007, the highlighted are: financing for the acquisition of real estate with 7.4%; of personal use vehicles with 4.8%; and, of personal property with 2.4%, except the last heading structure, that is higher, compared to the observed in October 2006. On the other hand, as to transfers, what stands out is the reduction of the debt payment column that went from 0.8% in October 2006 to 0.4% in October 2007.

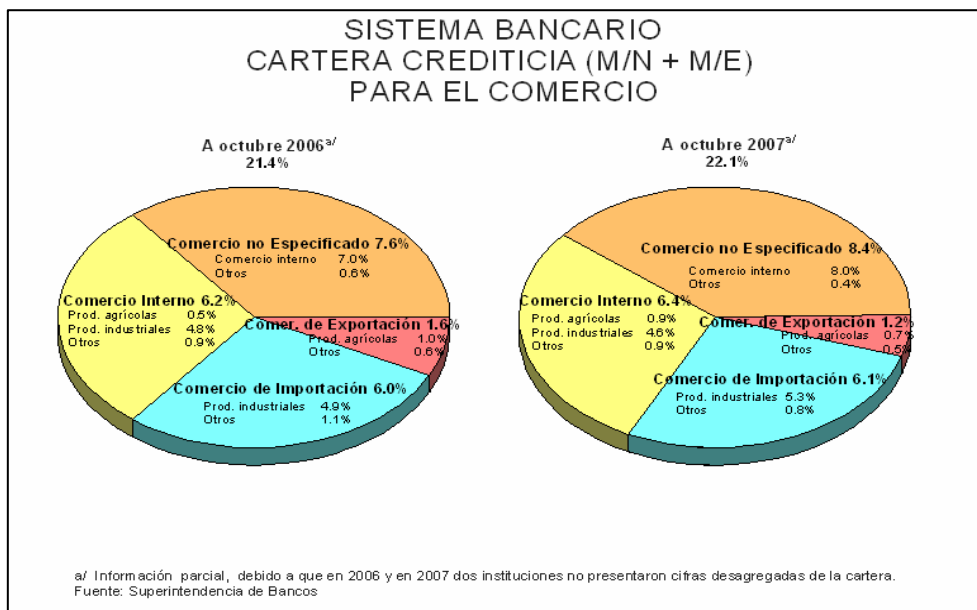
**b) Credit granted for commerce**

The credit commerce portfolio, to October 31, 2007, represented 22.1% of the total portfolio granted by the banking system, percentage higher by 0.7 percentage point to the observed to October 2006.

Following is the present subtraction of the most significant components of this activity.



*Banking System: Credit Portfolio for Commerce*



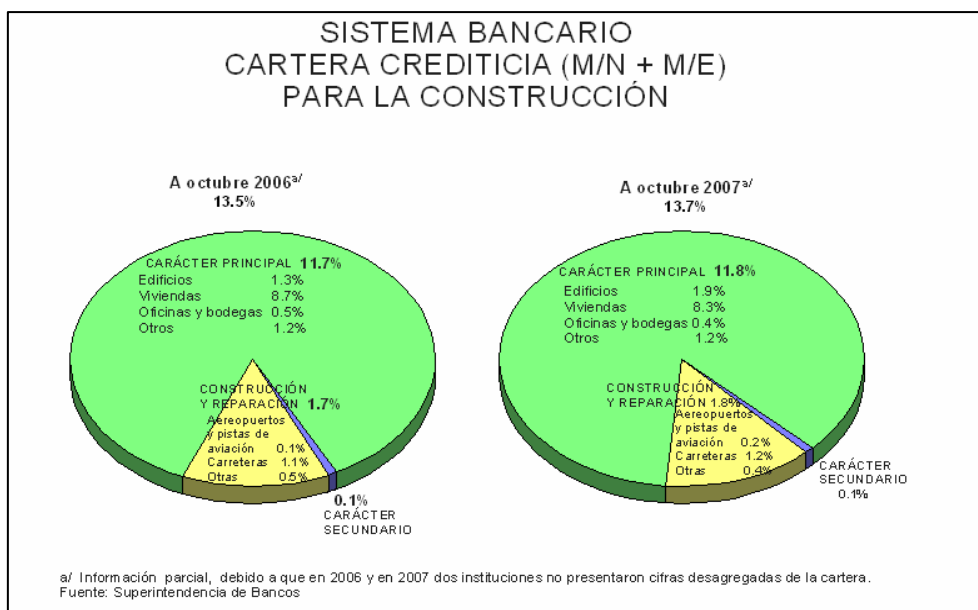
To October 2007, in terms of its relative weight regarding the total portfolio, the financing of non-specified commerce stands out with 8.4% (including the internal unspecified commerce and others); in that same order, these follow: internal commerce financing with 6.4% (include the commerce headings of industrial and agricultural products and other destinations); the financing of importation commerce with 6.1% (includes the heading for industrial products and others); and, last, the exportation commerce with 1.2% (made up of commerce of agricultural products and others). The structure of such headings does not vary significantly regarding October 2006.

**c) Credit granted for construction**

To October 31, 2007, the credit portfolio granted for construction represented 13.7% of the total portfolio of the banking system (13.5% to October 2006).

Following is a separation of the most significant components of this activity.

*Banking System: Credit Portfolio for Construction*



To October 2007, we can highlight main character financing with 11.8% (includes buildings, housing, offices, warehouses and other headings), percentage higher by 0.1 percentage point regarding the observed to October 2006 (11.7%). As to the structure of the headings, in the case of financing for buildings, this is slightly higher to the observed in October 2006, since it went from 1.3% to 1.9%, while that channeled toward housing was marginally reduced from 8.7% in 2006 to 8.3% in 2007, which is more representative, which results congruent with the dynamism of the construction sector.

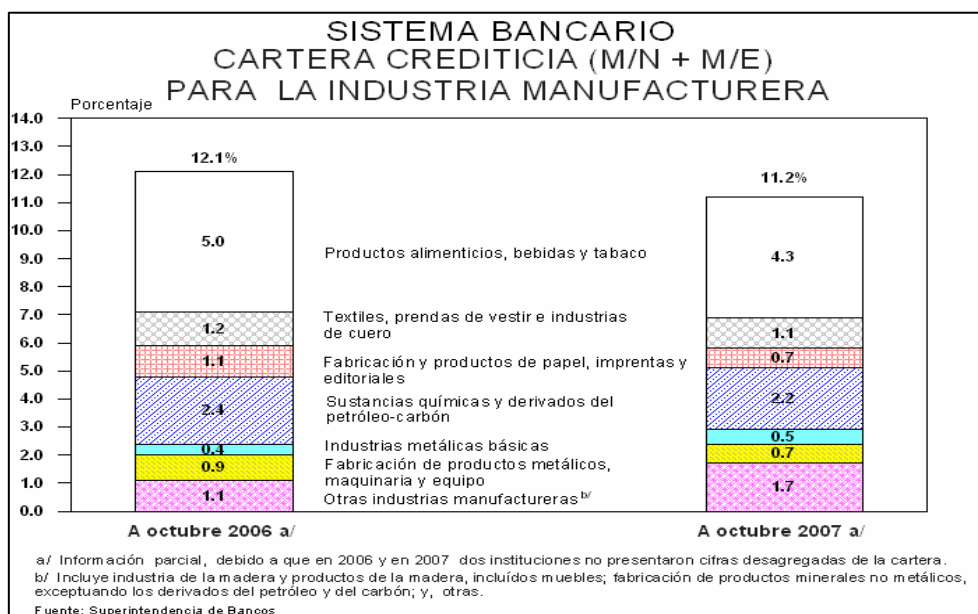
**d) Credit granted for the manufacturing industry**

To October 31, 2007, the credit for the manufacturing industry represented 11.2% of the banking system portfolio (12.1% to October 2006).

Following is a separation of the most significant components of this activity.



*Banking System: Credit Portfolio for the Manufacturing Industry*



When evaluating each of the components of the manufacturing industry it is had that to October 2007, the financing granted to the food, beverage and tobacco products manufacturing stands out with 4.3%; to the chemical substances industries and that derived from carbon-petroleum with 2.2%; to textile industries, clothing and leather with 1.1%; and, to the metallic products, machinery and equipment industry with 0.7%. The referred structure, except financing granted to metallic based industry and other manufacturing industries, is lower to the observed in October 2006.

