Minutes of Banco de la Republica (Central Bank of Colombia) Board of Director's Meeting of 29th June 2012

1. **Backgrounds**

    a. Recent developments in inflation

Annual consumer inflation in May stood at 3.44%, which means 1 basic point (bp) above the previous month record. This result can be explained by an increase in the annual variation of the CPI without foods which shifted from 2.81% in April to 2.94% in May, and a 29-bp reduction in the annual variation (4.72%) as compared with the previous month figure.
Year to date, a CPI increase of 1.92% has accrued, lower than the increment seen during the same period in 2011 (2.2%).

In the CPI without foods, the annual variation increase was due to a significant acceleration of the annual CPI for regulated items in the last month (from 3.83% to 4.42%). This fact was explained mainly by the energy price increase. As for fuels, the lowest international oil quotation has begun to be transferred to the domestic gasoline price, the annual variation of which fell from 5.7% in February to 3.7% in May.

The other CPI sub-baskets without foods, as well as the tradables and non-tradables sub-baskets showed small changes in May without actually affecting the performance of annual inflation in a significant manner. While annual variation of tradables rose from 0.91% to 0.96%, the non-tradables variation fell from 3.77% to 3.74%. Leases kept rising (5 bp) on a continuous basis for over a year, and finally stood at 3.7% in May.

The annual variation of the CPI for food fell from 5.01% in April to 4.72% in May.

This behavior has been explained by the perishables group that, in the same period, declined from 4.68% to 1.18% thus suggesting that the conditions of the farming supply have tended to go back to normal. On the other hand, rises were originated in the processed foods sub-baskets (rice among others) and out-of-home meals.

Core inflation indicators experienced a slight increase. The average of three indicators monitored by Banco de la Republica closed at 3.35%, which means 5 bp above the previous month.

In May, the annual variation of the PPI declined from 1.56% to 0.80%, and kept on declining since the fall commencing last October. In the past two months, the variation of the PPI for imported items (-1.1%) has began to be less negative, in line with the lower peso appreciation recorded in April and May. In contrast, the annual variation of the local PPI (1.2%) continued to go down during May, which reflects the slower adjustment rhythm of the PPI for farming, as well as for industry, and mining.

Inflation expectations deriving from the TES (treasury securities) at different horizons declined in the past month and are standing around 3%, while those obtained from the month survey did not show significant changes: inflation expected as of December is 3.3%, and 12-month inflation is 3.5%.

b. Growth

In the first quarter of 2012, the Colombian GDP grew 4.7% in annual terms, this figure standing at the lower part of the forecast interval established by Banco de la Republica's technical team. In this manner, the national economy actually registered decelerations in its growth rate for two full quarters after an expansion of 7.5% in the third quarter and 6.1% in the fourth quarter of 2011. As compared with the previous three-month period, a new slowdown was registered considering that the annual growth of the GDP shifted from 5.1% at the end of the previous year to 1.1% in the first quarter.

By spending type, this slowdown in the GDP was explained mainly by a moderation in investment dynamics by shifting from an annual growth of 14.2% in the last quarter of 2011 to 8.3% in the first quarter of 2012. Within this aggregate, the fall (8.1%) registered in civil works stood up, as explained to a great extent by a drop corresponding to the oil and mining sector. Investments in transportation equipment and machinery did also record downturns, but they are growing again at high rates since 2000, above their averages. Building construction was the only investment component having experienced acceleration, since it grew from 1.8% in the fourth quarter of 2011 to 4.5% in the first quarter of 2012.

Likewise, a slowdown in the annual growth rate was observed in household consumption. This aggregate, with a 5.9% expansion (as opposed to 6.1% in the fourth quarter of 2011) was the variable having contributed the most to the GDP performance, and it continued to grow at a rate higher than its average since 2000. Household spending in the first quarter of 2012 was driven mainly by both purchases of non-durable goods and service dynamics. On its side and for a second consecutive quarter, durable goods consumption reached an annual expansion rate lower than its average since 2000. Government consumption continued to show moderate growth, in this manner becoming the less dynamic aggregate on the demand side. As a result of the above, domestic demand grew at and annual rate of 6.1% in the first quarter.

In the first quarter, a sharp annual growth reduction was registered in exports and imports, where the growth rate for the latter shifted from 21.3% in the fourth quarter of the previous year to 13% in the first quarter of 2012, and from 16.2% to 6.3% in the case of external sales. The combined contribution of both aggregates to GDP growth was negative (-2.2 pp).

