Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on July 24, 2009

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on July 24, 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, economic growth and their prospects for the future were discussed, 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 was 3.81% in June, having fallen for the eighth straight month. Accumulated inflation during the first six months of the year was 2.22%, which is far less than the figure register in June 2008 (6.02%). The core inflation indicators continued to decline.

The annual variation in food prices dropped from 5.5% in May to 2.8% in June, largely due to perishable foods and, to a lesser extent, because of the price of grains, oils and other imported foodstuffs.

The annual increase in regulated prices slowed from 6.5% in May to 5.9% in June, owing to fuel prices.

Annual inflation in non-tradables, excluding food and regulated prices, stayed at 4.7% in June. Unlike the previous month, most of the upward pressure came from items with low indexing (4.2%). The annual variation in prices with high indexing continued to decline slowly, but remained above the 7% level. Inflation in rentals was 4.5% and completed four straight months of declines.

Annual tradable inflation, excluding food and regulated prices, was 2.78%. This is slightly less than in May (2.84%).

The inflation-expectation indicators calculated on the basis of TES were below the mid-point of the target range for inflation this year: between 1.55% (TES at one year) and 4.1% (TES at 10 years). However, the 10-year TES are above the long-term target announced by the Board of Directors (2% - 4%).

The annual increase in producer prices (PPI) went from 5.3% in May to 2.7% in June.

b. Growth

As reported by DANE, GDP growth during the first quarter compared to the same period last year was -0.6%. The reduction was due to the drop in internal demand (-0.5%) and exports in real pesos (-0.5%). Because the decline in imports was similar (-0.5% in real pesos), the contraction in net external demand was less (-0.4%) and its contribution to the setback in GDP was quite small.

Investment in civil works was the most dynamic component of internal demand. In fact, the rest of investment spending - largely private investment - was what declined the most. The annual increase in household consumption was slightly negative (-0.5%), while public consumption rose 0.2%.

On the supply side, the poorest performing sectors during the first quarter were industry (-7.9%), building construction (-14.1%) and commerce (-2.7%). The reductions in those sectors contrast with a major expansion in civil works construction (21.2%), the financial sector (4.7%) and mining (10.6%).

These circumstances are confirmation of the fact that the decline in GDP in Colombia since the fourth quarter of 2008 is related to the external crisis, as is the case with other economies in the region. The collapse of world trade has affected exports, above all non-traditional exports to the United States and to countries other than Ecuador and Venezuela. Exports have been hard hit since the fourth quarter of last year (in both dollars and volume).

The figures at hand show that although internal economic activity remains weak, expectations among the business community and consumers reveal signs of a recovery.

- The information released by DANE shows an annual drop of 6.5% in industrial production by May. For the first five months of the year, accumulated annual growth was -8.8%, which is slightly better than it was in the first four months of 2009 (-9.3%).

- The Fedesarrollo Business Opinion survey (EOE) for industry shows no further deterioration in May, but no clear sign of a recovery in business activity.

- According to DANE, annual retail sales were down 3.5% in April, which is better than the month before (-7.1%). This indicator continues to be affected, for the most part, by the sharp drop in automobile sales. When this item is excluded, the sales index at May shows an annual increase of 0.3%. During the first five months of the year, the annual drop in total retail sales came to 5.2%.

- The total demand for energy was up by 0.8% in June compared to 1.6% in May. The annual increase for the second quarter as a whole was 0.3%, which is less compared to the first quarter (0.8%).

- The Fedesarrollo Consumer Confidence Indicator in May improved for the second straight month, following the low point in April.

The trade balance so far this year, up to May, showed a surplus of US$300 m, which is US$448 m less than the surplus reported a year earlier. This was due to a 17.7% drop in exports, which exceeded the reduction in imports (-15.5%).

Total exports during the course of 2009, up to May, came to US$2,719 m. This represents a decline compared to the same period last year and was primarily the result of fewer exports of oil and petroleum derivatives to the U.S. market. By May, sales to the United States, which account for 33% of total exports, had fallen 27.5%. Exports to Venezuela, which represent 18% of total exports, were down by 0.8%. Industrial exports to the United States fell 31.7% during the early months of the year compared to the same period in 2008. Industrial exports to Venezuela declined by 17% during those same months, largely due to reduced sales of wearing apparel, vehicles, leather and furniture.

