**Minutes of Banco de la Republica (Central Bank of Colombia)**
**Board of Directors' Meeting of 28th October 2011**

On 28th October 2011, in the city of Bogota, the ordinary meeting of Banco de la Republica's Board of Directors was held with the presence of the Minister of Finance and Public Credit Mr. Juan Carlos Echeverry, the General Manager Mr. José Dario Uribe, and the exclusive full-time dedicated directors, Messrs. Carlos Gustavo Cano, Juan Jose Echavarria, Fernando Tenjo, Juan Pablo Zarate, and Cesar Vallejo, at which inflation and economic growth, as well as the perspectives for both situations are discussed, and decisions relating with the monetary policy are adopted. The following is a summary of the major subjects addressed at this meeting.

## 1. BACKGROUNDS

### a. Recent developments in inflation

Annual consumer inflation in September was 3.73% (0.31% monthly), which means 46 basis points (bp) more than in August. The cumulative price adjustment in the year elapsed as of September is 2.95%, thus higher that the one recorded last year (2.40%) in the same period.

During August, the most significant upward pressures came from the food sector. The annual variation of this basket went up to 5.7%, this being the strongest monthly increase (110 bp) in the course of the year. The main part of food inflation in this last month can be attributed to the perishables group and, particularly, the price of potatoes with increases accruing to 41% since June. These increases are of temporary nature and might be due to the late effects of the rainy season and the normal supply cycle for these products. Accordingly, these price variations are expected to revert once the production cycle is normalized.

With respect to the CPI variation without foods (3%), the sharpest increase was concentrated on the regulated basket (from 5.6% to 6.5%), and it was caused by raises in energy charges in some regions of the country. The other components of the basket of regulated items (fuels, public transportation and other public services) showed more moderate increases. With respect to the CPI of tradables without foods and the regulated, a slight upward trend in the annual variation (0.16%), coinciding with exchange rate depreciation in the past two months, stands out in the annual variation. As per the non-tradables CPI without foods and the regulated, September data (3.5%) do not change in a significant way as compared with the previous month.

Likewise, base inflation went up in the past month but to a lesser extent than total inflation. Although all indicators showed increases, they nevertheless remained within the target range.

Inflation expectations recorded a slight increase in the most recent measurements. The Central Bank's monthly survey shows that inflation expected by the financial market operators for the end of this year is 3.4%, at present, against 3.2% registered in the previous survey. Also inflation expected at the 12-month horizon is 3.4%, while one month ago it was 3.3%. Information obtained from the TES certificates suggests a similar behavior, with increases in the expected inflation at all horizons.

The variation in the producer price index (PPI) increased at an annual 6.6% rate against 5.2% in August. Raises were concentrated in the indicator's imported component.

b. Growth

The different indicators available for the third quarter 2011 confirm that Colombian economy would have continued to expand at a high rate. Just like in the first half of the year, the third-quarter growth would have been driven by domestic demand.

By type of expenditure, household consumption would continue to grow in August at high rates, as suggested by the retail sale indicators (9.7% per annum) and consumer-goods imports (30% per annum). Likewise, the real consumer credit portfolio in the third quarter of 2011 grew at an average rate of 21.6% (18.9% in the previous quarter). In September, household confidence showed further decline, as measured by Fedesarrollo; nonetheless, its level remains high, with a similar average to that registered in 2007 when consumption had grown at a rate higher than 7%.

With respect to investment, perspectives are equally favorable. This can be inferred from growth observed in imports of capital goods, as regards both their machinery component and transportation equipment. In addition, the national production of these goods continues to show positive growth rates propelled by the anticipated good performance of Colombian economy. The commercial portfolio keeps growing at rates close to 20% per year.

On the supply side, industry and construction indicators for the third quarter remain dynamic. In industry, a 9.5% expansion of production stands out. The Fedesarrollo survey of business opinion "*Encuesta de Opinion Empresarial de Fedesarrollo*" also shows good production perspectives for the sector.

In construction, positive dynamism was observed in the third quarter as suggested by the behavior of cement and its national dispatches; in August, they recorded annual growths of 9.6% and 22.2% respectively. The sector's mid-term trends are also favorable as indicated by the area being approved for construction pursuant to licenses granted. It continued to grow in August mainly propelled by the part destined to the residential segment.

