Minutes of the Banco de la Republica Board of Director's meeting on

December 16, 2011

On December 16, 2011, the regular meeting of the Board of Directors of the Banco de la Republica was held in the city of Bogota.

Present were:

Juan Carlos Echeverry, Minister of the Treasury and Public Credit
Jose Dario Uribe, the General Director
Full-time Board members present: Carlos Gustavo Cano, Juan Jose Echavarria, Fernando Tenjo, Juan Pablo Zarate and Cesar Vallejo

The inflationary and economic growth situations as well as the outlook for both were discussed and decisions were made with respect to monetary policy. Below is a summary of the main topics dealt with in this meeting.

1. BACKGROUND

a. <u>Recent developments in inflation</u>:

Annual consumer inflation in November was 3.96% (0.14% monthly), 6 basis points (bp) lower than in October. The adjustment of accumulated prices over the course of the year is 3.29%, which is higher than what had been registered during the same period last year (2.51%).

The drop in total inflation during the month was mainly due to the slowdown in the variation of food prices. The CPI excluding food, in turn, remained at 3.03%. This was the result of a decline in the annual change in the CPI for regulated items that offset the increase in the CPI for tradables and non-tradables (excluding food and regulated items).

In the case of the CPI for food the annual change went from 6.6% in October to 6.4% in November as a result of which the accumulated six-month rising trend has been interrupted. In terms of annual variations, the declines were concentrated in perishables as they went from 17.6% in October to 14.6% in November. For the majority of the other subgroups in the basket, there was an upswing in the annual change. In the case of potatoes and fruit, there have been absolute drops in prices that occurred after a period of significant rises. This suggests that the recent movements have been associated with the normal supply cycle for these products. So far, the intense rainfall caused by the Niña phenomenon has not caused an interruption in the supply chain for food except in the case of milk and eggs. The prices for imported food have registered few rises in the last few months in spite of the depreciation of the peso. This could be linked to some declines that have been seen in international prices.

The slowdown in the basket for regulated prices (a fall of 48 bp compared to October) was due to a correction in the fees for electricity in Cali after a sharp rise that was registered two months ago. In the case of the domestic price for gas and the prices for public transportation, there were no significant changes in November, but there was a significant rise in the cost of natural gas. This was the item that exercised the most upward pressure on that sub-basket.

The CPI for tradables excluding food and regulated prices, in turn, was at 0.6% (annual variation) compared to 0.4% the previous month. For several months this group has been showing increases that are related to the depreciation of the exchange rate in the second half of the year.

With respect to the non-tradables excluding food and regulated prices, the annual change in November was 3.6%. Rent, which is the main component of this basket, showed a slight upward trend which, nonetheless, does not imply any annual readjustments that are much above 3% yet (3.3% in November).

In spite of the fact that total inflation declined, core inflation continued to rising in November. The average for the three indicators monitored by the Banco de la Republica was at 3.34%, which is 7 bp more than the month before. Even if all of the indicators rose, they would still remain within the target range.

Inflation expectations did not show significant changes in the last month. Those expectations obtained through the monthly survey as of December of this year are at 3.6%, which is the same as it was a month ago, and those for 12 months are at 3.4%, which is slightly above the responses in October. The expectations obtained on the basis of the TES showed a slight dip after the increase registered the previous month. All of them except for the 10 year expectations stayed between 3.5% and 4.0%.

In November, there was a significant reduction in the annual variation of the PPI (to 6.8% after 7.9% last month). The slowdown occurred in both the group of imported goods and the one of locally produced and consumed goods.

b. <u>Growth</u>

The latest indicators of economic activity for the third quarter of 2011 confirmed that the annual growth rate for the economy surged in comparison to what had been seen in the first half of the year. It also confirmed that the Colombian economy is still being driven mainly by domestic demand.

In the information that was recently published, the most interesting was the data on public works projects for the third quarter. According to DANE, the indicator rose 22.8% in annual terms. The largest expansion within the area was in construction work associated with the mining sector. The census on building shows that there has been an increase of close to 10% annually in area occupied by buildings in the third quarter. Other quarterly indicators associated with the service sector (hotels, travel agencies) and livestock (animal slaughter) also showed favorable performance in the third quarter.