FOB imports totaled US$12,383 m between January and May, posting an annual decline of 15.5%. In CIF terms, they came to US$13,088 m and were down by 16.3%. The most important drop in total purchases was in intermediate goods and raw materials acquired in the United States, especially mining and pharmaceutical products.

According to the Comprehensive Household Survey (GEIH), employment between January and June 2009 rose at an average rate of 2.1% for the nationwide total and 1.5% in the 13 metropolitan areas. However, the increase in labor supply (global participation rate) was greater, probably because of deteriorating household income. The result was higher unemployment: 11.9% for the total nationwide and 12.9% in the 13 metropolitan areas during the moving quarter ended in May. These annual increases are similar to the ones posted in the moving quarter ended in March.

c. External Context

Although the world economy continued to contract during the second quarter, several indicators of confidence, credit, corporate earnings and inventory and orders in the industrial economies allow for more optimism with respect to the end of the recession. The U.S. Federal Reserve raised its estimates for growth in the United States. In Europe, there has been no substantial change in expectations regarding an increase in real GDP this year and the next.

Several Asian economies (China and India) shows signs of recovery with respect to foreign trade, while commodity prices remain close to the levels registered in 2007. All of these factors point to a recovery in world economic growth during 2010.

A number of countries in the region have seen their risk premiums decline, and the major currencies have appreciated against the dollar, including the Colombian peso.

At any rate, there still is concern in a number of the developed economies about: i) less income for consumers if inflation increases because of a hike in energy prices; ii) sluggishness in capital goods industries, those producing durable goods (automobiles) and construction activity; and iii) the hefty amount of debt acquired by banks, large multinational companies, households and the public sector.

d. Financial Variables

Monetary aggregates have been affected during the past month and a half by a shift in deposit taking that raised the annual increase in bank reserves from 16% in May to 21.9% in June. Consequently, the growth in base money rose as well (to 14.7% in June). However, the tendency in the broadest measure of the money supply (M3) experienced no major changes, and annual growth in M3 by the end of the first six months of the year came to 16%.

Permanent liquidity in the market is expected to increase during July and August due to the redemption of COP$6 trillion in TES. Eventually, this temporarily will make the Central Bank a net debtor.

Nominal growth in the commercial loan portfolio was 18.5% by July 15, having declined with respect to the increase in May and June. The consumer loan portfolio slowed to a nominal increase of 2.8% by the start of July. Growth in the mortgage loan portfolio also slowed a bit in June (13.7%). As a result, the financial system's total loan portfolio in pesos was up by 14% at mid-July compared to 15.5% at the end of May.

By May, the annual increase in external borrowing by the private sector; that is, loans contracted with lenders outside the country, was -3.5%. The loan portfolio in foreign currency with the financial system continued to decline during June.

Interest rates on deposits continued to fall during June; however, the downturn in the benchmark DTF rate (5.7%) came to a halt in July. Rates on preferential credit and loans to builders continued to decline. In this context, real rates have dropped and, in June, all were below their historic averages (calculated since 1986 or since 2001). Compared to those averages, the lowest rates were the DTF and interest on ordinary lending.

The TES curve posted respective reductions of 95 bp, 45bp and 40 bp in the short, middle and long segments. It flattened out in the middle and long segment, and steepened in the short segment.