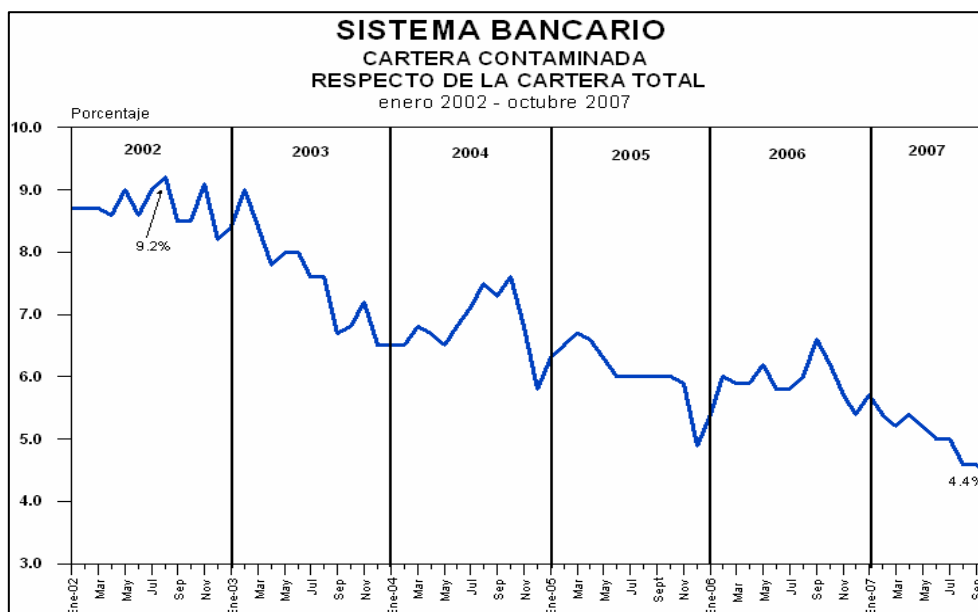
### 3. Credit portfolio quality

As to credit portfolio quality, it is observed that the portion of the contaminated portfolio (default portfolio plus past-due portfolio) regarding the total credit portfolio of the banking system, has shown an important improvement, especially if we take into account that in August of 2002 said indicator was at 9.2% (which represents the highest percentage observed during the January 2002 to October 2007 period).

To October 31, 2007, the amount of the contaminated portfolio was at Q2,899.7 million, equivalent to 4.4% of the total credit portfolio. Said amount of default portfolio represented 1.8% (2.7% to October 2006) and past-due portfolio of 2.6% (3.5% to October 2006).

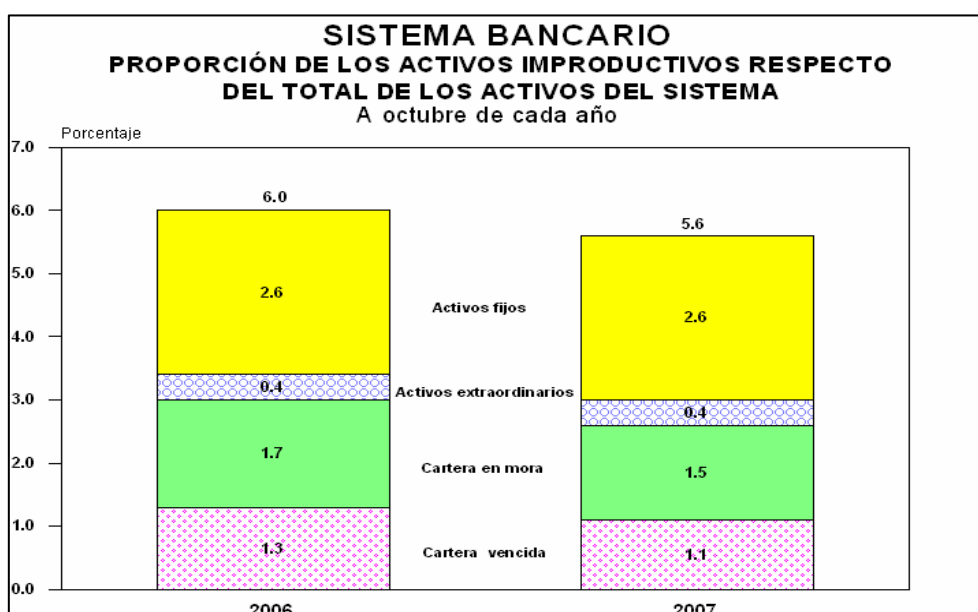


*Banking System: Contaminated Portfolio compared to Total Portfolio*



As to unproductive assets of the banking system (integrated by the contaminated portfolio, the extraordinary assets and fixed assets) as a proportion of the total assets, reflect an improvement, since they continued to show a falling tendency, when to October 2007, they were at 5.6%, lower percentage to the registered in October 2006 (6.0%).

*Banking System: Proportion of Unproductive Assets regarding Total Assets of the System*





#### 4. Econometric estimation of banking credit demand to the private sector

Modern economic literature<sup>48</sup> indicates that the banking credit demand to the private sector has certain fundamental determinants that explain, among them, the economic activity and the credit price (asset interest rate). In that regard, based on the econometric method of Ordinary Squared Minimums the logarithmic functions were estimated for the banking credit demand to the private sector, total, in M/N and in M/E with statistical information available for the January 2000 to October 2007 period (last information available). The econometric results obtained confirm that the degree of dependency of the demand of banking credit to the private sector, in total, in M/N and in M/E in the country, regarding the economic activity and some of the macroeconomic prices (interest rate and nominal exchange rate), is significant if we examine the values of the determination coefficients ( $R^2$ ) of 99.47%, 98.43% and 99.28%, respectively. It is also worth indicating that the explicative variables resulted statistically significant at a trust level of 95% and satisfactorily fulfill the expected sign, in other words, an increase in the economic activity implies an increase in the credit demand; an increase in the asset interest rate reduces credit demand; and, an appreciation of the nominal exchange rate increases the credit demand, as is illustrated in the following graph.

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<sup>48</sup> INTER-AMERICAN DEVELOPMENT BANK (2005). "UNLEASHING CREDIT: How to broaden and stabilize the banking system", REPORT 2005 of Economic and social progress in Latin America, Washington, D.C. For more details see Levine, Ross y Sara Zervos. (1998). Stock Markets, Banks, and Economic Growth. American Economic Review; y, Rajan, Raghuram G. y Luigi Zingales, 1998. Financial Dependence and Growth. American Economic Review.



### INSERT 8

#### SISTEMA BANCARIO MODELOS DE DEMANDA DE CRÉDITO BANCARIO, TOTAL, EN MONEDA NACIONAL Y EN MONEDA EXTRANJERA

VARIABLES EXPLICATIVAS	MODELO 1 Ln CSP <sub>t</sub> TOTAL		MODELO 2 Ln CSP <sub>t</sub> MONEDA NACIONAL		MODELO 3 Ln CSP <sub>t</sub> MONEDA EXTRANJERA	
	Coeficiente	Estadístico t	Coeficiente	Estadístico t	Coeficiente	Estadístico t
Constante $\alpha$	14.30	36.08	14.92	30.30	11.95	22.08
IMAE <sub>t</sub>	0.08	32.92	0.09	30.32	0.12	28.78
Tasa de interés activa <sub>t</sub>	-0.07	-54.86	-0.03	-21.08	-0.10	-26.89
Ln tipo de cambio <sub>t</sub>	-1.44	-7.54	-2.17	-9.10	-0.86	-3.23
Residuo <sub>t-1</sub> *	0.96	25.39	0.87	15.83	0.95	16.95
Promedio móvil <sub>t+1</sub> *	0.38	3.72	0.24	2.14	0.21	1.70
Período muestral	enero 2000 - octubre 2007		enero 2000 - octubre 2007		mayo 2001 - octubre 2007	
Coeficiente determinación R <sup>2</sup>	0.994712		0.984307		0.992761	
Durbin-Watson	1.777021		1.949473		1.827549	

\* Se corrigió la autocorrelación con base en el método de Cochrane-Orcutt y el impulso del promedio móvil de los residuos.

Nota: De acuerdo con el número de observaciones, el valor crítico  $t$  es igual a 1.980 al nivel de significancia del 5%.

Donde: Ln CSP<sub>t</sub> = Logaritmo natural del crédito bancario al sector privado en el período  $t$ .

IMAE<sub>t</sub> = Ritmo de crecimiento del Índice Mensual de la Actividad Económica en el período  $t$ .

Tasa de Interés activa<sub>t</sub> = Tasa de interés activa promedio ponderado del sistema bancario en el período  $t$ .

Ln tipo de cambio<sub>t</sub> = Logaritmo natural del tipo de cambio de referencia del último día de cada mes en el período  $t$ .

The results suggest that when the inter-annual growth rhythm of the economic activity increases by 1.0%, where the other variables remain constant, the banking credit demand to the private sector, total, in M/N and in M/E, grow approximately 0.08%, 0.09% and 0.12%, respectively. As to a fall in 1.0% in the asset interest rate, weighted average, the banking system, where other variables remain constant, increases the credit demand, total, in M/N and in M/E, by around 0.07%, 0.03% and 0.10%, in that order. Last, an appreciation of 1.0% in the nominal exchange rate, *ceteris paribus*, increases the demand of banking credit to the private sector, total, in M/N and in M/E by around 1.44%, 2.17% and 0.96%, respectively.

