Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on September 19, 2008

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on September 19, 2008.

Present:

Mr. Óscar Iván Zuluaga, Minister of Finance and Public Credit
Mr. José Darío Uribe, Governor, Central Bank of Colombia
Permanent Board Members:
Mr. Fernando Tenjo
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Juan Mario Laserna
Mr. Leonardo Villar

The situation and prospects for inflation and economic growth were discussed and monetary-policy decisions were reached. The following is a summary of the most important topics addressed at the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in August was 7.87%, having increased for the fourth month in a row. Accumulated inflation in the first eight months of the year came to 6.74%. Annual core inflation averaged 5.1% and 5.8% for five and three indicators, respectively. These indicators declined slightly for the first time this year (six basis points in both cases).

The build-up in inflation during August was due to food prices, with most of the upward pressure coming from vegetables, fruits, tubers and milk. Annual inflation in regulated prices was 9.4%, which is similar to what it was in August. Fuel prices and public utility rates continued to exert upward pressure in this category.

Inflation in tradable goods rose from 2.1% in July to 2.3% in August. Non-tradables, excluding food and regulated prices, declined for the second month in a row, going from 5.1% inflation in July to 5% in August. This inflation basket item has accumulated a 60 bp decline during the past year,

The various measurements of inflation expectations resulting from local government bonds (at 1, 5 and 10 years) continued to ease, although they remain well above the long-term target for inflation.

Annual producer inflation, measured by the total PPI, declined from 9.6% in July to 9% in August.

b. Internal Growth

The available information suggests the pace of growth in the Colombian economy has been less than expected. For the third quarter, the performance of industry and commerce (at July), as well as the business opinion surveys, confirm the slowdown in growth, particularly with respect to the industrial sectors that produce textiles, clothing and footwear, and vehicles and transport materials. The loss of momentum in these manufacturing areas coincides with a reduction in the volume of exports to Venezuela and the United States.

On the job market, salaried employment is falling, while so-called "self-employment" continues to grow at a good pace.

c. The External Context

The international financial crisis worsened in September, predominantly in the United States. The bankruptcy of Lehman Brothers and fears that other financial institutions might meet a similar fate added to the uncertainty on financial markets.

These events caused stock market indexes around the world to drop and led to a shift in the composition of investment portfolios towards safer securities, such as short-term US Treasury Bonds. This, in turn, strengthened the dollar against most currencies.

Prospects for growth in the developed countries have deteriorated, as they have in some Latin American economies. However, growth rates are still high in countries such as Peru, Brazil and Venezuela.

The information at hand suggests that inflation in the developed countries and in some emerging economies like China might be starting to give way. This has prompted the central banks of many countries to interrupt the interest rate hikes witnessed in past months.

As to the emerging economies, the financial crisis has limited access to credit and made it more expensive. Moreover, the drop in most international commodity prices should contribute to the decline in inflation within the region. However, it also affects terms of trade, especially for oil exporting countries such as Colombia and its major trading partners in the region.

d. Financial Variables

Annual growth in the primary monetary aggregates accelerated during the past month. For example, the increase in M3 went from 11.5% to 16.3% between July and August.

In August, the peso loan portfolio in the financial system maintained a growth rate of 19%, which is similar to what it was in July. The way this aggregate has behaved in recent months denotes no sign of a slowdown. The more moderate increase in the retail loan portfolio (16.8% growth in August) continues to be offset by the momentum in the commercial loan portfolio (21.4% in August). The mortgage loan portfolio has expanded by around 15.8% in the last three months.

Interest rates on lending were up, as they were for ordinary and mortgage loans, while those for retail loans declined slightly. In real terms, the average loan rates calculated by the Central Bank of Colombia and the DTF were close to their historic averages calculated since 1986.

As a result of the uncertainty on international markets, the exchange rate has devaluated 15.4% since the Board of Directors held its last meeting.

