Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on June 19, 2009

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on June 19, 2009.

Present:
Mr. Óscar Iván Zuluaga, Minister of Finance and Public Credit
Mr. José Darío Uribe, Governor of the Central Bank of Colombia

Full-time Board Members in Attendance:
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Fernando Tenjo
Mr. Cesar Vallejo
Mr. Juan Pablo Zárate

Inflation and the economic situation growth were discussed with respect to growth and prospects for the future, and monetary-policy decisions were reached. The following is a summary of the principal topics addressed during the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in May was 4.77% having fallen for the seventh month in a row. Accumulated inflation during the first five months of the year was 2.3%. This is well below the figure registered last year (5.12%). The core inflation indicators continued to decline.

The annual variation in food prices fell from 7.9% in April to 5.5% in May, mainly due to perishable food prices, which went from an annual increase of 14.5% in April to 4% in May.

The annual increase in regulated prices declined from 7.6% in April to 6.5% in May, due to fuel and residential natural gas prices.

Inflation in non-tradables, excluding food and regulated prices, was down as well, having gone from 4.9% in April to 4.7% in May. Less of an annual variation in items with "low indexing," particularly personal services, was a highlight. The variation in items with "high indexing" (financial, medical and educational services) was less as well, but is still above the 7% level. Inflation in rentals completed three consecutive moths of declines and was 4.7%.

The annual increase in prices for tradable goods, excluding food and regulated prices, went from 2.6% in April to 2.8% in May.

The inflation-expectation indicators measured on the basis of local government bonds increased in recent weeks, particularly for the five and 10 year horizons.

The annual variation in producer prices (PPI) declined from 6.6% in April to 5.3% in May.

b. Growth

DANE reported a 19.4% annual increase in civil works for the first quarter of 2009, highlighting the contribution from the sector comprised of waterways, ports, dams and other port works, which saw 54.6% growth with respect to the same quarter the year before, and the contribution from the mining construction subsector, with an annual variation of 93.5%.

The information at hand shows signs of recovery in expectations among business people and consumers, even though internal economic activity remains weak:

- The DANE figures on industrial production at April show -14.5% growth that month. This sharp drop was due, in part, to fewer working days in April 2009 compared to the year before, because of Easter Week.

- The Fedesarrollo Consumer Opinion Survey (EOE: Spanish acronym) for industry in April shows a drop in the indicators for orders and inventories compared to the levels reported the month before.

- According to DANE, retail sales in April were down 7.1% in annual terms, which is similar to the drop in March, but more than the annual decline reported during the first quarter (-5.5%). In May, the commerce information released by Fenalco suggests no major break in these tendencies.

- Cement production is down by 15.1% during the course of the year to May. However, this is less than the drop registered for the year to April (-16.6%). Cement production can be related to both national construction and foreign orders.

- The Fedesarrollo EOE for industry and commerce in April shows that business people in these sectors have better expectations for production and sales during the next three months. This, in turn, occasioned a break in the downward tendency in these variables.

- The Fedesarrollo Consumer Confidence Indicator registered an important increase in May and recovered from the extremely low level observed in April.

The trade balance in the first quarter of 2009 showed a deficit of USD11 million, in contrast to a surplus of USD342 m registered a year earlier. This was due to the fact that the drop in exports (13.2%) exceeded the drop in imports (-9.5%).

The annual decline in export value (USD1,144 m) during the first three months of the year is explained largely by fewer sales of oil and petroleum derivative to the U.S. market. Sales to that market, which account for 31% of all exports, fell by 26.8%. Exports to Venezuela represent nearly 20% of the total and rose 4.1% due to an increase in sales of beef, fuel and boilers.

FOB imports between January and April totaled USD 10,058 m and experienced an annual reduction of 12.5%. In CIF terms, they came to USD

10,640 m and were down by -13.3%. Intermediate goods and raw materials acquired in the United States, especially mining, chemical and pharmaceutical products, registered the most significant drop in total purchases.

c. External Context

Following the dramatic downturn in the world economy during the last few months, several indicators of household and business sentiment show signs of improvement. Moreover, the sharp inventory reduction observed in GDP in the United States suggests a change in economic performance during the second half of the year.

