Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on May 29, 2009

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on May 29, 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. Pablo Zárate

Inflation and the economic situation 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 at the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation was 5.73% in April, having declined for the sixth month in a row. For the first four months of the year, cumulative inflation was 2.3%, which is well below the figure for the same period last year (4.2%). Most of the core inflation indicators dropped faster than at the beginning of the year or at the end of 2008.

Annual food inflation declined from 8.7% in March to 7.9% in April. The bulk of the drop was in processed foods.

Due to fuel, regulated price inflation went from 8.1% in March to 7.6% in April.

Non-tradable inflation, excluding food and regulated prices, declined from 5.36% to 4.8% in April, mainly because of rentals. It is important to point out that this indicator has not gone below 5% since March 2007.

Tradable inflation, excluding food and regulated prices, rose from 2.5% in March to 2.6% in April.

The various inflation-expectation indicators measured on the basis of local government bonds at 1, 5 and 10 years continued to fall. At the start of May, they were between 3.2% and 4.0%, which is the lowest level since mid-2006.

The annual variation in producer prices (PPI) declined from 6.8% in March to 6.6% in April.

b. <u>Internal Growth</u>

Available figures confirm the fact that internal economic activity remains weak.

- The data released by DANE on industrial production show 0.4% more activity in March compared to the same month in 2008. When adjusted by the number of working days, this amounts to an annual reduction of 7.2%. DANE reported a 7.5% slump for the first quarter.

- The annual rate of decline in the demand for energy was 5%. However, when adjusted by the number of working days, it increased 3%.

- The Fedesarrollo consumer sentiment indicator fell again in April, while the consumption indicator dropped to levels similar to those posted in mid-2002.

- February retail sales reported by DANE reflect an annual reduction of 7.1%, following the downturn begun in mid-2008. This coincides with the lower sales indicator reported by Fenalco for April.

- The decline in building permits and cement production continues.

As to external demand, total exports in dollars were down 15.3% for the year to February, following a 51.9% increase during the same period in 2008. This reduction was reflected in traditional exports (-21.4% in 2009 versus 74.8% in 2008) and non-traditional exports minus gold (-14 % in 2009 versus 16 % in 2008). Coals was the only product in the traditional group to register positive performance, while ferronickel, oil and petroleum derivatives, and coffee suffered declines originating with a drop in their implicit prices and not in export volume (with the exception of coffee).

With the exception of bananas, the value of non-traditional exports to the U.S. (minus gold) continued to decline (-30.1% in 2009 versus 9.9% in 2008). All exports to Venezuela showed less momentum as well compared to the same period in 2008, having gone from 86 % annual growth in 2008 to -12 % in 2009. Nonetheless, sectors such as agriculture, the chemical industry, thread, yarn and fabric, base metals, and machinery and equipment posted annual increase compared to the same period in 2008. As to countries other than the United States, Venezuela and Ecuador, sales of non-traditional products were down 10% by February (having been up 16.4% by February 2008). This was mainly because of a 0.9% decline in industrial exports (14% at February 2008), particularly clothing, food and beverages, and machinery and equipment.

On the contrary, non-traditional exports to Ecuador experienced a 3.5% annual increase, after declining 0.1% during the same period in 2008.

Total imports dropped 10.2% between January and March 2009 compared to the same period in 2008. An analysis by product (CUODE classification) shows the slowdown was led, in part, by intermediate goods, which went from 18.3% growth for the year to March 2008 to an annual rate of -22,0% for the same period in 2009. The annual reduction in consumer goods was 6.3% by March 2009, in contrast to 15.7% annual growth in 2008. Capital goods are up 1.1% this year, showing less momentum compared to their high point in February 2008, when they increased 35.4%.