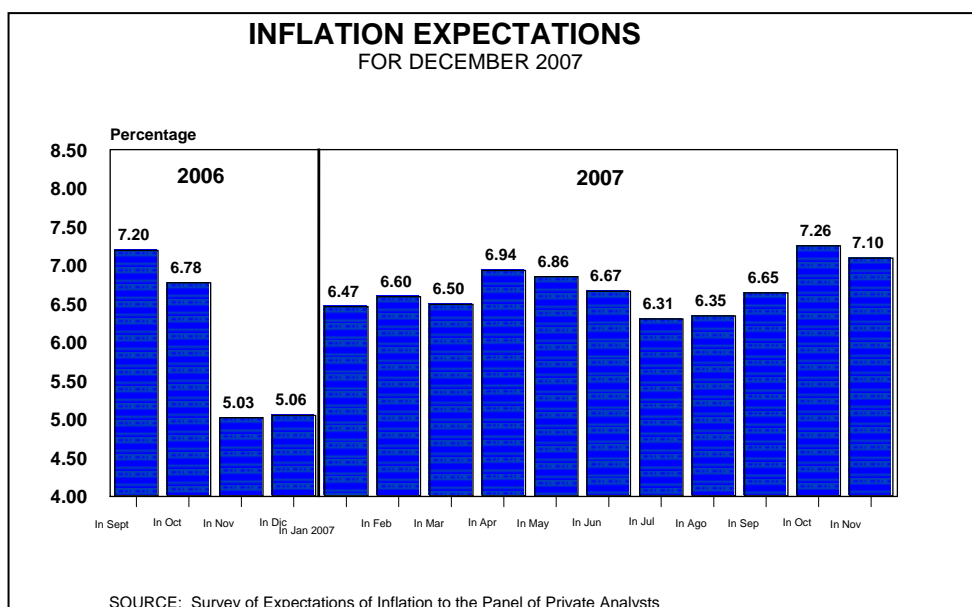
#### G. SURVEY OF EXPECTATIONS OF INFLATION TO THE PANEL OF PRIVATE ANALYSTS

The expectations of inflation are defined as the perception of the economic agents of the future behavior of prices in the economy. The inflation expectations that for a certain period form the economic agents, can influence substantially in the determination of the inflation rate that are finally registered in



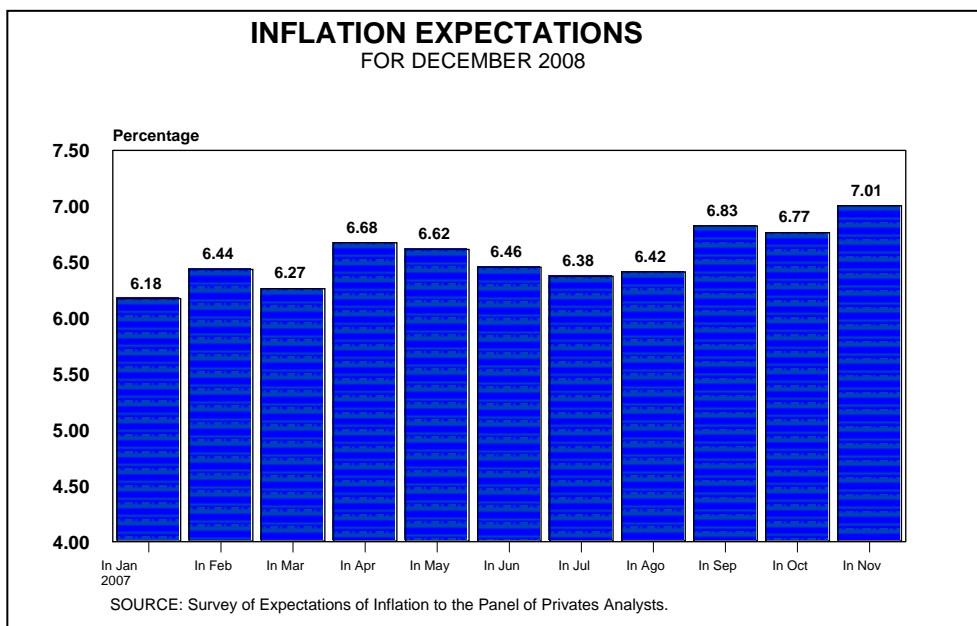
said period, which can also independently include the foundations of the economy.

According to the Survey of Inflation Expectations to the Panel of Private Analysts –EEI [For its acronym in Spanish]-<sup>49</sup> made in November 2007, the surveys forecast that for December of the present year that the inflationary rhythm is at 7.10%, percentage higher by 2.07 percentage points to the projected in November 2006 (5.03%). It is worth highlighting that as of the survey made in August 2007, the forecast of said panel has shown a tendency to rise, as is shown in the following graph.



On the other hand, said panel estimates that the inflation for December 2008 will be at 7.01%, percentage higher to the established target for that year in the Monetary, Foreign Exchange Rate and Credit Policy, determined for 2007 (4.5% +/- 1 percentage point). As of August 2007, the forecast for 2008 of said panel has shown a tendency toward the rise, as is shown in the following graph.

<sup>49</sup> Monthly survey directed toward national analysts and international from the private sector, knowledgeable of the operational procedures of the economic policy, which allows measuring their impression of these regarding the future evolution of the inflationary rhythm in Guatemala.



#### H. IMPLIED INFLATION EXPECTATIONS

This indicator constitutes an indirect manner of obtaining the inflation expectations of the economic agents, through the calculation of the average gap between the long term interest rates<sup>50</sup> and the short term interest rates<sup>51</sup>. The idea that underlies this calculation is sustained in the fact that the long term interest rates are generally greater than the short term interest rates, due to the fact that there are those that include premiums that compensate expected inflation as well as country risk. Due to the above, in order to obtain the referred perception, a country risk premium<sup>52</sup> is deducted from the long as well as short term interest rates, giving the gap corresponding to the premium for inflation as a result.

According to the observed numbers to November 2007, the implied inflation expectations indicated a gap of 6.15 percentual points, which are located over the upper limit of the tolerance margin of the inflation target (5.0% +/- 1 percentage point), suggesting a restrictive monetary policy. When

<sup>50</sup> For this purpose they defined interest rates as long term, total asset interest rates and new loans from the banking system interest rates.

<sup>51</sup> For this purpose they defined short term interest rates, repurchase agreements interest rates for between 1 and 7 day terms and weighted average interest rates for OEM (that include the weighting of 7 to 182 day terms).

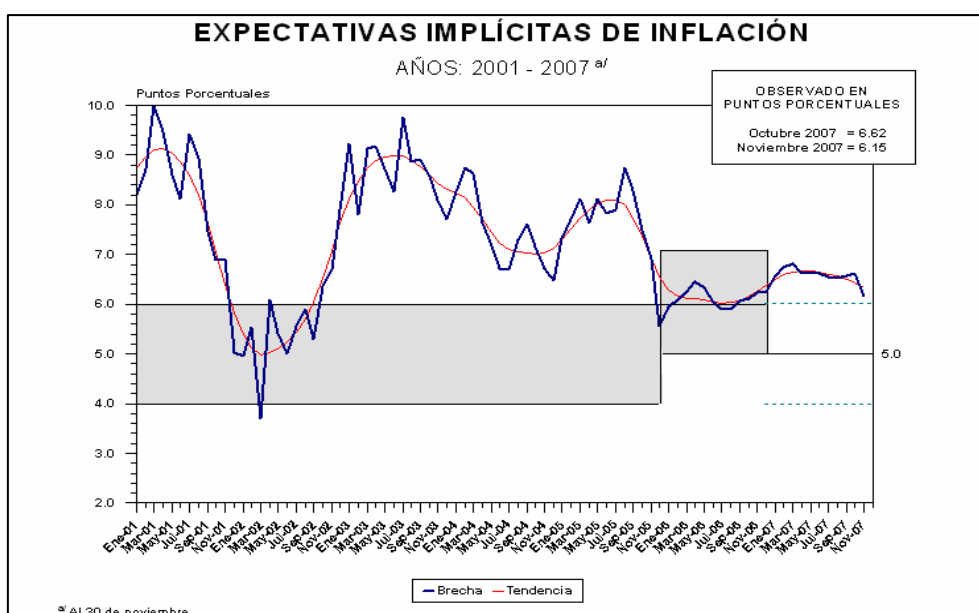
<sup>52</sup> The country risk premium as the difference between the weighted average return rate of the Treasury Bonds from the Republic of Guatemala placed in the international financial market (in 1997, 2001 and in 2003) and the return rate of the Treasury Bonds from the United States of America for a 10 year term. As of August 5, 2007, we exclude the 1997 is excluded due to the fact that same was amortized totally on the same date.



comparing the obtained result in November 2007, regarding the observed in November 2006 (6.23 percentage points), observes a slight decrease of 0.08 percentage points in the referred expectations.