As for the emerging market economies, the recovery in industrial production in China and India, along with certain signs of a recovery in exports from other Asian countries, have been an incentive to commodity purchases and have improved the sentiment in capital markets. Nevertheless, economic activity continues to decline in most countries. In Latin America in particular, the first quarter of 2009 saw a sharp drop in Mexico and contraction in Brazil and Chile, although not as dramatic. Peru would have experienced growth, but at less of a rate than the year before.

The decline in demand and lower commodity prices compared to the levels observed a year ago have helped to lower inflation within the region, particularly in Chile, Colombia and Peru. This, in turn, coupled with better expectations for inflation, has facilitated additional interest rate cuts by the central banks. However, some market rates, especially those for consumer lending, have yet to react in line with the monetary stimulus.

During the last three months, the region's major currencies have appreciated against the dollar and are reaching the levels observed a year ago with respect to the euro. This offset the depreciation witnessed between January and February. The build-up in the major Latin American currencies has occurred in the context of a weakening dollar against the other hard currencies and less risk perception with respect to the emerging countries.

d. Financial Variables

In May, M3 and liabilities subject to reserve requirements (LSR) registered 16% annual growth, following the temporary slowdown observed in April. That slowdown and the subsequent recovery were related to the accumulation of National Treasury deposits with the Central Bank of Colombia in April and the draw on May 15 to cover COP$4 trillion in TES that fell due. Another COP$6 trillion in TES are set to mature in July.

Annual growth in the loan portfolio in domestic currency came to 15% in May, which is similar to the increase observed during the previous quarter. As to the different types of loans, the slowdown in the consumer portfolio continued; its nominal annual growth at May was 3.9%. However, the balance of consumer loans has stabilized at around COP$39.4 trillion since March of this year. The reduced speed of consumer lending contrasts with the added expansion in commercial loans. The commercial loan portfolio registered an annual increase of nearly 21% by May, with the momentum in disbursements on ordinary, preferential and treasury loans being particularly important.

The loan portfolio in foreign currency with local intermediaries declined by COP$1,087 m during the course of the year to May. Direct external lending was up US$279 m by April.

The Central Bank's interest rate cuts (500 bp) passed through quickly to the inter-bank market, to deposits and to commercial lending; however, in the case of household loans, the pass-through has been slower. At the end of May, the interbank rate (6.00%) and the IBR (6.04%) were in line with the benchmark interest rate. Moreover, from the onset of the rate reduction policy (December 19, 2008) up until the last week of May 2009, the DTF rate fell by 408 bp to 6.11%. The decline in rates on ordinary consumer lending between the same dates also has been significant (-443bp), having gone from 17.75% to 13.32%. The drop in interest rates on consumer and mortgage loans during the same period was less (-134 bp and -159bp in the same order). Those rates ended May at 24.20% and 15.73%, respectively.

When discounting non-food inflation from the interest rates on savings and loans, the results also show an important reduction. Real average DTF and lending rates (according to the method used by the Central Bank) declined by 305bp and 362bp, respectively, between December 2008 and May 2009. In May, they were 1.72% and 8.38%, in that order.

The interest rate on short-term TES declined in line with the benchmark rate. The rates on longer term TES have seen less of a reduction. Between December 19, 2008 and May 29, 2009 the TES zero coupon curve registered respective reductions of 395bp, 228bp and 162bp in the one, five and 10-year tranches.