The monthly figures up to April show higher unemployment nationwide and in the 13 major urban areas: 12.1% for the country as a whole 12.9% in the 13 urban areas. Respectively, these figures are 1 pp and 1.6 pp above those registered for the same period last year. As in March, the higher unemployment rates in April were due primarily to a large increase in the labor supply (measured by the global participation rate). That month, occupation rates were up slightly.

c. The External Context

The U.S. economy posted a 6.1% annualized quarterly (a/q) decline during the first quarter of 2009. This is the third consecutive drop in GDP in the United States. The contraction in the fourth quarter of 2008 came to 6.3%. The Euro Zone and the United Kingdom also experienced a considerable setback during the first quarter: 9.8% a/q and 7.4% a/q, respectively. Japan was the most dramatic case, with a 15.2% a/q drop in GDP. However, the financial markets have regained a measure of optimism, as demonstrated by an increase in stock market indicators and consumer and investor confidence, and by the drop in risk premiums.

The emerging economies have been hard hit and many reported less economic activity in the first quarter. For example, in Latin America, the annual decline in Mexico's GDP was 8.2%. Peru reported annual GDP growth (3.1%), but it has slowed. There is no first-quarter GDP data for Chile and Brazil, but indicators such as the one for industrial production point to a sharp slowdown in activity during that period.

Some emerging market economies are benefitting from the recovery in commodity prices, and countries such as China and Korea are showing signs of recovery. After having declined sharply, exports from China, Hong Kong and Korea posted positive levels in March and April.

A number of central banks reduced their benchmark rates again during the past month and a half. The European Central Bank (ECB) lowered its rate by 25 bp to 1%. In Latin America, the latest adjustments were made by the central banks in Chile and Peru, with respective cuts of 50 bp and 100 bp, which placed the rates in those countries at 1.25% and 4.00%.

The exchange market in Latin America has reversed since March, pursuant to the decline in risk perception. There has been a sharp, generalized build-up in the price of the region's currencies in relation to the dollar as of March. The euro in relation to the dollar exhibited a similar trend, as did other currencies in Asia and Eastern Europe.

d. <u>Financial Variables</u>

The annual increase in base money slowed during April. The same was true of M3, given less growth in liabilities subject to reserve requirements (LSR), which was related to an increase in government funds on deposit at the Central Bank at the end of April and the beginning of May to cover TES maturities.

During the last month and a half, the decline in the financial system's nominal portfolio in domestic currency came to a halt and the annual rate of growth in that portfolio stabilized at around 15%. As to the different types of lending, most of the momentum centered on commercial loans, which posted an annual increase of 19.6% during the first week of May, as opposed to 17% in March. The largest disbursements in recent weeks were for preferential loans, with annual increases of nearly 100%. On the other hand, the increase in disbursements on ordinary loans remained at around 40%. The year to date has seen an increase in maturities on new commercial loans, especially ordinary lending.

Annualized growth in the consumer loan portfolio during the last two months was negative in nominal terms and was accompanied by further deterioration in quality and increased loan-loss provisioning. Slightly more than half of the provisions accumulated this year, per portfolio in domestic currency, are for consumer lending.

The slowdown in external borrowing continued during March and April. A reduction in the loan portfolio in foreign currency explains this trend, since direct borrowing by the private sector increased 5% (in March) with respect to the same month in 2008.

Given the foregoing, the annual increase in total borrowing (domestic and foreign currency) was 12.9% in March, which is less than in February (13.5%) and at the end of 2008.

Studies done by the CB technical team show lending has been affected by factors related to both supply and demand. The consumer loan portfolio appears to be governed by restrictions on supply. As for the mortgage loan portfolio, in addition to supply constraints, the demand for loans of this type has slowed. The commercial loan portfolio is the one least subject to supply constraints.

In April and early May, the policy rate cuts continued to pass through quickly to market rates, particularly in the case of interest rates on deposits and commercial lending. During April, the CDT and DTF rates declined by slightly more than 100 bp compared to the month before, and interest rates on ordinary, preferential and treasure loans fell by nearly 130 bp. Deposit interest rates dropped by around 300 bp between December 19 and the end of April, while the reduction in commercial lending rate was between 260 bp and 390 bp. The pass-through to interest rates on household loans has been much slower, although it did pick up speed last month with respect to consumer lending. Consumer, credit card and mortgage lending rates dropped 85 bp, 101 bp and 142 bp, respectively, between mid-December 2008 and April.