It is worth indicating that as of March 2007, there is a slight tendency of the referred indicator to fall, as is shown in the following graph, situation that denotes a moderation in the inflation expectations of the economic agents, associated to Monetary Policy restriction measures in 2007, begun in the referred month.

*Implied Inflation Expectations*



## I. SYNTHETIC INDEX OF THE INDICATIVE VARIABLES

For 2007, the Monetary Board agrees to continue the follow up of the indicative variables through an index that allows jointly evaluating the orientation of the referred variables, taking into consideration the relative importance that each one of them has in the decision making process of the monetary policy.

The importance that each indicative variable has in the referred process is determined through a survey in which each member of the Monetary Board gives their opinion on the relative weight that each variable must have in order to define the orientation of the monetary policy. In that sense, the synthetic



index incorporates an indicator, for each orientation category<sup>53</sup>, the different assigned weightings to each variable, which facilitates making comparisons between the results of a week and another, since the referred index provides a percentage for each orientation category, which is easily comparable to the percentage from other dates.

In the following graph, with numbers observed to November 29, 2007 the results of the synthetic index obtained, based on the relative assigned weight to each indicative variable, were presented.

## ÍNDICE SINTÉTICO DE LAS VARIABLES INDICATIVAS

Al 29 de noviembre de 2007

VARIABLES INDICATIVAS	Peso relativo de la variable	ORIENTACIÓN Y PESO RELATIVO				
	(%)	Relajada	Moderadamente relajada	Invariable	Moderadamente restrictiva	Restrictiva
1. Ritmo Inflacionario Total Proyectado	12.09					12.09
2. Ritmo Inflacionario Subyacente Proyectado	12.36					12.36
3. Tasa de Interés Parámetro	9.34					9.34
4. Tasa de Interés Pasiva de Paridad	9.07			9.07		
5. Liquidez Primaria	11.26					11.26
6. Medios de Pago	8.79	8.79				
7. Crédito Bancario al Sector Privado	9.07					9.07
8. Expectativas de Inflación del Panel de Analistas Privados	7.69					7.69
9. Expectativas Implícitas de Inflación	9.34					9.34
10. Pronósticos de Inflación de Mediano Plazo del MMS	10.99					10.99
<b>TOTAL</b>	<b>100.00</b>	<b>8.79</b>		<b>9.07</b>		<b>82.14</b>

<sup>53</sup> In this methodology they calculated five indexes, one for each orientation (relaxed, moderately relaxed, invariable, moderately restrictive and restrictive), whose sum is 100. The moderately relaxed orientation is referred to the location below the punctual value of the inflation target, but is found within the tolerance margin of +/- 1 percentage point. Analogously, the moderately restrictive orientation is referred to the location over the punctual value of the inflation target, but that is found within the tolerance margin of +/- 1 percentage point.



As we observe in the previous graph, 82.14% of indicative variables advise a restrictive monetary policy; 9.07% advise an invariable monetary policy orientation; and 8.79% advise a relaxed monetary policy orientation.

With the object of comparing the evolution of the suggested monetary policy by the indicative variables based on the synthetic index during the current year, we made the following graph that takes into consideration what said variables suggest with numbers to December 28, 2006.

### ÍNDICE SINTÉTICO DE LAS VARIABLES INDICATIVAS

Al 28 de diciembre de 2006<sup>a/</sup>

VARIABLES INDICATIVAS	Peso relativo de la variable	ORIENTACIÓN Y PESO RELATIVO				
	(%)	Relajada	Moderadamente relajada	Invariable	Moderadamente restrictiva	Restrictiva
1. Ritmo Inflacionario Total Proyectado	12.09				12.09	
2. Ritmo Inflacionario Subyacente Proyectado	12.36				12.36	
3. Tasa de Interés Parámetro	9.34	9.34				
4. Tasa de Interés Pasiva de Paridad	9.07			9.07		
5. Liquidez Primaria	11.26					11.26
6. Medios de Pago	8.79					8.79
7. Crédito Bancario al Sector Privado	9.07					9.07
8. Expectativas de Inflación del Panel de Analistas Privados	7.69				7.69	
9. Expectativas Implícitas de Inflación	9.34				9.34	
10. Pronósticos de Inflación de Mediano Plazo del MMS	10.99	10.99				
<b>TOTAL</b>	<b>100.00</b>	<b>20.33</b>		<b>9.07</b>	<b>41.48</b>	<b>29.12</b>

a/ Para efectos de comparación se eliminó el Índice de Condiciones Monetarias y se ponderó de nuevo el peso relativo del resto de variables indicativas.

In the following graph we can observe that the orientation with the greatest relative weight in December 2006 indicated a moderately restrictive monetary policy (41.48%), whereas the orientation with greater relative weight in November 2007 (82.14%) suggests restricting the monetary conditions.



<b>SYNTHETIC INDEX OF THE INDICATIVE VARIABLES</b>		
<b>ORIENTATION</b>	<b>12/28/2006 (%)</b>	<b>11/29/2007 (%)</b>
<b>Relaxed</b>	<b>20.33</b>	<b>8.79</b>
<b>Moderately relaxed</b>	<b>0.00</b>	<b>0.00</b>
<b>Invariable</b>	<b>9.07</b>	<b>9.07</b>
<b>Moderately restrictive</b>	<b>41.48</b>	<b>0.00</b>
<b>Restrictive</b>	<b>29.12</b>	<b>82.14</b>
<b>TOTAL</b>	<b>100.00</b>	<b>100.00</b>

## **J. ADVANCES IN STATISTICAL IMPROVEMENT**

### **1. Advances in the implementation of the Monetary and Financial Statistics Manual**

In 2007 we advanced in the implementation of the Monetary and Financial Statistics Manual –MEMF [For its acronym in Spanish.], 2000 edition, from IMF, so that the monetary and financial statistics of the country include the methodological framework that incorporates the best international practices in matters of compilation and publication of said statistics from diverse central banks.

In that sense, it is convenient to indicate that the efforts made during 2007 allowed improving the statistical information, in coverage of financial institutions as well as the quality of the sectorization of financial instruments. According to the referred manual, as to the coverage of monetary and financial statistics, the same are divided into two big groups: the first, integrated by deposit stock companies (financial institutions that have the ability to create money), like the Central Bank, the banks of the system, financial stock companies, off shore entities and savings and credit cooperatives and the second, according to other financial stock companies, like the insurance and bonds companies, the bonded warehouses, the stock exchanges, credit card issuing entities, among others.



In the previous context, it is convenient to indicate that compiled statistical information is available according to the MEMF for all the institutions that make up the deposit stock companies sector. As to the information from other financial stock companies, we have insurance and bonds companies that make up 85% in asset terms of this group of institutions.

Regarding sectorization, it is convenient to highlight that during 2007, derived from the inter-institutional effort between the *Banco de Guatemala* and the Superintendencia of Banks, detailed information was obtained on credit letters, with which we could divide into sectors, first, the residence criteria and, later, the different resident sectors. The above, would allow the *Banco de Guatemala* to compile the monetary and financial statistics in the country, according to international norms.

Additionally, during 2007 they reached important agreements in matters of harmonization of monetary and financial statistics in Central America, Dominican Republic and Panama. With the effort of the IMF, the Executive Secretariat of the Central American Monetary Council and the other countries of the region, together, they were able to integrate a set of harmonized statistical graphs that are for classification criteria of financial instruments and sector dividing, according to international statistical standards.

Finally, it is worth indicating that the monetary and financial statistical information compiled according to the MEMF, will be published in 2008.

## **2. Advances in implementing of the V Payments Balance Manual**

The *Banco de Guatemala*, regarding the statistic treatment of the external sector, is in the implementation phase of the V Payments Balance Manual. In that sense, during 2007 they continued with concrete actions; in first place, between June 18 and August 31, the *Banco de Guatemala* continued with the business and institutional surveys program (Third Survey of the External Sector -ENCSE3-), with the objective of grouping economic and financial information corresponding to 2006 of the following entities: a) direct foreign investment businesses; b) national and foreign businesses of



international transportation; c) private institutions that receive donations from abroad; d) international organisms that work in Guatemala; and, e) businesses that make transactions with other services abroad. Second, in the context of making the registry of exchange statistics adequate, a project for new forms was prepared regarding the Statistics Registry of Income and Expense of Foreign Currency and the Daily Movement of Foreign Currency, which allows improving the statistical registry of an exchange nature.

Finally, it is worth indicating that they have foreseen that the Payments Balance for the 2004-2006 period, made up on the basis of the guidelines of the V Manual, be published at the end of 2007, while the Payments Balance for 2007 will be published in 2008.

### **3. Implementation of the Quarterly National Accounts**

In 2007 progress was made in the make up of the Quarterly National Accounts, within the conceptual framework of the National Accounts Systems of 1993 -SCN93-. The objective of the referred implementation is to contribute to the follow up of the behavior of the short term economic activity and have trustworthy and opportune information available for the decision making of the economic policy, particularly of the monetary policy.