2. DISCUSSION AND POLICY OPTIONS

The Board emphasized the following points in its deliberations:

- i The pace of price hikes still exceeds the targets set by the Board of Directors.
- ii Some inflation basket items continue to show lower price increases. The CPI, excluding food and regulated prices, is a case in point.
- iii The downward trend in international prices for food, raw materials and oil continues and could have a major impact on total inflation.
- iv Core inflation indicators were down slightly for the first time during the course of 2008.
- v There is uncertainty about how regulated prices will behave in the future, given the indexation mechanisms used to determine rates and non-tradable inflation.
- vi There have been major increases in production costs for companies, although the pace of PPI growth declined last month.
- vii There is uncertainty about how the world economy and Colombia's principal export markets, particularly Venezuela, will perform in the future.
- viii The impact of peso revaluation on inflation and prospects for growth in the tradable sectors.
- ix Inflation expectations continue to exceed the targets set by the Board of Directors, but declined last month.

The main points of discussion among the Board members centered on: (i) the effect of monetary-policy measures, given the time it takes them to work through to the economy; (ii) the elements that influence inflation forecasts for 2008 and 2009; (iii) the behavior of non-tradable inflation, excluding food and regulated prices, which was down in August for the second month in a row; (iv) the forecasts for the current account deficit; (v) the effects of exchange rate volatility and the devaluation observed in recent weeks; (vi) the possibility that international developments, in a situation with a current account deficit, might lead to future exchange rate adjustments; (vii) the uncertainty generated by the world financial crisis on international markets and the effect it could have on the Colombian economy; (viii) the difficulty in assessing the data on hand in a situation where there is a break in the growth cycle; (ix) the risk balance between growth and inflation in a context of rising inflation expectations and economic slowdown; and (x) the need to bolster the monetary authority's credibility and to anchor inflation expectations, given the possible side-effects of international food and fuel prices.

The Board members highlighted the virtues of the monetary policy decisions adopted as of April 2006 to eliminate surplus demand and credit in the economy, to control the influx of foreign speculative capital, to strengthen the balance of international reserves, and to mitigate the effects of higher international commodity prices on inflation expectations.

It also was emphasized that the information on hand indicates that economic growth in Colombia and in a most countries has been less than expected. The international financial crisis worsened during the past month, affecting the prices of certain assets in Colombia, particularly the peso exchange rate against the dollar, which has been extremely volatile of late. There is every indication that the uncertainty will continue, and the exact impact on world economic growth and the availability of resources for the emerging economies is unknown.

Finally, it was noted that the inflation forecasts presented in the June 2008 edition of the *Inflation Report,* which indicate this variable is likely to decline as of the fourth quarter of the year, will probably be reinforced by the new data on international prices and food. However, several Board members indicated this does not mean the stance of the country's monetary policy should be revised with intervention interest rate cuts, at least for now. This is because of two factors. On the one hand, the relative price shock has made inflation one of the primary causes of the economic slowdown, given its impact on available household income and costs for companies. On the other hand, although some inflationary pressures have declined recently, there are still elements out there that add to the risk of higher increases in the general level of prices. These include inflation expectations, which remain high, the uncertainty about how the exchange rate will behave and its impact on prices, and the outlook for the wage hikes that are scheduled to be decided in the coming months. Under these circumstances and with the information that is available, one cannot expect higher inflation to result in more growth. On the contrary, it is likely to delay the recovery in growth.

The members also felt the monetary authority's commitment to the long-term targets for inflation contributes to the conditions required for sustained growth in production and employment. Given the current situation, it was indicated that a premature change in monetary policy could actually increase expectations of inflation. This would raise intermediate and long-term interest rates, which would have a negative effect on economic activity, and would reduce the capacity of monetary policy to act in an anti-cyclical way in the future.

Another position within the Board is that, given the drop in non-tradable inflation excluding food and regulated prices, the decline in the average of the core inflation indicators, the sharp and more-than-expected slowdown in growth since the onset of efforts to tighten monetary policy, the more than 8% reduction in salaried employment during the three months between May and July, the decline in the business climate and in the business community's inclination to invest, as indicated in the latest survey done by the Central Bank, the effects of the international financial crisis on Colombia and its major trading partners, and considering that monetary policy must look ahead on a timeline of no less than 18 months to two years, the best approach is to begin normalizing monetary policy here and now, with a 25 basis point reduction in the Bank's intervention interest rate, so as not to be forced to make abrupt cutbacks of an unusual scale in the future.

Finally, it was noted that the international financial situation will have to be monitored and the necessary monetary policy measures will have to be adopted, in due course, to deal with its effects.

3. POLICY DECISION

The Board of Directors decided, by a majority vote, not to change the Central Bank's intervention interest rates.

Bogotá, Colombia
October 3, 2008