All TES interest rates decline sharply between late March and mid-April.

2. DISCUSSION AND POLICY OPTIONS

The following points were emphasized during the Board's deliberations:

i The increase in prices at rates that continue to exceed the inflation targets set by the Board, despite a sustained downward trend
ii The drop during the month in non-tradable inflation, excluding food and regulated prices, which was due to rentals
iii The decline in international prices for food, raw materials and oil, compared to the high levels in 2008, which could have a significant impact on total inflation, depending on the country's trade policy and the exchange rate
iv The continued slowdown in economic activity, which is confirmed by available data
v The end to the slowdown in the total loan portfolio of the financial system, and the fact that most interest rates in the market declined quickly in response to the CB benchmark rate cuts

vi Negative growth in the United States and less growth on the part of Ecuador, Venezuela and other trading partners
vii The effect of the exchange rate on inflation and growth in tradable sectors
viii The downturn in interest on government bonds
ix Intermediate and long-term expectations for inflation, which are within the target range set by the Board of Directors

The main points of the discussion among Board members centered on: (i) the elements that affect inflation forecasts for 2009 and 2010, particularly the indexing mechanisms incorporated into certain prices; (ii) the lag between monetary policy measures and their impact on production and prices; (iii) the impact domestic gasoline prices can have on inflation (iv) the uncertainty generated by the world financial crisis in the international markets and its impact on the Colombian economy; (v) the region's access to external financing, direct investment flows, and the reasons for less growth in the financial system's loan portfolio; (vi) the risk balance between growth and inflation in a context where the economy is slowing faster than anticipated and expectations of inflation have declined; and (vi) the need to bolster the monetary authority's credibility and to anchor inflation expectations to the long-term target.

The Board mentioned the slowdown in annual consumer inflation. In April, it declined for the sixth month in a row. The drop involved food prices as well as other family-market-basket items, with the slowdown in non-tradables and regulated prices constituting a high point. The core inflation indicators continued to decline in April, as did inflation expectations, which approached the intermediate and long-term target range (3%+/- one percentage point).

The foregoing is proof of the fact that the slump in internal and external demand, the decline in inflation expectations and the drop in international commodity prices compared to the high point in 2008 have a great deal to do with less inflationary pressure. The Board believes annual inflation will continue to subside in the months ahead and could end the year below the midpoint of the target range (5%).

The slowdown in the world economy is confirmed by the output data for countries during the first quarter of the year. However, the last few weeks have seen signs of stabilization in the U.S. economy and a significant recovery in China. Moreover, asset prices in certain industrialized and emerging economies have begun to perform in a positive way. In Latin America, the sharp devaluation in currency prices at the start of 2009 has been corrected and risk premiums have declined.

In Colombia, the international crisis has manifest itself primarily in a loss of consumer and producer confidence and less momentum in exports and remittances. After being adjusted by the number of working days, the latest available figures on industry, commerce and construction point to sharp reductions. Nonetheless, the financial system remains healthy.

In view of the foregoing, the members of the Board unanimously agreed to lower the Central Bank's intervention rate by 100 bp to 5%. Mention was made of the fact that the intervention interest rate has been cut by 500 bp in nearly five months and its current level is clearly expansive. Interest rates on loans to companies and families are expected to continue to decline; although, in certain cases, they will be affected by risk premiums. The monetary stimulus, a less negative external environment and the expectation of added growth in public investment all point to the possibility of a gradual recovery in economic growth as of the second half of 2009. Given the data on hand, the Board expects any future reduction in the Central Bank's interest rate to be less than the recent cuts.

Finally, the Board reiterated the importance of continuing to monitor the international financial situation, so monetary-policy measures to address its impact can be adopted when needed.

3. POLICY DECISION

The Board of Directors agreed to reduce the Central Bank's intervention interest rate by 100 bp to 5%.

Bogotá D. C., June 12, 2009