On the supply side, the branches having contributed the most to the annual growth of the first quarter's GDP were, in this order, financial and leasing services, mining and commerce, restaurants and hotels. In the mining and manufacturing industry sectors, less expansion records were witnessed. In the case of mining, slowdown was due to supply problems. The growth rate of industrial GDP shifted from 3.9% in the last quarter of 2011 to 0.6% in the first quarter of 2012. The agriculture and construction sectors experienced annual drops, due to lower coffee production in the case of agriculture and to the behavior of civil works in the case of construction.

With respect to the economic situation for the second quarter, most part of information available shows a slowdown in the economic activity. In April, industrial production contracted in annual terms for two consecutive months. With respect to construction, the area approved of according to construction licenses continued to register annual setbacks.

Demand indicators suggest ongoing deceleration in household consumption in the second quarter, in this way getting closer to its average growth in 2000 (4.0%). This slowdown can be inferred from data relating to commerce sales (which fell 2.8% in annual terms in April) and imports (consumption goods sales in dollars grew 6% in April after having grown nearly 10% in March). Homes confidence in quarterly terms has declined slightly as compared to the first quarter of the year.

Colombian exports in April registered an amount of US$ 4.886 billion and grew 4% in annual terms. This growth rate is lower than that observed in previous months (22.5% on average between January and March), and it can be explained by a 41.7% reduction in agricultural exports, a 9% fall of industrial exports without basic goods, an a more reduced annual growth rhythm (11.5%) in external sales of mining origin. By products, oil and oil by-products grew 19.4% in annual terms in April, thus offsetting the 20% fall in coal sales. As for exports of coffee, banana, and flowers, they experienced reductions of 57%, 10.9% and 18.7% respectively. On its side, the fall of industrial exports was due to less sales of foods and beverages (-15.6%), chemicals (-9.8%), and textiles (-16.4%).

c. Financial Variables

The total national and foreign currencies (“MN” and “ME”) portfolio registered in May an annual increase of 17.7%, lower by 70 bp than in April and 346 bp as compared to December 2011. This behavior was determined by the commercial loan portfolio, the growth of which stood at 15.3%, 60 bp lower than the previous month’s rate, thus contributing to a year-to-date slowdown of 420 bp. As for the annual growth of the household portfolio, consumption declined from 25% in March to 22.1% as of Junes. On the other hand, the mortgage portfolio exhibited an annual 16.9% growth in May.

Real interest rates in May (excluding CPI without foods) for consumption, mortgage and ordinary commercial credits, in that order, stood at 15.9%, 10.2% y 9.0%

d. External Context

In the second quarter of 2012, the real activity and confidence indicators show a slowdown in global economy. In the United States, information suggests a slower growth rhythm, while in the eurozone, as well as in England, the economic activity continues to deteriorate. Japan, on its side, has moderated its expansion pace after a recovery associated with the reconstruction. China and India, like other developing Asian economies, have also deteriorated. In Latin America, Brazil continued to exhibit lower rates quarter after quarter and, as of March, its GDP annual growth approached zero.

In the United States, real activity indicators have continued to expand, though the last information available evidences some slowdown signs. Recent data from the labor market indicate that the recovery taking place in the first months of the year might cease to make satisfactory progress in the second semester. Thus, in June, both consumer confidence and sentiment indices in the manufacturing sector weakened.

On the eurozone side, although the economy did not shrink again in the first three months of the year, some real activity indicators available for the second quarter evidence that the region has continued to weaken. For this reason, a GDP contraction is highly likely in this period. In addition, starting in May, uncertainty grew in international markets due to a recrudescence of political and financial tension in the eurozone. The likelihood of large-sized economies like Italy being threatened by contagion grew, thus increasing risk perception significantly in the international financial markets.

The results of the recent elections in Greece, along with the commitment of the European Union to rescue the Spanish banking system were only a temporary relief of the markets' nervousness, since they cannot see short-term measures capable of stabilizing the economy and leading it towards recovery. The evolution of the agenda over better fiscal and financial integration would determine the way risk perception will behave in the next few months. If these discussions are carried out in a fast and credible manner, uncertainty could be expected to decrease.

The entrepreneur and consumer confidence indices remain depressed, while sentiment indices in the manufacturing and service sectors have worsened. The deterioration of economic prospects and signs indicating that they might get worse in the short term could jeopardize even more recovery opportunities in the developed countries. All the above keeps at high levels the risk of the European periphery's economies, impairs confidence, and might drag the eurozone down to a drop in its output even higher than projected by the markets.

The reduced European dynamism has began to affect the behavior of the emerging economies in Asia as reflected in the weakening of both exports and industrial production, and accentuating the ongoing slowdown they had been exhibiting since mid-2011, generated by the withdrawal of fiscal and monetary stimulus policies

Except for Indonesia, the April 2012 figures of industrial production in the major emerging Asian economies show deceleration. For the specific case of China, industrial production, retail sales, and investment growth have been moderate in the past few months. In India, economic growth has decreased in a significant manner in the past few quarters, and the real activity indicators for the second evidence the continuation of this tend.