In effect, in June 2007 the progress of the project was presented to the Monetary Board that includes preliminary results from the GDP quarterly series corresponding to the 2001-2005 period, for the production focus as well as the expense focus. They are currently integrating the quarterly estimations of the GDP corresponding to 2006.

They also continued with the polling for the manufacturing industry, commerce and services activities, which are used to estimate the quarterly accounts of 2007.

## **IV. ADVANCES IN THE OPERATIVE FRAMEWORK OF THE MONETARY POLICY**

### **A. PLACEMENT OF TERM CERTIFICATES OF DEPOSIT -CDP- PER DUE DATE**



The Monetary Board, in the Monetary, Foreign Exchange Rate and Credit Policy determined for 2007, authorized the *Banco de Guatemala* to issue Term Deposit Certificates, in quetzales, per due date, in order to help strengthen the secondary market and propitiate the formation of a yield curve that better reflects the behavior of the interest rates in said market.

The Monetary Board, in resolution JM-154-2007 dated September 5, 2007, approved the Regulation for the Reception of Term Deposits in National Currency, to be constituted in the *Banco de Guatemala*, which came into effect on October 8, 2007. Among other aspects, said regulation establishes that the reception of term deposits can be made for a determined term or by a due date, that the biddings can be made directly or through the commerce exchanges authorized to operate in the country and that the bids could be presented and awarded per price or by interest rate, according to the established for the corresponding convening.

Last, the General Management of the *Banco de Guatemala* in resolution GG-08-2007 dated October 3, 2007, approved the Norms for the Bidding of the Rights for the Constitution of Term Deposits in National Currency in the *Banco de Guatemala*, through the Authorized Commerce Exchanges to Operate in the Country, which went into effect on October 8, 2007.

#### **B. TRANSFER OF TITLEHOLDING OF TERM DEPOSIT CERTIFICATES IN CUSTODY IN THE BANCO DE GUATEMALA**

In order to contribute to the development of an agile and safe secondary market, the Monetary Board authorized the *Banco de Guatemala* to continue with the process of implementation of measures oriented to making transfers of title-holding of Term Deposit Certificates in custody in the *Banco de Guatemala*.

In that sense, the regulation referenced in the previous clause, contemplates that the term deposit will represent custody by registry in the *Banco de Guatemala* or by term certificates of deposit. Also, establishing that when the depositor decides to leave the term deposit in custody in the *Banco de Guatemala*, this will extend a proof, that grants the legitimate titleholder the accreditation of the deposit, which could be issued in printing, through a coded



electronic message, generated in the Gross Settlement System in Real Time - LBTR [For its acronym in Spanish] -, or by other electronic means established by the *Banco de Guatemala*.

Regarding title holding of a registered term deposit in custody in the *Banco de Guatemala*, the regulation of merit declares that the same can be transferred at the request of the last titleholder registered in the Central Bank, in writing with a signature legalized by a notary; through a coded electronic message, generated by the LBTR system, sent by a direct participant in the proper name or in the name of a direct or indirect participant in the referred system; or through other electronic means established by the *Banco de Guatemala*.

## **V. EVALUATION ASPECTS OF THE MONETARY POLICY**

According to resolution JM-168-2006 of the Monetary Board, the target for the inter-annual variation of the consumer price index, for December 2007 is of 5.0% (+/- 1 percentage point). To November 2007, the total inflationary rhythm was at 9.13%, greater percentage, to the registered in November 2006 (4.40%) as well as to the upper limit of the target of the referred year. The subjacent inflation to the mentioned month was of 8.30% also higher to the observed to November 2006 (5.20%). The mentioned behavior is the result, among others, of the following factors:

a) The international price of oil has registered a growing tendency throughout 2007, which has generated an increase in the price of derived products (gasoline, diesel and propane gas). In effect, of the total inflation (9.13%), 0.92 percentage points correspond to direct imported inflation, whereas 2.14 percentage points are explained by the indirect imported inflation (or second round effect).

b) The international price of corn has evidenced record levels in the current year, situation that has influenced in the price of other products that make up the CPI, such as products for tortillas, meal for animals, cereals and poultry meats;

c) The international price of wheat has also grown significantly, which has influenced the internal price of bread, flour and pastas;



d) The monetary issue has registered an important deviation regarding the programmed runner, which marks excess of primary liquidity in the economy, even when the analysis of the technical departments points to the fact that there is a portion of this deviation that is due to acceleration of economic growth and to the level of resources available in automatic tellers; and,

e) The banking credit to the private sector continues evolving over the upper limit of the programmed runner, which has caused inflationary pressures on demand.

It is worth pointing out that to date the supply shocks, as was indicated, associated to increases in the international price of oil and its derivatives, corn and wheat, the monetary policy can only moderate the inflation expectations of the economic agents and of the second round effect of the referred shocks; in other words, those that are produced when the prices to the final consumer grow proportionally more than the raise coming from the supply shocks. On the other hand, during the year a growth rhythm of the banking credit to the private sector was registered over the programmed runner, which added to the excess of primary liquidity and to the economic growth greater to the mid-term potential, according to the measure of the Semi-structural Macroeconomic Model, would have generated the additional inflationary pressures. The previous elements, as well as the monthly analysis of other indicative variables and of the Inflation Risks Balance, oriented the actions of the Monetary Board during the year.

In that context, in the first months of the year the Monetary Board, in a cautious and gradual framework, decided to not modify the level of the leading interest rate, even when there are factors that advise restricting the monetary policy, due to the fact that keeping the stability of the financial system remained a priority, taking into consideration the bond, as a consequence of the suspension of operations of a banking entity. Later, decided to increase the leading interest rate on five occasions: March 28 from 5.00% to 5.25%, on April 25 from 5.25% to 5.50%, on September 26 from 5.50% to 5.75%, on October 31 from 5.75% to 6.00% and on November 29 from 6.00% to 6.25%.



The Monetary, Foreign Exchange Rate and Credit Policy determined for 2007 was focused on the fundamental objective of keeping stability in the general level of prices and in the same explain the principles that regulate the participation of the Central Bank in the monetary and exchange markets for the fulfillment of said objective.

As to the money market, the participation of the Central Bank has been held using the monetary stabilization operations in market conditions. In that regard, even when the monetary program to November of this year show important deviation in the balance of the monetary stabilization operations of the programmed (on Q2,780.0 million), the monetizing effect derived from the mentioned deviation was partially counter subtracted by the increase in the balance of the deposits by the Central Government in the *Banco de Guatemala* (on average, Q2,030.0 million) in the context of coordination of the monetary and fiscal policies. Other monetizing factors during the year were the decrease of deposits of the banks in the system in the *Banco de Guatemala* that would have been regulated, on the one hand, the greater demand of cash registered during the first months of the year and to the use of excess of legal reserve for the financing of operations of banking credit to the private sector, as a result of less dynamism observed in the banking fund-raising. The above, is reflected in the deviation of monetary issue, which remained, on average, at Q1,200.0 million. According to the technical analysis, of this total, approximately Q500.0 million would not generate inflationary pressures, due to the fact that they correspond to an increase in the monetary supply congruent with an increase in the demand.

The inter-annual growth of the credit to the private banking sector over the programmed runner, even when in the present year began to register gradual deceleration, denotes that in this way there still persist inflationary pressures. This gives evidence that even when the Monetary Board had adjusted the leading interest rate to November on five occasions, it is necessary to improve the transmission mechanism of the monetary policy so that said adjustments gradually transfer to other interest rates, in the monetary stabilization operations of the *Banco de Guatemala* as to the asset and liable



interest rates of the market, in order that, on the one hand, the inflationary pressures moderate and, on the other hand, to give incentive to savings, requirements to continue with the dynamic and sustained economic growth.

Within that context, it is necessary that the Monetary Board and the Execution Committee persist in giving privilege to the only objective which is to control the inflation and to continue implementing measures that point to perfecting the secondary market and to increase the number of actors that participate in biddings in the Central Bank.

As to the exchange market, in a context of flexibility in which the nominal exchange rate is determined by the interaction between supply and demand of foreign currency in the referred market, we observed a moderate volatility in the quote of the nominal exchange rate, so the participation regulation of the Central Bank in said market was not activated. Even so, it is worth highlighting that in the explicit inflation target scheme, a greater flexibility is desirable, reason that makes it necessary to analyze the convenience of introducing greater flexibility to said rule.

It is pertinent to point out that, even when throughout 2007 the supply shocks deepened (hikes in international prices of raw material and supplies); in the internal ambit, the monetary policy was supported by the fiscal policy performance and by the formation of the positive expectations of growth of the productive activity on behalf of the economic agents, derived of the best business climate, as well as the levels of investment forecast, associated to the enforcing of the Free Trade Agreement between the United States of America, Central America and the Dominican Republic -DR-CAFTA -.