2. DISCUSSION AND POLICY OPTIONS

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

- i The pace of price hikes and their sustained downward trend
- ii The continued decline in annual food inflation
- iii The effect international prices for food, raw materials and oil could have on total inflation, depending on how the exchange rate behaves
- iv Improved confidence among producers and consumers, despite sluggish economic activity
- v Continued growth in the peso loan portfolio with the financial system, beyond the nominal increase in GDP but less than in past months, thanks 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 Central Bank's benchmark rate cuts.
- vii Negative growth in the United States and less economic growth in Venezuela, Ecuador and the economies of other Colombian trading partners
- viii The impact of the exchange rate on inflation and growth in the tradable sectors
- ix The drop in interest rates on government bonds
- x The pattern of intermediate and long-term expectations for inflation

The main points of the discussion among the Board members centered on: (i) the elements that affect the inflation forecasts for 2009 and 2010, particularly an eventual rebound in food 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 the dwindling momentum in the loan portfolio with 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 appropriateness of continuing to lower the intervention rate, given the latest data; (vii) the behavior of the exchange rate in resent weeks; and (ix) the need to bolster the monetary authority's credibility and to anchor inflation expectations to the long-term target.

The Board members highlighted the fact that annual consumer inflation (3.81%) was down for the eighth straight month. Once again, food and regulated prices were responsible for the decline, which was more than expected. The core inflation indicators declined yet again, and medium and long-term expectations for inflation were near to ceiling of the long-term range targeted by the Board of Directors (3%+/- one percentage point).

The pattern in prices shows that weak internal and external demand, lower inflation expectations and the drop in commodity prices compared to the high point in 2008 spell less inflationary pressure. The Board expects annual inflation to end the year below the floor of the target range (4.5%).

The world economy is stabilizing. Several economic indicators in the United States point to a break in the negative trend in GDP growth in that country. Economic conditions in Europe continue to deteriorate. China's economic growth has increased substantially. This, in turn, has had a favorable impact on commodity prices and the Asian economies. Most of the Latin American economies continue to experience a moderate slowdown in growth and less inflation.

The risk premiums of a range of countries have declined and the major currencies have appreciated once again with respect to the dollar. The Colombian peso is no stranger to this situation, having appreciated more than expected. One reason is the successful placement of Colombian corporate bonds on the international market to finance investment projects. The Board of Directors is mindful of the risks associated with peso appreciation in an atmosphere of weak external demand, and will continue to monitor the exchange market carefully.

In Colombia, the latest information continues to show improvements in indicators of business and consumer sentiment and confidence with respect to the second half of the year. The annual growth rates for exports and imports in dollars are negative, and terms of trade are near the levels registered in mid-2007. Moreover, remittances from abroad have been falling throughout the year.

Interest rates on loans and deposits have declined steadily, thanks to the cut in the Central Bank's intervention rate. The Board of Directors expects the decline in those rates to continue and to stimulate economic growth. The performance of the financial system is healthy.

Several Board members said they prefer to hold the intervention interest rate at its current level, based on the following considerations. (i) The sharp increase in the money supply, the decline in food and regulated price inflation, a less negative external environment and the added momentum in civil works point to a gradual recovery in economic growth as of the second half of the year. ii) The slump in consumer inflation so far this year is due, in part, to temporary factors that could turn around in the future. (iii) Lower interest rates are not likely to have much of a positive impact on productive activity due to the weight of external factors in the reason for the slowdown in the country's economic growth. (iv) Contrary to the situation in other countries, the Colombian economy is not experiencing a financial crisis that would justify extreme policy measures and unusually low interest rates. (v) The growth figures for the loan portfolio suggest its momentum is affected not by liquidity problems, but by insufficient demand for credit. The members believe the current stance of the country's monetary policy makes it possible to consolidate the reduction in inflation towards its long-term targets.

Another Board member requested an evaluation of the impact of the different types of exchange intervention and proposed the Central Bank's intervention interest rates be lowered by 50 basis points, taking into account a number of supervening facts; namely, (i) an increasingly negative output gap, as indicated by continued economic decline and rising unemployment; (ii) the growing trade risks for Colombia posed by Venezuela and Ecuador; (iii) the sharp appreciation in the Colombian peso, among highest in the region and above that of our main competitors; and (iv) an inflation rate at June that is the lowest in the last 47 years and will continue to decline in the months ahead to a point well below the target range by the end of the year.

3. POLICY DECISION

The Board of directors agreed, by a majority vote, to hold the Central Bank’s intervention rate at 4.5%.

Bogotá D. C., August 6, 2009