In contrast, a reduction is expected in the agricultural sector's production for the third quarter, due to the impact of climatic factors particularly on the coffee crop. Total exports in August grew at an annual 50% rate. This growth was originated in increased sales of crude oil and by-products, coal, and industrial products.

The impetus seen in exports of mining origin can be explained by the behavior of both prices and amounts, the indexes of which recorded annual increases of 38% and 22% respectively. Exports of basic foods of agricultural origin had a lower annual variation (4.2% per year) in August, but, instead, their recovery was slight with respect to the previous month. The price and amount indexes calculated suggest that the increase is more clearly explained by prices (13% per year). In August, external sales without basic products (i.e.

industrial goods and other agricultural products) showed an equally significant annual growth (41%). It was observed in both prices (14%) and amounts (26%).

Regarding employment, DANE information as of August suggests that growth in labor demand was higher than labor supply. This allowed unemployment and underemployment rates to keep on falling during the past few months.

Taking all the above into account, the different forecasting models gave a growth interval between 6% and 7% for the third quarter's GDP.

For the rest of the year, the models do not foresee any important changes in the trends of the macroeconomic variables and, for the whole year 2011, they predict a GDP growth between 5% and 6%.

With respect to 2012, the models suggest a slightly lower growth as compared with the expectations for 2011. These results derive from the projections obtained for key variables like raw-material prices and world's growth.

c. Financial variables

Total credit in national currency ["*moneda nacional*"] (MN) and foreign currency ["*moneda extranjera*"] ("ME") was maintained at high growth rates, above the estimate for the nominal 2011 GDP.

As of September, total (MN and ME) credit was incremented at an annual rate of 23.5%, higher by 38 bp to that observed in August. The consumption portfolio recorded the highest growth rate: 25.8%, exceeding the August rate by 88 bp.
On its side, the mortgage portfolio remained at the annual growth rate of 17.3% prevailing in the previous month.

In September, real interest rates (excluding CPI without foods) for consumer, mortgage and ordinary commercial credits, were placed at 15.1%, 10.0% and 8.0%,

d. <u>External/foreign context</u>

The Greek debt crisis and the vulnerability of the countries in the European periphery to the likelihood of contagion have continued to affect the markets face to the systemic risks currently threatening the Eurozone stability and the weak United States economic growth. In the Eurozone, there is a growing possibility of a recession, this contributing to force a decline in growth forecasts. On their sides, the most recent (September) indicators regarding the manufacturing and services activity are contracting, and the exporting dynamism has diminished.

In the United States, consumer confidence has fallen to very low levels in the past three months (October); this is reflecting in a moderate consumption growth. Likewise, supply indicators are pointing out at deceleration but, as yet, without showing backward movements in their levels. Moreover, the deterioration of the economic and financial situation in Europe, and the effects this may have on world demand, may continue to be a limiting factor to their exports. The United States' economic growth for the third quarter 2011 reached 2.5%, a higher figure than the one being incorporated in the external demand projections.

The emerging economies keep on expanding, but at a slower pace. The GDP in China decelerated in the third quarter and might continue to decline in the remainder of the year, given the predicted weakening of Chinese external demand. In the case of Brazil, a strong deceleration is anticipated as of September in the country's industrial activity, as well as a significant reduction in its GDP growth during the second semester of the year.

As a result of the above, the technical team reduced this year's growth forecasts for the major developed economies. Nevertheless, the GDP growth for the set of Colombia's commercial partners was maintained because price increases in some countries like Ecuador were revised, given the recent trends.

For next year, growth forecasts were significantly reduced for the developed economies and the emerging ones as well. Overall, in 2012, our main partners' growth, though positive, is expected to be lower. It is assumed in this estimation that the economic authorities will adopt credible measures to alleviate the sovereign debt problems in order to ensure the soundness of their financial systems so as to restore the agents' confidence.

Face to the diminished perspectives of world growth, international price forecasts for basic goods exported by Colombia were also reduced, particularly for 2012. Projections take into account the recent trends showed by these quotations in the past three months.

The expected reduction in both basic goods prices and world growth will lead to containment of inflationary pressures in the developed economies. With this, the comfortable position of the monetary policy should be maintained longer than previously planned. Particularly, the reference rates in the United States and Europe are expected to remain at very low levels, at least until mid 2013. In the case of the emerging economies, pressures upon prices may lessen more slowly, thus making it harder to predict falls in the interest rates.