Within that dimension, it is opportune to point out that before an adverse international scenario that was not forecast (rises in the prices of raw material and supplies, world economic deceleration and greater volatility in the international financial market) and an increase of inflationary pressure on behalf of demand (increase of the deviation of the monetary issue and growth of the banking credit over the programmed runner), it is evident that for 2008 the monetary policy should react opportunely in order that the inflationary rhythm decelerate to the inflation target proposed, situation that would raise the



credibility of the monetary policy in goods-services, money and exchange markets, as well as that of the economic agents.

Finally, the maintenance of fiscal discipline and of the coordination of the fiscal and monetary policies will be determinant in the consecution of the inflation target for 2008 and for 2009.

Sincerely,

Johny R. Gramajo Marroquín  
Director  
Dept. Economic Studies

Sergio Javier López Toledo  
Subdirector  
Dept. Economic Investigations

Luis Felipe Granados Ambrosy  
Asesor II  
Dept. Banking and Financial  
Analysis

Otto René López F.  
Director  
Dept. Economic Statistics

Rómulo Oswaldo Divas Muñoz  
Director  
Dept. Monetary Stabilization  
Operations

Edgar R. Lemus Ramírez  
Director  
International Dept.

Gerardo Noél Orozco Godínez  
Advisor III  
Juridical Advisor

Sergio F. Recinos Rivera  
Financial Manager

F. Estuardo García Alburez  
Secretary

Oscar Roberto Monterroso Sazo  
Economic Manager  
Coordinator

The present document was approved by the Technical Council of the *Banco de Guatemala*, in the December 14, 2007 session.

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# ANNEXES



## ANNEX 1

### SURVEY ON FAMILY REMITTANCES 2007, PERSPECTIVE OF GENDER

As of 2003 the International Immigration Organization –OIM [For its acronym in Spanish]- has made surveys on family remittances, which allow quantifying their effect on the economy of the country, as well as its socio-economic impact mainly on the relatives of those who emigrated who are the beneficiaries of said remittances. In that context, the survey made in 2007 covers diverse topics like the quantification of family remittances; the different modes of sending and receiving them; the socio-economic characterization of the benefited population; the frequency of reception; and the housing conditions. However, when taking into consideration that men as well as women participate, the referred survey focused its analysis on the aspects related to remittances from the perspective of gender.

According to the results of said survey, it is estimated that family remittances in 2007 will reach an amount of US\$3,898.8 million, which would benefit 3,762,798 persons distributed in 961,732 homes, which means that each home receives around US\$338.00 monthly. As to income from family remittances, it is used for the following activities: consumption, that includes food, clothing and shoes, transportation, home equipment and other expenses (48.8%); for investment and saving that includes, purchase of assets, real estate, regular savings, monetary deposits and long term deposits (22.7%); for intermediate consumption; in other words, for the purchase of goods to develop another economic activity (15.2%); and, to social investment, which refers to the separate treatment given to expenses in health and education, due to the fact that the same constitute investment in human capital (13.3%). The results of the survey indicate that the mechanisms through which the homes receive family remittances are mainly the following: electronic transfers (82.6%), *money order* (5.3%) and bank accounts (10.1%).

Also, regarding the sending of family remittances according to the family relation with the beneficiary, the results of the survey show that the remittances are sent to the following: children 48.6%, spouses 17.1%, siblings 13.4%,



parents 3.2% and other relatives 17.7%. When we consider the frequency of reception of family remittances in the home, it was determined that 67.9% receive monthly; 8.0% between 4 and 5 times a year; 7.0% every six months; 6.3% once or twice a year; 5.7% quarterly, while the remaining percentage of homes receives a remittance every 13 months or more.

The greater amount of family remittances comes from the United States of America (97.7%). In an analysis per city, it was concluded that the same come mainly from Los Angeles (30.1%); New York (12.1%); Miami (9.6%); Boston (3.9%); Washington D.C. (3.8%); and, Houston (3.6%). The territories most benefited by the reception of remittances are the following: Guatemala (28.9%), San Marcos (9.5%), Huehuetenango (8.8%), Quetzaltenango (5.9%), Alta Verapaz (5.5%), Jutiapa (4.9%), Izabal (4.3%), Escuintla (4.3%) and Chiquimula (4.1%). Also, 44.9% of those who receive family remittances are in urban areas and 55.1% in rural areas of the country.

Finally, it is important to point out that the average annual rate of Guatemalan immigrants is around 11% regarding the total population of the country, which is due, according to the surveys on family remittances, mainly to the lack of employment and to the need of improving economic conditions. In absolute terms, the number of Guatemalan immigrants in 2002 was of 1,237,162, while for 2007 said number is estimated at 1,482,247, of which 84.8% sends remittances to Guatemala.



## ANNEX 2 SITUATION OF HYDROCARBONS IN CENTRAL AMERICA<sup>54</sup>

The countries of the Central American region are net importers of hydrocarbons, only Guatemala counts on a small petroleum production, which is exported almost entirely.

In the energy sector, the national authorities of the sub-sectors of hydrocarbons and of electricity have worked toward strengthening regional integration. However, in the hydrocarbons sub-sector the conformation of a regional market is found in an incipient phase. To date a series of studies has been made geared toward promoting development in said market, in order to increase the competency among the participants that operate in the countries, which could benefit the consumers with competitive prices. Recently, the process of *Unión Aduanera* has registered significant progress in the harmonization of quality and environmental norms derived from petroleum. Regarding the electricity sub-sector, progress has been substantial, since in the region there is an important exchange among the different countries. A very important event was the recent approval of the Framework Treaty of the Electric Market of Central America<sup>55</sup>, on behalf of legislative organisms from 6 countries.

### 1. Production and consumption of electricity

The energetic consumption in the region is characterized by a high dependency of petroleum derivatives and of biomass<sup>56</sup>; this last in its majority is non-renewable. However, the production of electricity, with a low participation in the global balance, uses equal parts of petroleum derivatives and renewable sources, mainly hydroelectricity.

In effect, between 2004 and 2006, the value of the importations made by region increased close to 72%, when going from US\$4,001.6 million to US\$6,878.2 million; however, the value of importations of hydrocarbons is variable in each country, as a reflection of the specific characteristics of their

<sup>54</sup> Includes Panama.

<sup>55</sup> Has as its purpose to stimulate the competition in the wholesale market of the electricity sub-sector and is composed of the respective markets that subscribed it (Guatemala, El Salvador, Honduras, Costa Rica and Panama).

<sup>56</sup> Fuel that is obtained as a biological resource, such as wood, agricultural residue and manure.



economy and of its energetic alternatives. In 2006, the participation of the countries in the value of importations of hydrocarbons of the region was the following: Guatemala, 25.6%; Costa Rica, 17.9%; El Salvador, 16.3%; Panama, 15.5%; Honduras, 15.3%; and, Nicaragua, 9.4%.

In the 2000-2006 period, the annual importations of crude oil reduced 52.3%, when going, in thousands of barrels, from 35,183 to 16,801. Added to the production of petroleum derivatives in refineries from imported crude oil, it is necessary to acquire already refined products abroad. In effect, during 2006 the production of derivatives was of 16,203 thousand barrels, while the importations reached 82,569 thousand barrels to satisfy the regional consumption of 95,406 thousand barrels, which allowed increasing the inventories by 3,366 thousand barrels. The main imported derivatives in 2006 were the following: diesel with 28,304 thousand barrels; and, gasoline with 22,179 thousand barrels; values that represent, in both cases, little more than triple the regional production.

It is worth highlighting that Guatemala is the country in the region with the greater consumption of hydrocarbons, which in 2006 was of 26,238 thousand barrels, followed by Costa Rica with 16,776 thousand barrels, El Salvador with 15,433 thousand barrels, Panama with 15,063 thousand barrels, Honduras with 14,981 thousand barrels and Nicaragua with 9,144 thousand barrels.

## **2. Energy options for the region**

According to the Economic Commission for Latin America and the Caribbean –CEPAL [For its acronym in Spanish] <sup>-57</sup>, in the mid term, for diversifying its energy matrix and, in this way, reducing its dependency of petroleum derivatives, the countries of the region count on two options<sup>58</sup>: the first is carbon which is abundant in many parts of the world but requires large spaces and infrastructure for storing and use; and, the second option, is the fuel

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<sup>57</sup> Economic Commission for Latin America and the Caribbean –CEPAL [For its acronym in Spanish]-. Proposal for a Sustainable Strategy of the Sub-Sector of Hydrocarbons in Central America 2003 and the Economic Commission for Latin America and the Caribbean -CEPAL- Central American Isthmus: Statistics of Hydrocarbons, 2006.