2. DISCUSSION AND POLICY OPTIONS

The following points were emphasized by the Board during its deliberations:

i The pace of price hikes and its steady decline
ii The drop in food inflation and in non-tradable inflation excluding food and regulated prices
iii International prices for food, raw materials and oil, which could have a major impact on total inflation, depending on the country's trade policy and how the exchange rate performs
iv Better expectations, despite weak economic activity
v Growth in the peso loan portfolio in the financial system due to the commercial loan portfolio and, to a lesser extent, the mortgage loan portfolio
vi The rapid decline in most interest rates in the market in response to the Bank's benchmark rate cuts.
vii Negative growth in the United States and less economic growth in Venezuela, Ecuador and the economies of other trading partners
viii The impact of the exchange rate on inflation and growth in the tradable sectors
ix The rise in interest rates on government bonds
x Intermediate and long-term expectations for inflation

The main points of the discussion among the Board members centered on: (i) the elements that affect inflation forecasts for 2009 and 2010, including the indexing mechanisms incorporated into certain prices; (ii) the lag between monetary policy measures and their impact on production and prices; (iii) the uncertainty generated in international markets by the world financial crisis and its impact on the Colombian economy; (iv) the region's access to external financing, direct investment flows, and the reasons for limited momentum in the loan portfolio in the financial system; (v) the risk balance between growth and inflation in a context where the economy is slowing and inflation is falling; (vi) the relevance of continuing to lower the intervention rate, given the latest data; (vii) the recent increase in medium and long-term expectations for inflation; and (viii) the need to bolster the monetary authority's credibility and to anchor inflation expectations to the long-term target.

The members of the Board underscored the fact that annual consumer inflation (4.77%) declined for the seventh month in a row. Again, this was a case of food prices, in addition to non-tradable goods and regulated prices. The core inflation indicators continued to decline.

The price pattern ratifies the fact that weak internal and external demand, expectations for inflation and the drop in commodity prices compared to the high point in 2008 are reflected in less inflationary pressure. The Board expects annual inflation to drop sharply in June and to end the year below the midpoint of the target range (5%).

Several indicators of expectations in the industrialized economies changed for the better, which suggests they could be stabilizing. The recovery of production in China and India, together with certain signs of a recovery in exports from other Asian countries, have stimulated commodity purchases and improved performance on the capital markets. However, the negative effects of the world crisis are expected to continue throughout the year. Most Latin American economies saw a contraction in output growth during the early months of 2009, together with a pronounced drop in inflation. The sharp devaluation in Latin American currencies witnessed at the start of 2009 has been corrected in a context marked by a weak dollar and less perception of risk with respect to the emerging market economies.

The international crisis has affected Colombia mostly by dampening consumer and producer expectations and slowing the momentum in exports and remittances. Business and consumer expectations reveal signs of recovery for the second half of the year, even though economic activity remains weak. Lending continues to grow at a good pace, fueled largely by commercial borrowing, while the performance of the financial system remains healthy. The Board of Directors expects interest rates on commercial and household loans to continue to fall.

Several Board members indicated they preferred to leave the intervention interest rate unchanged or to cut it by 25 bp, based on the following considerations. Unlike other countries, Colombia has not suffered a financial crisis that justifies extreme policy measures and unusually low interest rates. Moreover, given the significant weight of external factors in the explanation for the slowdown in the country's economic growth, lower interest rates probably would not have a major positive impact on productive activity. In addition, medium and long-term expectations for inflation registered an increase during the past month. If that increase persists, monetary policy would have to react accordingly.

Other members voiced their preference for a 50 bp cut in the intervention interest rate and an announcement to the effect that, with the data at hand, no further changes in that rate are anticipated in the near future. The latter takes into account the delayed effect of a cumulative reduction of 550 bp in the intervention rate on economic growth during the remainder of the year and in 2010, the recent pattern in medium and long-term expectations for inflation, and the fact that part of the reduction in inflation is the result of a temporary shock in food prices.

The members agreed the sharp increase in money supply, the reduced variation in food and regulated prices, a less negative external environment and the added momentum in civil works suggest a gradual recovery in economic growth as of the second half of the year. Moreover, they agree the stance of the country's monetary policy makes it possible to consolidate the reduction in inflation towards its long-term targets.

Given the foregoing, the members of the Board decided to lower the Central Bank's intervention rate to 4.5%. This implies a reduction of 50 bp.

3. POLICY DECISION

The Board of Directors agreed to reduce the Central Bank's intervention interest rates by 50 bp and to announce that, given the data now available, no additional changes in that rate are expected in the near future. This decision places the Bank's intervention interest rate at 4.5%

Bogotá D. C., July 3, 2009