Minutes of the Banco de la República Board of Director's meeting on July 23, 2010

On June 23, 2010 the regular meeting of the Board of Directors of the Banco de la República was held in the city of Bogota.

Present were:
Oscar Ivan Zuluaga, 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

The inflationary and economic growth situation as well as the outlook for both were discussed and decisions were made in relation to monetary policy. Full time director, Cesar Vallejo, did not attend for reasons that were justified. Below is a summary of the main topics dealt with in this meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation was at 2.25% in June, 18 bp higher than in May. Monthly inflation was 0.11% and the indicators for core inflation declined again.

The annual change in food prices went from 1% in May to 1.5% in June basically due to the prices for perishables.

The annual change in the prices for regulated goods went from 4.6% in May to

5.1% in June. This was the consequence of the adjustments that were made in fuel prices.

The annual change in the prices for non-tradable goods excluding food and regulated goods declined from 3.9% in May to 3.8% in June.

The annual increase in the prices for tradable goods excluding food and regulated goods remained stable at -0.5% in June.

Using preliminary data for July, inflation expectations derived from the negotiations for 1, 5 and 10 year public debt stood at 1.44%, 3.85% and 4.31% with variations of -3 bp, +21 bp and +23 bp respectively compared to the average for the previous month.

Inflation expectations in the quarterly and monthly surveys done by the Banco de la República at the beginning of June continue to show declines and are within the long term target range fixed by the Board of Directors.

In June, annual inflation for producer prices (PPI) was 2.1% compared to 1.3% that was registered in May. The PPI mainly rose due to a drop in the base of comparison for the previous year.

b. <u>Growth</u>

At the end of June, DANE released the annual growth of the GDP for the first quarter of the year. This was calculated on a new reference base year and with important methodological modifications. The result was 4.4% which was higher than what was predicted by the technical team at the Banco de la Republica in their latest forecast (3.4%). Compared to that from the quarter immediately before it, the GDP for the first quarter rose 1.5%, a figure that corresponds to an annualized rate of 6.2%. Thus there have been five complete consecutive periods of expanding GDP in quarterly terms.

Household consumption was the expenditure item that contributed the most to the growth of the GDP in the first quarter of 2010. This aggregate had four quarters of positive annual growth with the expansion in the first quarter of 2010 (3.5%) higher than that of the previous quarter.

Investment in fixed capital was the second highest expenditure item in the contribution to growth. In the first three months of the year, this aggregate rose at a high annual rate (8%) and was driven by public works construction. It is important to emphasize that with the new 2005 base, gross formation of fixed capital expanded throughout 2009.

Net exports (exports minus imports), in turn, contributed negatively to growth. While imports rose at a positive annual rate for the first time since the fourth quarter of 2008, exports continued shrinking in annual terms although at a slower pace than the rate seen last year. For imports, the recovery was mainly driven by the purchase of consumer goods.

By branches of economic activity, the sectors that were responsible for the annual growth of the GDP were, in the following order, construction (public work projects), mining, utilities, industry and trade all of which had an annual growth higher than 3%. In the case of utilities, the good performance of those offered by the government stood out. The only sector that showed an annual decline in its economic activity was agriculture, which was due to a contraction of the GDP in the fishing sector and to the fact that coffee production remained at low levels with respect to the year before.

For the second quarter of 2010 the majority of the available indicators suggest that the annual expansion of economic activity continued at a more dynamic pace than what was seen in the first quarter of the year. Some relevant indicators show the following:

– The Fedesarrollo Consumer Opinion Survey that measures the household confidence index rose in April, May and June and approached its highest historical levels this last month. The Consumer Confidence Index has been driven mainly by the better expectations that households have regarding the future performance of the economy and to a lesser degree, a better perception of the current economic conditions. The improvement in consumer confidence goes hand in hand with more financial resources to purchase durable goods, housing and cars.

– The retail sales reported by DANE grew in real terms at an annual rate of 8% and 13.1% for the months of April and May respectively. The expansion of retail sales in May, excluding automobiles, was 7.9%.

– In May, the annual change for the industrial production index (IPI) excluding coffee threshing was 7.5% which is lower than for the month of April (7.9%). In spite of the fact that in May, the seasonally adjusted level of the IPI fell slightly, the series is maintaining a solid rising trend.

Based on the available information, the technical team did a forecast of the annual GDP growth for the second quarter of the year. The result of this exercise was a predicted interval of 4.3% to 5.5% with 4.9% as the most probable figure. For all of 2010, the technical team estimates that the GDP will grow within a range of between 3.5% and 5.5% with 4.5% being the most probable.