<sup>58</sup> It is worth highlighting that in the Congress of the Republic of Guatemala they discussed an initiative that hopes to approve the Law of Carbureting Alcohol, which main purpose is to allow the mix of gasoline that is commercialized in the country with carbureting alcohol (ethanol), if said law is approved, this will constitute an additional option for the case of Guatemala.



called Orimulsion<sup>59</sup>, same that is currently used in an electricity generation plant in Guatemala. This fuel, would be economically viable, could guarantee the generation of electricity in the long term and at a low price. Also the use of this fuel will help reduce the deterioration of the environment. The proximity of Venezuela, its only producer, allows counting on this fuel as an option in the mid-term.

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<sup>59</sup> Fuel made of bitumen (heavy petroleum).

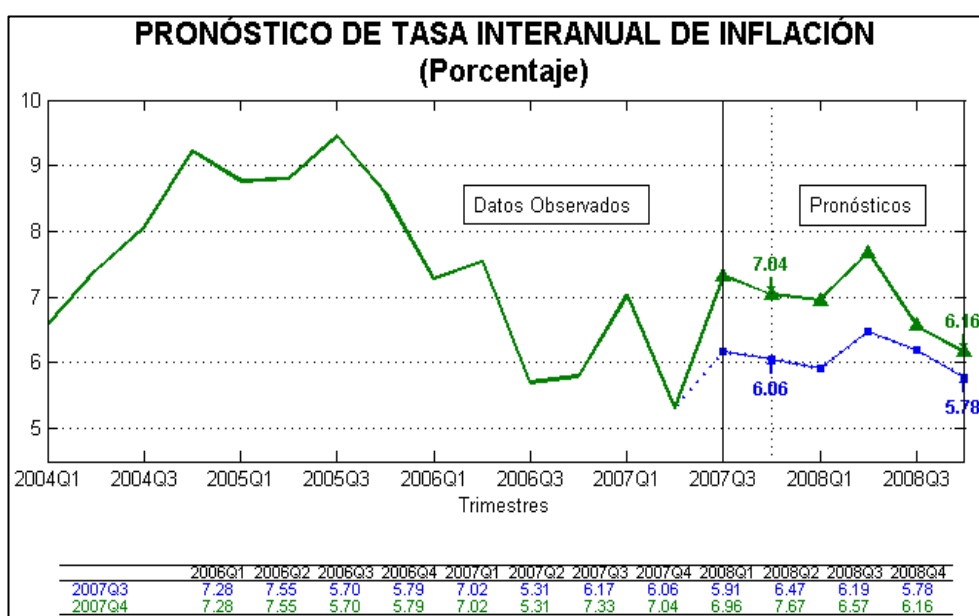
### ANNEX 3

#### RESULTS FROM THE FOURTH RUNNING OF 2007 OF THE SEMI-STRUCTURAL MACROECONOMIC MODEL

##### A. FORECASTS OF INFLATION IN THE MEDIUM TERM

In November 2007 the fourth running of the Semi-structural Macroeconomic Model took place in said year, which allowed obtaining forecasts of inflation in the mid-term consistent with the inter-relations of the main macroeconomic variables that affect the inflation, forecast that is presented in the following graph.

Inter-annual inflation rate forecast



As we can see, according to the forecast of the fourth running of 2007 (continuous line with triangles), for the fourth quarter of 2007 it is expected that the inter-annual inflation be at 7.04% (6.06% in the third running), while for the fourth quarter of 2008 it is expected that said variable be at 6.16% (5.78% in the third running). Said forecasts are conditional in that the Monetary Authority must hold an active monetary policy that leads the inflation toward its equilibrium values in the medium and long terms<sup>60</sup>.

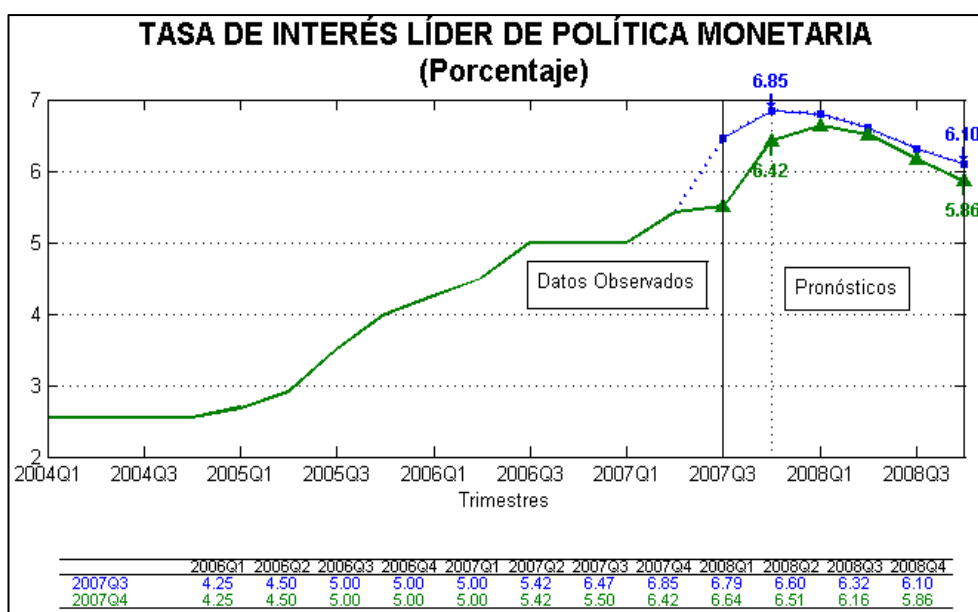
<sup>60</sup> The model is calibrated so that in the long term (2012) it converges with an annual inflation rate of 3%.



In other words, the Monetary Authority is supposed to implement actions to determine the trajectory of the leading interest rate of the monetary policy. In the following graph the trajectory of said rate is illustrated (continuous line with triangles) that will be compatible, according to the MMS, with the inflation forecasts presented.<sup>61</sup>

The average value observed of the leading interest rate of the monetary policy registered in the third quarter of 2007 was of 5.50%, while for the fourth quarter of 2007 and the first of 2008, according to the fourth running of the MMS in 2007, the quarterly averages of said interest rate will be at 6.42% and 6.64%, respectively. As of the second quarter of 2008 a new descending trajectory of the interest rate will begin, in said quarter it will be at 6.51%, while in the last two quarters of 2008 it will be at 6.16% and 5.86%, in that order, as we can observe in the following graph.

*Leading Interest Rate of the Monetary Policy*

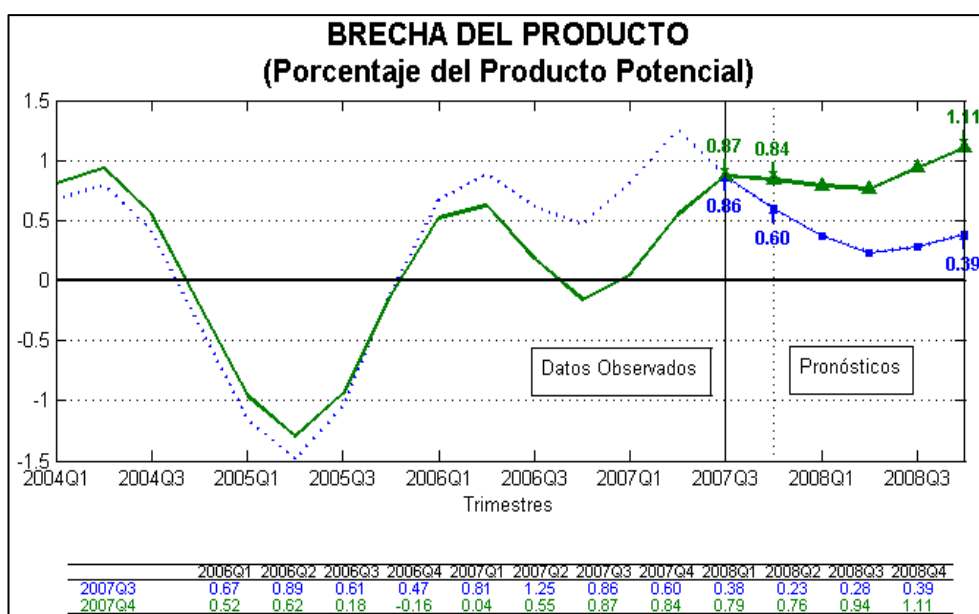


<sup>61</sup> The trajectory for the leading interest rate of the corresponding monetary policy to the fourth quarter of 2007 involves lower rates that correspond to the third running of that year, although the inflation forecasts of the fourth running are higher to those of the third, mainly due to the reduction effect in the observed values and forecasts of the US interest rates and on the other hand, in less measure to the fact that the Monetary Authority in October of this year increased the leading interest rate of the monetary policy for the fourth time by 25 basic points.



Regarding real economic activity, the product gap<sup>62</sup> experimented positive and growing values in the first three quarters of 2007 as we can see in the following graph (continuous line with triangles). On the other hand, from the fourth quarter of 2007 up to the second quarter of 2008, it will continue to be positive, but decreasing. As of the third quarter of 2008 the gap will be positive and growing. Eventually, in the long term, it will converge at its seasonal level in which it will reach a value of zero.