To conclude, the external demand growth for next year is uncertain, and it involves high risks. If the European Union succeeds in refraining fiscal insolvency fears, there is a probability of obtaining a moderate world growth in 2012. Otherwise, if the situation in Europe gets more complicated and if the United States does not ratify the previous quarter's growth trend, the scenario becomes less favorable and it would include a recession in the Eurozone. In this last scenario, both consumers and investors' confidence in emerging economies might be reduced, in this way affecting their domestic demand and the capital market. Also a reduction in national income may occur, since a depressed external demand tends to generate decreases in the prices of the basic goods like those our country usually exports. Should this last situation occur, its worst negative impact would occur in 2012.

## 2. DISCUSSION AND POLICY OPTIONS

Some members of the Board suggested that the Bank's intervention rate should be increased by 25 basis points, taking into account the following reasons: (i) Annual consumer inflation in September was 3.73% (0.31% monthly), i.e. 46 bp more than in August; (ii) Short-term forecasts indicate that inflation will be above the middle point of the target range by the end of

2011. Base inflation measures and inflation expectations have recovered again; (iii) The new information available is still reflecting a very dynamic internal demand, propelled by both private consumption and investment. If confidence and international prices for the main export products remain at high levels, it is to be expected that the strong dynamism of demand would be extended over the next quarters and would generate capacity pressures; (vi) Although the annual growth of bank credit was stabilized, this was achieved at a high rate. The most dynamic portfolio is the consumer portfolio with increases almost threefold the nominal GDP growth estimated for 2011. Price indexes of new and used housing reached the maximum records in the series. The strong dynamism of these financial indicators, usually associated with demand excess and unbalance risks, may be explained in part by real interest rates still remaining at low levels; (v) A timely increase of the Bank's interest rates contributes to the preservation of inflation within the target range, and reduces the risks of financial unbalances subsequently leading to unnecessary volatility of both product and employment; (vi) Uncertainty about the evolution of the world's economy should not delay those decisions that are necessary for the stability of Colombian economy.

Other members of the Board shared the concern expressed by the first group, but they deemed appropriate to keep the interest rate unaltered, taking into account those external factors that reflect higher risks and more uncertainty. However, if international confidence tends to recover and real domestic indicators continue to show their current dynamism, and no major contagion by the external situation is seen, the economy is likely to require lesser monetary stimulus.

Other Board members considered that it is desirable to maintain the Bank's interest rates taking into account that: (i) With respect to 2012, models show a lower growth than expected for 2011. These results derive from the projections at hand for key variables such as the price of raw materials and the world's growth. In general terms, the internal mid-term outlook appears to be less favorable as a consequence of the probable effects of the developed economies' low dynamics. (ii) The agreement signed at dawn on the 27th October at Brussels to avert the deep European crisis left enormous and unanswered questions, like the lack of a definition regarding the delicate situation of Italy and the progressive raise in the country's debt cost, as well as the capitalization of the Eurozone banks and the types of involvement of the major emerging economies in the financing of the rescue fund, among other issues; (iii) The more recent predictions regarding the United States' growth are seriously deteriorated; (iv) A less dynamic world economy would reduce the excessive increase in asset prices and credit growth in the near future; (v) Although the inflation record has increased, this increment seems temporary and it is due to both the delayed effects of the rainy season and the normal cycle of perishable foods supply. In addition, the Bank's technical team predicts inflation decreases in the next 6 months; (vi) The base inflation measures have not changed significantly as compared with the previous month; this suggests that demand pressures on prices have been moderated. Generally, all the inflation indicators have remained within the target range; (vii) Credit dynamics and the increasing value of assets may be due to structural factors, and not only to a low interest rate; (viii) In any ways, imagining prudential regulation measures additional to the interest rate is justified; (ix) Market interest rates have increased recently; this suggests that there is no excess liquidity level in the economy.

## 3. POLICY DECISION

The Board of Directors has unanimously agreed to keep the intervention interest rate unaltered at 4.5%.

The Board will continue to carefully monitor the international situation, the inflation behavior and projections, and growth, as well as the active markets performance; and it insists that monetary policy will depend upon the new information available.

Bogotá D.C., November 11 2011