The total exports in dollars for the month of May came to US$3,510 million thus registering an increase of 28% with respect to the same month last year. This trend is explained by the increase in the mining sector (42%) and industrial sector (21%) exports. In volume, sales abroad from those sectors also showed increases (31% and 13% respectively). However, in May industrial sector exports excluding coffee, petroleum derivatives, nickel-iron and gold registered levels similar to those seen in the same month in 2009 with an annual growth of 1%.

The main export products (coffee, coal, nickel-iron, petroleum and its derivatives), which represented 61% of the total sales abroad in the month of May, registered an annual growth of 51% in value and 31% in volume during that period.

In May, industrial sector sales to Venezuela excluding the main products (coffee, petroleum derivatives, nickel-iron and gold) shrank 68% in annual terms while those to Ecuador, the United States and the rest of the countries had annual rises of 42%, 27% and 57% respectively. In spite of the fact that countries like the United States, Brazil, Chile, China and Ecuador have been the destinations for a larger share of our industrial exports excluding the main products, the average monthly levels so far in 2010 for the total sales of these products (US$867 m) remain below the levels registered during the same period in 2007 (US$947 m).

The total imports (CIF) for the month of May came to US$3,184 million, a value that was 30.1% higher than that registered for the same month the year before. This increase came mainly from the larger purchases of consumer goods (durable goods in particular) and intermediate goods (specifically fuel and goods for industry). Imports of capital goods, in turn, registered an increase of 14.4% in May with respect to the same month the year before due to the larger purchases of goods for industry (36.6%).

In the March-May period, the unemployment rate for the national total was 12%. In the 13 main cities, it declined, going from 12.9% for the same period in 2009 to 12.5% in 2010. Upon analyzing the seasonally adjusted series, it can be seen that over the course of the quarter, the unemployment rate declined in comparison with the levels seen at the end of 2009 and beginning of 2010. This was possible due to lower pressure from the overall rate of participation which had stopped expanding at the pace it had been growing at the end of 2009.

c. External Context

During the second quarter, the global economy continued growing due to the better trend in emerging economies and the United States. The developing countries, the Asian countries in particular, are still leading the revival of world demand although a significant recovery has been seen in Latin America as well.

In spite of this favorable panorama, the public debt crisis in Europe has generated fear regarding the sustainability of the world recovery and, in particular, of the developed countries.

Furthermore, the developed economies continue to face problems that could limit their growth over the next few quarters. The most serious ones are the weakness that the labor market is showing, the high level of household debt and the restrictions on bank loans that remain in effect.

With respect to the emerging economies, an event from last month that stands out was the slight slowdown of China's GDP which grew 10.3% in the second quarter of 2010 after the 11.9% seen in the previous quarter. This phenomenon is due to a change in the economic policy posture adopted by that country a few months ago to cool down the economy. In spite of this, growth for China and the rest of Asia is expected to remain strong for the rest of the year.

In Latin America, dynamic growth was seen in the first quarter. The most outstanding cases were Brazil and Peru, which had annual rates of 9% and 6% respectively.

However, although the prices for commodities had had sharp falls due to the financial upheaval, they showed a tendency to recover by remaining at historically high levels. For what is left of the year and for 2011, substantial changes in their levels are not expected, as a result of which, the terms of trade for countries that are exporters of raw materials like Colombia will continue to be favored.

With respect to consumer inflation, both total and core inflation remain at low levels in the majority of the industrialized countries. Therefore, and due to the weakness of growth and employment, the central banks for these economies are expected to keep their interest rates at levels close to zero in 2010 with a few notable exceptions like Canada and Australia.

In Latin America, with the exception of Argentina and Venezuela, inflation seems to be under control at relatively low levels. In spite of this, the sharp economic growth has led to adjustments to the monetary policy of various countries in the region.

Regarding the currencies, the dollar has strengthened so far this year against the euro and the pound sterling although in the case of emerging economy currencies the trend has been mixed. The Colombia peso, in particular, has appreciated around 8% so far this year. Finally, the risk premiums have remained stable or decreased slightly for emerging economies, especially for Latin American countries.

d. Financial Variables

In the last few months, the annual growth of cash has surged. Based on the most recent data from the beginning of July, its growth is at 11.5% or 6 percentage points more than what was registered at the beginning of the year.

M3 and liabilities subject to reserve requirements, in turn, that had shown relatively stable nominal rates of growth rose in volatility as a result of the trend of mainly fiduciary deposits. In real terms, the average rate of growth for M3 was 4.4% in June.