The strong domestic demand for the period occurred within a framework of relatively low, real interest rates, high availability of loans, and a rise in employment. Under these conditions, household consumption has continued to show strong performance, especially in relationship to the purchases of durable goods. Investment has been driven by public works construction projects, by the purchases of machinery and transportation equipment, and by the expansion of housing.

By branches of activity, the sectors that have registered higher rates of growth are construction and mining.

The few indicators available for the fourth quarter of 2011 are showing a little slowdown in the rate of annual growth although their strength is still high. Sales of vehicles continued to rise per unit in November. Consumer confidence recovered in November after having dropped in the previous three months. The level of this indicator can still be considered high (it has been above its average since 2001). The consumer loan portfolio continues to expand at rates that are close to 25%.

With respect to supply, most of the indicators associated with the industrial sector remain stable (orders, inventory, demand for electricity, etc.). ANDI also revealed that the growth of industrial production up to October was 6%, a figure that is similar to the one given a month earlier (6.1% for the year up to September).

In October, total exports in dollars came to a value of US$4.713 million and grew 32.6% annually. This increase is mainly the result of mining exports. Foreign sales of agricultural commodities (coffee, bananas and flowers) declined 5.3% compared to the same month a year ago. This performance came from primarily the drop in the quantities of coffee (20% annually) and flowers (15.5% annually) sent. The rest of the exports excluding commodities registered an annual growth of 8.1% driven mainly by food, beverages and chemical products.

In the labor market, the unemployment rate continued its declining trend. The monthly figure as of October was 9.0% for the national total and 10.2% for the thirteen main cities. With respect to the national total, this figure is the lowest for the last decade. Again, the larger growth of the labor demand (measured as the employment rate) in comparison to the growth of the labor supply (measured by the overall participation rate) explains the drop in the unemployment rate.

The performance described is in line with what is contemplated in the September Inflation Report where there is a range of output growth for the entire year that is between 5% and 6%.

c. <u>Financial Variables</u>

Total loans in national (NC) and foreign (FC) currency are maintaining high rates of growth. All of the types of credit including those for both household and business continue to register a growth that is well above the growth of economic activity.

In November, the real interest rates (discounting the CPI excluding food) for consumer, mortgage and commercial loans were at 14.9%, 9.9%, and 8.3% respectively. These figures are lower than the averages that have been seen since 1998.

d. Foreign Context

The measures taken to overcome the European debt crisis after the meeting between the European Central Bank and the leaders of the European Union from December 7 to 9 seem to have been considered insufficient by the markets. This is what has been demonstrated by the recent increase in the interest on the Italian and Spanish 10-year bonds and the drop of the euro to US$1.30, its lowest level since January of this year. As a result, the financial markets are remaining at high levels of volatility.

The new information available suggests that the global economy is deteriorating at a higher rate than expected. In the euro zone, a very low rate of growth is projected for the last quarter of 2011 and the first one of 2012 with a high risk that it will go into negative territory. In particular, the marked deterioration of business and consumer expectations just like the lower rate of expansion in the largest economies in the region (Germany and France), causes them to anticipate a mediocre performance in 2012. Furthermore, the liquidity restrictions of the European banks, in spite of the cut in the benchmark interest rate (from 1.25% to 1%) and the new liquidity easing approved by the European Central Bank, threaten to strangle credit. Add to this the rigidity of the fiscal adjustment imposed by the new regulations, which limit the structural deficit to 0.5% of the GDP for member countries of the European Union. This could accentuate the slowdown in economic activity in the short term. In the United States, the better indicators for economic activity in the last few weeks have mitigated fears of a double recession. However, the foreign risks associated with Europe or a sharp slowdown in China could limit their rate of growth.