In the Latin American economies, the economic growth of Chile, Mexico, Peru, and Venezuela was favorable in the first quarter of the year, as opposed to the situation in Brazil where, once again, real activity has decelerated. Current year's information in April shows that industry has shrunk in Brazil, Colombia, and Peru. Growth in Chile and to a lesser extent in Mexico has decelerated.

The world's economic slowdown has reduced pressures upon international commodity markets. Oil and food prices have decreased in a significant manner in the past few months.

In this context, monetary policy in the advanced economies remains lax and no hardenings are to be expected in the next few quarters. Conversely, if the global environment deteriorates further, central banks in this group of countries could implement better encouragement measures.

To this date, the most recent data show that the main effects on the Colombian economy of the European crisis and the global economic slowdown have been deteriorating in external sales which would give way to growth deceleration in the tradables sectors other than mining, and a lower oil price that would adversely affect the terms of trade. With respect to the latter, the index observed as of May is still kept at high levels, in part as a consequence of the lower international price for imported goods. To this date, other channels through which the national economy might suffer (i.e. external financing, internal confidence and country risk) have not been significantly affected.

2. POLICY DISCUSSION AND OPTIONS

By a majority, the Board of Directors deemed appropriate to keep the policy interest rate unaltered, considering the following factors:

(i) Global growth declined in the second quarter of the year. In the United States, information suggests a lower growth rate while in the eurozone several indicators show that the economy is shrinking. Problems in this region have affected global economy prospects through both confidence and trade and capital flows. The emerging economies exhibit a more moderate expansion rhythm reflecting mainly in the weakening of exports and industrial production.

(ii) In Colombia, like in other emerging countries, the global economy weakening effects have been felt in lower demand and export prices. This has lead particularly to growth deceleration in the tradable sectors other than mining. Both industrial production in March and April and the agriculture GDP in the first quarter of the year have shrunk.

(iii) Civil works construction fell in the first quarter, a phenomenon not having been envisaged in the Bank’s projections. In contrast, the financial, commercial and transportation and communications sectors exhibited significant dynamism propelled by growth in domestic demand, which has been encouraged by the favorable confidence and financing levels.

(iv) Generally, Colombian economic growth in the first semester has been lower than expected. The GDP growth figure in the first quarter stood close to the upper limit of the forecast range carried out by the Bank's technical period for this period. A downward revision is foreseen in the forecast range for the year.

(v) The annual growth of the commercial loan portfolio continues to slow down. Household - and particularly consumer - credit, though more moderate now, remain high. The mortgage loan portfolio is growing at a good pace along with another increase in the new-house price index in March which remains at historically high levels.

(vi) In May, annual inflation was 3.44%, this figure being similar to the April record. The core inflation average, just like the mean of inflation expectations one-to five-year ahead, stands at a rate slightly higher 3%.

Some Directors highlighted the dynamic growth of private domestic demand, as well as the dynamism of foreign direct investment inflows, and a stable unemployment rate despite deterioration in the international environment, particularly in the eurozone. They stressed that neither financing nor confidence and country risk have been significantly affected regardless of the reduction experienced in the national exports by reason of both lower prices and amounts, and a growth slowdown above projections. They deemed that inflation expectations are close to the mid-point of the target range, and economic growth is not far from its potential. They pointed that even if credit dynamics became more moderated in the past few weeks, financial unbalance dangers and risk-taking in the economy have not vanished; this would likely affect employment and output growth sustainability in the medium term.

Other Directors said that, according to information available, ongoing international deterioration can be foreseen for a prolonged period of time, with adverse effects on domestic demand and the terms of trade. In the internal sphere, more deceleration than expected has been observed in the agriculture and industry sectors which are the most important contributors to formal employment in the country. They are of the opinion that monetary policy effectiveness lies on the authorities' anticipation ability; therefore, in this scenario, a stance relaxation phase must be undertaken in order to prevent drastic adjustments in the future. Consequently, they have proposed a 25-bp reduction in the intervention rate.

3. POLICY DECISION

According to the assessment of the current balance of risks, the Board of Directors has decided to keep the intervention interest rate unaltered. The new information shall permit to establish new monetary policy actions.

The Board confirms that Banco de la Republica has both the tools and sufficient resources to meet the liquidity needs in local and foreign currencies usually required by the economy, as well as those likely to be felt in an environment of international financial turbulence.

The Board will continue to carefully watch over the international situation, inflation behavior and projections, as well as growth and the performance of asset markets; and it restates that monetary policy will depend upon the new information available.

Bogotá Colombia, july 13th 2012