With respect to loans, the annual growth of the portfolio in nominal local currency recovered in comparison to May. The declining trend for the commercial loan portfolio halted and the mortgage and consumer portfolios strengthened their surge. As of July 2, the annual rates of growth were 0.9%, 22.2% and 8.9% respectively. The total portfolio in local currency grew 5.6%.

During the second half of the year, it is possible that there will be better loan performance based on the surveys of the financial sector done by the Banco de la República which capture aspects of supply. Based on those results, the loan entities seem to be more willing to grant loans compared to what was observed at the end of 2009 and the beginning of 2010. With regards to demand, the Fedesarrollo survey indicates that consumers are more willing to purchase real estate and durable goods that require financing.

With respect to the interest rate, the interbanking ones have remained adjusted to the policy rate since mid-April. The reductions in the Banco de la República's benchmark interest rate continued their transmission to the market rates in June. In the case of the DTF, the level was 3.5% this last month compared to 3.6% in May. With regards to the lending rates, all of them showed declines in June that swung between 9 bp (for consumption) and 38 bp (for mortgage). There was also a reduction in real terms, especially in those for mortgages.

With respect to the price for assets, stocks resumed to their tendency to appreciate. Public debt securities with maturities of more than one year also rose in price. The price index for used housing is at historically high levels.

Between June 18 and July 21 the rates for public debt securities showed negative variations of 10 bp, 51 bp and 65 bp in the short, medium and long tranches respectively.

2. DISCUSSION AND POLICY OPTIONS

Over the course of the discussion the following points stood out: (i) the result of inflation up to June was lower than that expected by the Banco de la República's technical team; (ii) the indicators for core inflation resumed a declining trend and are within the target range fixed by the Board; (iii) inflation expectations continue to drop; (iv) the information from DANE about the growth of the GDP in the first quarter confirmed a faster recovery of the economy than what was expected; (v) the improvements in the businessmen's and consumer's expectations; (vi) stable growth in the monetary aggregates; (vii) the growth of the financial system portfolio in legal currency at levels similar to the estimated rise in the nominal GDP for 2010; (viii) the recent trend in the prices for assets; (ix) the trend in the market interest rates in response to the reduction of the Bank's benchmark rate; (x) the effect of the exchange rate on inflation and the growth of the product of the tradable sectors; (xi) the interest rates for public debt securities which fell during the month and (xii) the recovery of the world economy and the severe uncertainty generated by the crisis in some European countries.

The Board members' main points of analysis centered around the following aspects: (i) the inflation projections for 2010 and 2011; (ii) the reduced variation in prices for tradable goods due to the appreciation of the peso compared to the dollar; (iii) the lagged effect of monetary policy measures on production and prices; (iv) the projections for economic growth for 2010 which suggest a more rapid recovery than predicted and which led the technical team to raise their forecast for the year; (v) the recent movement in the financial system portfolio and in the high level of prices for assets; (vi) the drop in inflation expectations; (vii) the recent trend in capital flows; (viii) the balance of risk between growth and inflation in a context of a recovering economy and inflation that is at the long term target range and (ix) the need to maintain the monetary authority's credibility and anchor inflation expectations to the long term target.

The Board of Directors emphasized the following regarding the inflation trend for the month: (i) annual consumer inflation in June was 2.25%, which was higher than in April (18 bp) but below what was expected by the Banco de la República's technical team; (ii) the majority of the core inflation indicators started falling again and remain in the lower part of the target range for long term inflation set by the Board (3% plus or minus 1%); (iii) inflation expectations also continued to fall; (iv) the result of inflation last month is in line with the projections made by the technical team which shows, with a high degree of confidence, that inflation will be within the long term target range in 2010 and 2011.

The Board emphasized that the information received in the last few weeks indicates that the economy is growing at a faster pace than expected without generating inflationary pressures. The growth in exports, which is driven by the recovery of momentum in the global economy and better terms of trade; the rise in consumer and producer confidence; the momentum of various leading indicators and solidity of the financial system confirm the strength of the Colombian economy. Given the above, the technical team of the Banco de la Republica raised their forecast for the growth of the GDP for 2010 indicating that this will be within a range of 3.5% to 5.5% with 4.5% being the most probable.

In the second quarter, the global economy continued to grow due to the better trend in the emerging economies and the USA with the steady recovery of the economies in Latin America standing out. The international markets, in turn, stabilized after the financial crisis in Europe. All of the above led to a reduction in the risk premiums and the appreciation of various currencies in the region including the Colombian peso.

The Board believes that the expansionary monetary policy that has been adopted has contributed to the short term economic growth.

3. POLICY DECISION

The Board of Directors agreed to keep the benchmark rate of the Banco de la República unchanged and it will remain at 3%.

Bogota, Colombia
August 6, 2010