*Product Gap*



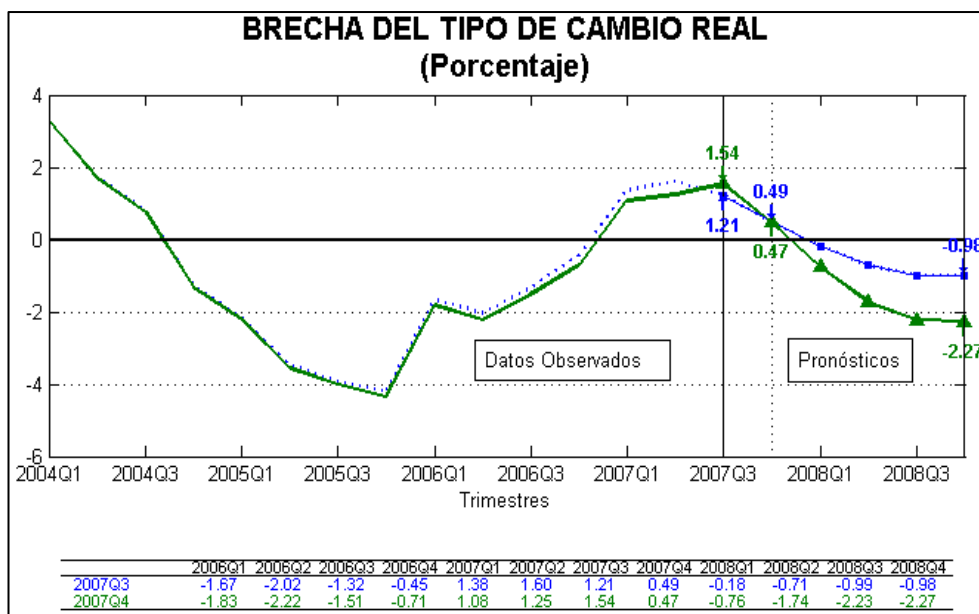
The trajectory of the real exchange rate<sup>63</sup> gap, consistent with the reported forecasts can be appreciated in the following graph (continuous line with triangles), in which we illustrate that said gap was positive in the third quarter of 2007 (1.54%), which indicates that the quetzal would be depreciated in real terms, compared to its equilibrium value in long term. Later, according to forecast, the gap reduces throughout the horizon forecast, reaching a negative value of -2.27% in the fourth quarter of 2008 (0.98% in the third running).

<sup>62</sup> Defined as the difference between the observed gross domestic product and the potential gross domestic product. The potential gross domestic product is defined as the level of the gross domestic product that does not induce inflationary or deflationary pressures in the economy.

<sup>63</sup> Defined as the difference between the observed real exchange rate and the tendency value (or equilibrium value) of said variable, measured as a percentage of the real tendency or equilibrium exchange rate.



*Real Gap Exchange Rate*



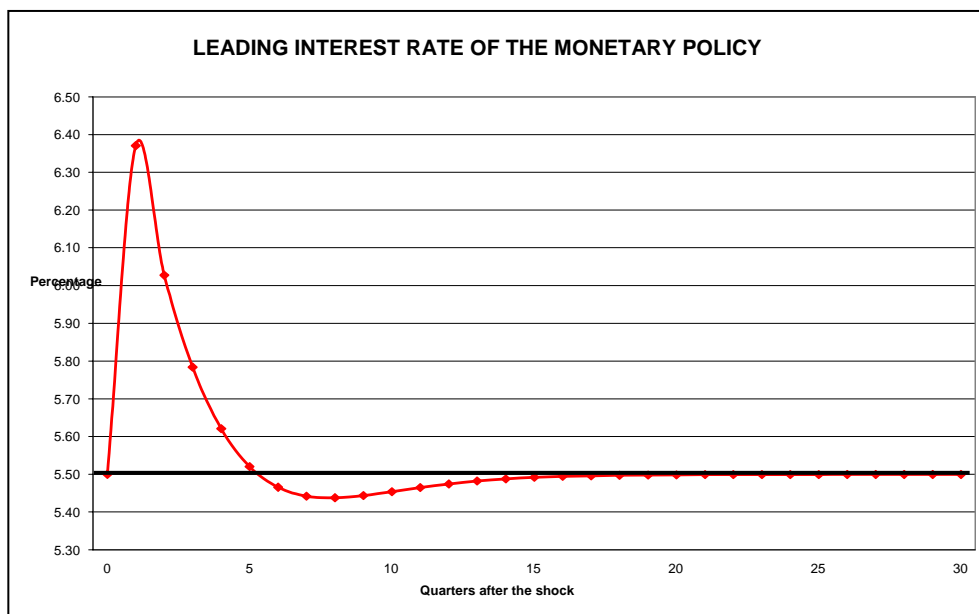
**B. EFFECT ON THE INFLATION AND ON THE ECONOMIC GROWTH RATE, AS A RESULT OF AN INCREASE IN THE LEADING INTEREST RATE OF THE MONETARY POLICY**

The effect generated by an increase of a percentage point in the leading interest rate of the monetary policy on the endogenous variables of the MMS can be measured through analysis of impulse-reaction functions. For the effect, the variables of the model are supposed to be found seasonally at first; in other words, in its equilibrium levels in the long term. Later, a shock (increase) is simulated on the selected variable and the model quantifies the effect that said increase has on the other variables, in a determined period. The mentioned simulation is illustrated in impulse-reaction graphs. It is worth indicating, also, that due to the properties of convergence imposed on the MMS, the variables of the model converge to the value of its seasonal stage; therefore, it is possible to quantify the total effect of the shock on each variable, making an abstraction of the effects that could come from shocks on other variables in the model.

The following graph illustrates the effect on the positive shock of a percentage point in the leading interest rate of the monetary policy, as well as

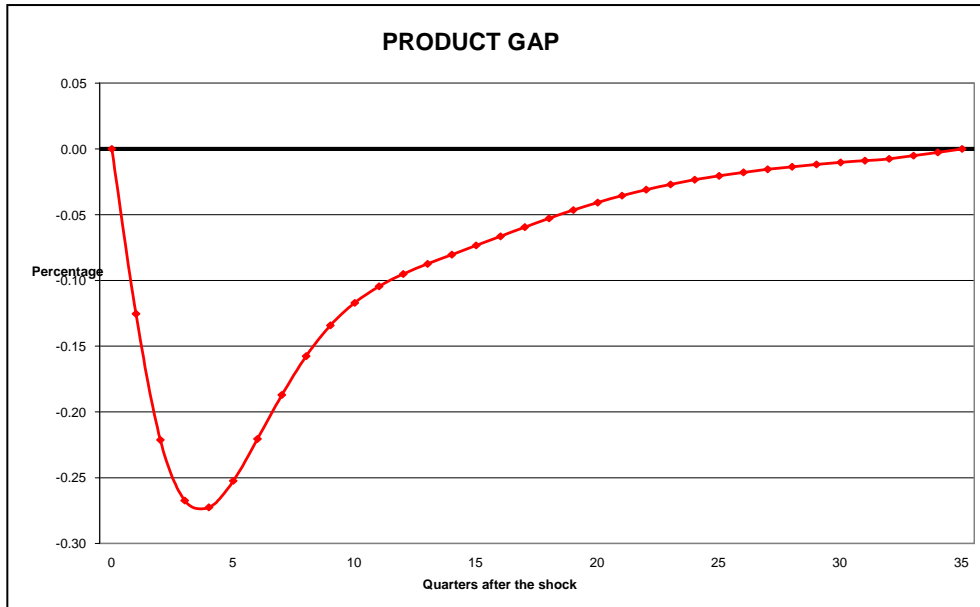


the dynamism of said variable, after impact. The seasonal value<sup>64</sup> of this variable is of 5.5% and is represented by a horizontal line. The total duration of impact is of approximately fifteen quarters, after the increase of a percentage point. However, the interest rate comes back to its equilibrium value in the long term about five quarters after impact. Later, as of the fifth quarter, the interest rate falls slightly below said level and converges gradually to its equilibrium value of 5.5%.



The graph shows the effect of the positive shock of a percentage point on the leading interest rate of the monetary policy on the product gap. As we observe, the increase of the interest rate causes a reduction in the product gap; in other words, the observed product can reduce up to 0.27%, in the fourth quarter regarding the potential product. However, the mentioned shock tends to dilute and the observed product converges toward its potential level, so the product gap tends toward zero, in the long term.

<sup>64</sup> State of the economy in the long term in which the variables grow at constant rates previously specified.



As we see in the graph, the equilibrium inflation rate in the long term is of 3%. A positive shock of a percentage point in the leading interest rate of the monetary policy generates a growing decrease in the inflation rate, which reaches a 2.90% in the seventh quarter; following, said rate converges slowly to its equilibrium state in the long term.

