Minutes of Banco de la Republica (Central Bank of Colombia) Board of Director's Meeting of 28th May 2012

On 28th May 2012, in the city of Bogota, D.C., 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 Governor 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 April stood at 3.43%, which means 3 basic points above the previous month's record. This result can be explained to a great extent by an increase in the annual variation of GDP for food which shifted form 4.56% in March to 5.01% in April.

Rises in the CPI for foods came from the processed food baskets (rice among others) and meals eaten out of home. In the latter case, annual variation has already climbed to 5.9%, likely due to the sharp growth experienced in domestic demand. On the other hand, the annual variation of perishable foods continued to decline, which suggests that farming supply conditions are tnding to return to normal.

Moreover, the CPI without foods recorded a mild fall in its annual variation, as explained by a significant deceleration in the CPI for regulated items (from 4.9% to 3.8%) that was concentrated in electric power fees. In addition, the brake put on the international oil price since the end of February has made minor adjustments possible to domestic fuel prices.

With respect to the annual variation in prices for tradables without foods and regulated items, a non-anticipated acceleration (from 0.7% to 0.9% in March) took place, relating to a sharp adjustment in telephone fees and a lower price appreciation in April as compared to previous months. Worth mentioning is the fact that the peso ceased being appreciated since mid-March and its depreciation began since mid-May. On the other hand, the annual variation in the CPI for non- tradables without foods and regulated items rose 6 bp in the month, and ended up close to 3.8%. Leases continued to accelerate on a gradual basis as it has been occurring for over twelve months now up to 3.6%

Core inflation indicators rose after having remained virtually unchanged for two months. The average of the three indicators monitored by Banco de la Republica closed at 3.3%, which means 7 bp more than in the previous month.

In April, the annual variation of the PPI remained at 1.6, in this manner consolidating the fall experienced in the previous months. In the case of the PPI for imported items, the accumulated appreciation of the peso kept the annual variation in negative terrain, though upward, while the local PPI continued to decelerate as leaning on a lower adjustment rhythm in farming prices.

Inflation expectations deriving from the TES (treasury securities) at different horizons increased slightly in the past month and are standing above 3.0%, while those obtained from the monthly survey did not show significant changes: inflation expected as of December is 3.3%, and 12-month inflation is 3.5%.

b. Growth

The most recent indicators regarding the economic behavior in the first quarter of 2012 exhibit mixed signals. On the one hand, household consumption would have accelerated with respect to what was registered by the end of last year while, in the other hand, the industry grew very little in this period.

The good behavior foreseen for private consumption in the fist quarter is based on the dynamics of commerce sales with a 5.1% growth (according to the National Administrative Department of Statistics – DANE), which continue to show an upward trend. In addition, imports in dollars of consumption goods grew 10.3% in March, as propelled mainly by imports of non-durable goods. Likewise, private consumption would have been favored by the good conditions existing at the labor market, since the unemployment rate has continued to decline while total and salaried employment are exhibiting relatively high (about 5%) positive annual growth rates.

With respect to supply indicators, the fall in oil and coffee production in the previous months adds to the rather modest behavior of the manufacturing sector having contracted 0.9% in March in annual terms. With this record, industry production grew 1.7% on an annual basis in the first quarter, this being the lowest figure for a whole tree-month period since 2009. In analyzing production by sub-sectors, it is found that half of them are stagnant or even counter falling.

In construction, cement production moved backward in the first quarter as compared to the previous one, although it shows important annual growths (of about 8%). Besides, in the area approved of, according to construction licenses, a strong annual contraction (18%) was recorded in the first quarter. Although this fall is due to comparing the current record with past year's high levels, also some stagnation in the indicator can be seen.

As for Colombian exports, they experienced and annual growth of 16.1% in March (in dollars). This behavior can be explained by the increase of external sales of commodities of mining origin, particularly oil and coal. On the other hand, agricultural exports declined 15% in annual terms, owing to the fall in coffee and banana sales. The reduction in the remaining exports was 1.5% due to a comparison basis effect, since their value had increased in a significant manner with respect to the two previous months.

By incorporating the above information, a deceleration was seen in the GDP growth in the first quarter of 2012 as opposed to the fourth quarter of the previous year, in annual terms. The negative behavior of the industry would have been offset by the commercial sector's dynamism.

For the second quarter, the scarce information available points to deceleration in household consumption. On the one hand, vehicle sales grew 2.4% less than a half of what had been observed (5.6%) in the first quarter. Worth highlighting is the fact that these goods bolstered the expansion of household spending to a great extent in previous months. On the other hand, in May, slight moderation in the consumption portfolio growth was noticed, with an annual growth rate of 23.2% (as of May 4), as compared with 25% registered in March.

The Fedesarrollo business opinion survey for April showed a good performance for several indicators (orders, stocks, production expectations and so forth). Year-to-date, these behaviors have taken place simultaneously with stagnant trend growth rate levels in the industry. Therefore, this might suggest that this tendency may continue in the second quarter.