In the emerging economies the data from the latest months show a sharper slowdown than was estimated in the central scenario in the September Inflation Report as a result of domestic and foreign factors. China and Brazil have begun to implement less restrictive monetary and fiscal policies in order to encourage domestic demand and counteract the effects of more limited foreign growth. In China, the fall in housing prices has begun to generate concern. During the last few years, construction has been the primary motor for growth in this economy and a crisis in that sector could cause a sharp slowdown.

In terms of monetary policy, the advanced economies are holding to a lax position and some emerging economies such as Brazil and Thailand have begun to lower their benchmark rates. For the next few months, analysts expect that more economies will follow suit and help stimulate domestic demand in each country.

The international prices for the main commodities have declined moderately. Specifically, the international price for petroleum is in the upper part of the range estimated in the last quarterly report. As a result, the terms of trade remain high and continue to drive national income.

The biggest risk of the central growth forecasts is a disorderly adjustment in Europe. If this should materialize, the global economy will grow considerably less than expected, the international prices for commodities could fall and global risk aversion will be exacerbated. This will have an adverse effect on the Colombian economy. There is a lot of uncertainty about the magnitude of a tightening like that and its effects.

2. DISCUSSION AND POLICY OPTIONS

The majority of the Board thought it would be advisable to keep the Bank's benchmark interest rates unaltered based on the balance between the foreign and domestic situations, a balance that is, nonetheless, highly sensitive to the new information available.

The opinion of the Board was that, regarding the foreign front, the following points should be kept in mind: (i) The international financial markets are still showing high levels of volatility as a result of the sovereign debt problems in Europe. It is probable that the economies in the euro-zone will shrink in the last quarter of 2011 and in the first half of 2012, though there is high level of uncertainty about the magnitude of the contraction and its effects. (ii) If a disorderly adjustment should materialize in Europe, the worldwide economy will grow considerably less than expected, the international prices for commodities could fall, and global risk aversion would be exacerbated. All of this would adversely affect the Colombian economy. (iii) The United States economy may expand at a moderate rate and it is expected that it will continue to do so for a prolonged period. (iv) Various emerging economies have shown recent signs of a slowdown.

In the domestic context, the following should be kept in mind: (i) The international prices for commodities remain at high levels and are stimulating the national income of producing countries. (ii) The most recent information on the performance of economic activity suggests that the growth of the GDP in the third quarter will surpass 6%. (iii) Commercial lending is growing at a high rate and seems to be surging. The performance of consumer loans suggests that households have raised their degree of leveraging considerably. (iv) The indices for new and used housing prices are still at their maximum registers. (v) The measurements of core inflation continue to rise and the majority are surpassing 3%. (vi) The information available shows that, as a result of the increases in the benchmark interest rates and the performance of other international and local variables, inflation expectations obtained through the TES stopped rising and even showed a slight drop and, (vii) signs that, even if the Colombian economy remains strong, this momentum could be moderating.

The inflation expectations and forecasts are increasingly dominated by the expectations and predictions concerning the climate, which monetary policy lacks appropriate tools to deal with and, (viii) the probable impact of decisions regarding wages and labor regulations on inflation expectations and workings of the labor market.

One member of the Board expressed as his opinion that the benchmark interest rates should be raised 25 bp based on the following: (i) The sectors in the domestic context of the Colombian economy that were pointed out indicate the need for an increase in the benchmark rate. As was mentioned before, the excessive growth of loans and the persistence of low interest rates could be a source of financial imbalances, while the excessive expansion in demand or increases in labor costs, could raise inflation expectations and lower the credibility of monetary policy in a context in which the core inflation indicators continue to grow and, (ii) even if the international financial markets remain at high levels of volatility as a result of the difficulties related to the sovereign debt problems in Europe, the level of uncertainty has not changed with respect to the previous month and the probability of a disorderly financial adjustment is low. In addition, the United States economy is expanding at a positive rate.

3. POLICY DECISION

The Board of Directors agreed by majority to keep the benchmark interest rate unaltered.

The Board will continue to monitor the international situation, the inflation trend and projections, growth, and the performance of the asset markets carefully and reiterates that the monetary policy will depend on the new information available.

Bogota, December 22, 2011