Given the above, projections for full year 2012 submitted in the March Inflation Report did not change. The forecast interval remains between 4.0% and 6.0%.

c. Financial Variables

Total credit in national and foreign currency ("MN" and "ME") registered in April an annual increase of 18.3%, 135 and 499 bp below those of March and July 2011, respectively. This behavior was determined by the commercial loan portfolio, the growth of which stood at 15.9%, this rate being 160 bp less than in the previous month, and adding a 745 bp deceleration in the past nine months. As for household credit, that destined for consumption having stabilized at a 25% grew rate between July 2011 and March 2012 kept a mild moderation in the last weeks with a reduction of 25% in March to 23.3% as of May 4. On the other and, the mortgage portfolio showed in April an annual growth of 16.9%, this record being close to the average (17.2%) since July 2011

Moreover, real interest rates in April (discarding CPI without foods) for consumer, mortgage and ordinary commerce credit, in that order, stood at 16.3%, 10.3%, and 9.3%, these rates being lower than their respective averages estimated since 1998 (excluding mortgage credit, the average of which is measured from May 2002).

d. External Context

For the first quarter of the year, the most recent data of global economic activity show better growth than expected in some developed economies (Germany, Japan and, to a lesser extent, the United States), along with records below the forecasts in certain countries of the European periphery (Spain and Italy), and more deceleration than predicted in some emerging economies (like China and Brazil).

In the United Sates, production continued to expand rather slowly, while real activity indicators suggest that this trend tends to continue. In the eurozone, although production came to a halt in the first quarter of the year, it nevertheless was higher than expected by the analysts and the Bank's technical team. The larger expansion of German economy with relation to the rest of the region prevented it from sliding into a recession. If this country's production is excluded, the result would be a eurozone growth having remained in contractive terrain for three quarters.

More recent data as of April such as consumer and entrepreneur's confidence in the U.S. manufacturing and service sectors show that they have been kept at low levels. In the case of the eurozone, confidence is slightly more deteriorated as compared with previous months, just like some real activity indicators; all this suggests, as foreseen, that growth in the second quarter would be negative.

With respect to emerging economies, the effects of the European crisis have already begun to affect the major economies in Emerging Asia. Therefore, both exports and industrial production have continued to decelerate and some of them have contracted.

In the Latin American economies, signals are mixed. On the one hand, real activity has continued to decelerate in Brazil despite the economic authorities' efforts towards economic reactivation in the country. On the other hand, economies like Mexico, Chile, Ecuador, Peru and Venezuela go on growing at a good pace, although some of them with increases below their true potential. The highest risk perception has heightened volatility in the international capital markets and been translated into a slight increase in the risk premiums in the region's economies, together with a depreciation of their currencies with respect to the United States dollar.

With relation to international oil prices, the reduced tensions in the Middle East and Northern Africa, as well as the high oil inventories in the United States and increased fears of a recession in Europe, have helped decrease these prices. Nevertheless, the levels continue to be favorable for the exporting economies.

In this context, monetary policy in the advanced economies continues to be lax and no hardening is expected in the few next quarters. Conversely, if the global environment becomes more deteriorated, the central banks in this group of countries will implement more encouragement measures.

In brief, results as of March suggest that the GDP of the country's trade partners may grow in 2012 at a positive rate, though lower than the rate seen in 2011. The few figures of April's real global activity continue pointing out to a deceleration scenario worldwide.

The international financial market is awaiting the result of the elections to be carried out in Greece on 17th June. There is a strong likelihood that a new elected government led by the Syriza left-wing party would be willing to renegotiate or even reverse the structural reforms and fiscal commitments accepted by the former government as a condition to have access to the second financial rescue at the beginning of the year. The non-performance of these commitments would stop the flow of rescue and external finance funds, this entailing for the country, among other things, sovereign debt default, a banking crisis and, with it, the imminent Greek exit from the Euro. This scenario might have serious consequences for the economies in the whole eurozone with regard to Greece's official and private debt default, since this would bring enormous losses for both the European Governments and banking system.

Likewise, the probable exist of Greece from the eurozone might infect other countries in the region. Debt default by the Greeks would increase the pressure on the sovereign debt of other economies in the European periphery and increase its problems, in this manner punishing the cost of these countries' debt still further by making it be perceived as more risky. Should larger countries like Spain or Italy arrive to this situation, the rescue funds of the BCE (the European Central Bank) and the IMF might be insufficient to provide some relief.

The European banking system is already in a precarious situation; therefore, a significant financial shock like the one that may occur if Greece does not remain in the euro might affect it still further with very intense repercussions in the real sector. Even the likelihood of possible bank runs in the European periphery is beginning to be contemplated in the face of general fear of financial system bankruptcy.

In the last few weeks, the financial markets have been equally attentive to the evolution of the banking system in Spain. By mid-April, the Spanish government found itself in the need of intervening Bankia, one of the largest commercial banks, as a result of the high exposure of this entity to the real estate sector having increased the amount of bad credits. Bankia capitalization reveals the week situation of the Spanish banking system and its high exposure to the real estate sector. Although the other major banks in the country do not show the same problems, this cannot be affirmed in the case of smaller entities. In the face of this situation, the Spanish government intervention in other banks is not to be dismissed, and this would compromise further its fiscal situation.

For fear that this may become generalized in other countries, the European Committee has suggested that the region's rescue fund may be used to capitalize those banks in need for those resources. Nevertheless, the idea has not had the German support and, even if it is eventually approved of, many debates and political consensus are required; but they might be very time consuming and likely to hold up a solution for the current European banking situation.

Should the increased risk perception and the deterioration of the region's consumer and investor confidence resulting from these recent facts be prolonged, they would negatively affect the eurozone dynamism already weakened, thus increasing the risk of a strong recession in an environment where their economies have little fiscal and monetary leeway space to confront it, apart from a fragile financial system.

Although not information is still available for an assessment of the effect of these latest events on the manufacturing sector/industry worldwide if risk factor levels remain high, and this might erode confidence at world level with negative consequence on consumption, investment, credit, and global trade and commerce in general. In addition, if Greek exit form the eurozone materializes, the likelihood of a financial crisis leading to a new global recession may increase. Under this last scenario, the negative effects on the Colombian economic activity might be very strong.

2. POLICY DISCUSSION AND OPTIONS

Unanimously, the Board of Director deemed that maintaining the policy interest rate unaltered would be appropriate, considering the following factors:

(i) In the external context, German economic growth in the first quarter did more than offset GDP falls in the remaining countries. In the same period, both Japan and the United States to a lesser extent registered higher growths than projected. In the large emerging economies like China, Brazil and India, deceleration has been worse than expected;

(ii) In May, uncertainty grew regarding the permanence of Greece in the eurozone. This added to other financial an political events in Europe rose international risk premiums, affected securities markets in a negative way, and weakened the currencies of the emerging economies, including the Colombian peso;

(iii) The recent developments taking place in Europe increased the risks of a strong recession in this continent in an environment where their economies have little fiscal and monetary leeway space to confront it, and a fragile financial system. The growing likelihood of this scenario heightened the uncertainty of core growth forecast for Colombia;

(iv) The international oil price was reduced below the expectations a month ago. Despite this fact, the terms of trade continue to be high and serve to bolster growth in national income;

(v) In Colombia, economic growth in 2012 is expected to stand between 4% and 6%. Both private demand dynamism in terms of both household consumption and investment will continue to be the main source of this growth. However, information available throughout the year points out to more moderation in household consumption and investment in line with the growth forecast for the full year;

(vi) The increase in the commercial loan portfolio has slowed down, as explained by lower dynamic in loans in foreign currency. The increase in household loans, particularly consumer credit, remains high. However, the quality of the latter has deteriorated;

(vii) In April, annual inflation (3.43%) was slightly less than estimated and similar to the previous month's record. Averages for the core inflation measurements and expectations rose slightly, although risks to inflation are moderate.

Some co-directors highlighted the good performance of the Colombian economy, motivated by the dynamic behavior of household consumption, high confidence levels, capital inflow dynamism of foreign direct investment, the favorable terms of trade observed up to the present, and the dynamic performance of most production sectors. All of the foregoing helps think that with the current interest rate levels in our core scenario, the growth of the economy is close to its actual potential, and the inflation projections are attaining the 3% target.

Nevertheless, they emphasized the high and growing degree of uncertainty confronted by the Colombian economy as a result of public debt problems and the weakness of the financial system in some of the eurozone economies. Should these risks materialize, they might affect in a considerable manner the prices of the major export product and confidence as well. Anyway, Banco de la Republica has the monetary policy framework required to face them, together with sufficient tools and resources to attend to liquidity needs in both local and foreign currency, as well as those that might occur in an international environment of financial turbulence.

Additionally, co-directors insisted in the need to keep the careful monitoring of consumer credit that, despite having shown a slight moderation in the past few weeks, maintains a high annual real growth rate with respect to the real GDP growth.

Finally, after having adhered to the decision of maintaining the reference interest rate unaltered, a co-director, said that, in his opinion, Europe has already slid into recession and contraction, excluding Germany. He believes that Spain and is a particularly hard case, and that China, India, and Brazil are decelerating more than expected. Although Colombian exports in dollars continue to increase, he proves that agricultural and industrial sales have lost dynamism while mining and energy exports are growing quite vigorously. In the domestic economic activity, he has seen deceleration signs and is concerned about the poor performance of the industry. Given that a good monetary policy depends of the authorities' anticipation ability, he considers that if the current status quo is maintained, it would be necessary to undertake a monetary policy relaxation phase provided inflation and expectations continue to converge, even slowly, to the mid point of the target range.

On its side, the Ministry of Finance estimated that, thanks to the good collection result and the good recent financing conditions, the National Government has sufficient liquid resources to finance its budget and, should it be desirable, to implement countercyclical fiscal policies.

3. POLICY DECISION

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

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

Bogotá DC, June 08 2012