Minutes of the Banco de la Republica Board of Director's meeting on February 24, 2012

On February 24, 2012, the regular meeting of the Board of Directors of the Banco de la Republica was held in the city of Bogota with the presence of the Minister of Finance and Public Credit Mr. Juan Carlos Echeverry, the Governor and Managing Director 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. BACKGROUND

a. Recent developments in inflation

Annual consumer inflation was 3.54% (0.73% monthly), 19 basis points (bp) less than in December.

The decline in inflation during the month was the result of lower pressure on the baskets of tradables excluding food and regulated items, of regulated prices and of food. The basket for non-tradables excluding food and regulated items (3.6%) did not show any changes compared to what was seen in December 2011.

In the specific case of the prices in the basket for tradables excluding food and regulated items, a decline of 8 bp was seen with respect to the result in December (0.8%) thus interrupting the upward trend it has experienced since September 2011. This suggests that the appreciation of the peso since January 2012 may be having an effect on this variable.

The annual change in the prices for regulated goods, in turn, went from 5.8% in December to 5.2% in January, a fall that was larger than expected. This was possible because of the fact that, at the beginning of this year, there were no readjustments in the Transmilenio fares in Bogota unlike what happened last year. In the area of utilities, however, there were significant changes in the rates for electricity and natural gas added to the ones observed in previous months. In the case of natural gas, for some time now, there has been enough capacity to transport it and that has made it difficult to meet the demand on the Caribbean coast in particular.

With respect to the prices for food, the drop in the annual change that occurred in January was significant as it went from 5.3% in December to 4.9%. The production of various perishables, especially potatoes, has gone back to normal and allowed the prices to fall and the annual change in this subgroup to drop. There were also few adjustments in the prices of products like oil and this could be due more to the appreciation of the peso than to movements in international prices which have not declined. Because of that, the annual change in the CPI for processed food items also fell this month. The above mentioned changes more than offset a new upswing in eating out (from 5.6% in December to 5.9% in January).

The annual variation of the prices in the basket of non-tradables excluding food and regulated items remained stable at 3.6%. However, in the case of rent, its heaviest component, there was a new rise which came to 3.5% in January compared to 3.4% in December. This item has been showing an uninterrupted upward trend for the last nine months.

All of the indicators of core inflation declined slightly thus temporarily suspending the rising trend that has been experienced for five months. The average of the three indicators monitored by the Banco de la Republica was at 3.3%, which is a decline of 15 bp with respect to the month before.

In spite of the drop in total consumer inflation, expectations did not change substantially. Those from the monthly survey for December and for 12 months ahead remained at 3.6% in both cases. Those derived from the TES at different maturities remained close to 4%.

Although wage adjustments had tended to be compatible with the inflation target up until December, the 5.8% raise in the minimum wage for 2012 increased the risk that pressure from the cost of wages would arise. Added to this is the fact that the labor market is not expected to be as weak in 2012. In January of this year, the upswing in the prices for eating out and health services above what had been registered last year could be a symptom of both phenomena.

In contrast, non-salary costs saw a reduction in January when the significant decline in the annual change in the PPI to 3.7% in comparison to the 5.5% in December is taken into account. This indicator has fallen for three months straight and, especially in January, this was due to the appreciation of the peso and the better conditions in agricultural supply.

b. Growth

The most recent information indicates that domestic demand continued to expand at a good pace towards the end of 2011 and had a dynamic beginning of the year.

The favorable performance of household consumption in the fourth quarter of last year was confirmed by the changes in imports and employment in December. That month the dollar value of imports of consumer goods grew 9.6% in annual terms. This is a high rate but lower than in previous months. The labor supply, in turn, continued to show improvements with respect to the creation of job positions and the reduction in unemployment, which should have a positive effect on consumption. In December, there was an upswing in the number of people employed on the national level and in the 13 metropolitan areas. Even if there was a slight rise in the unemployment rate in the 13 metropolitan areas that month, it is still premature, with the limited information available, to suggest a break in the downward trend seen in 2011.

The information available as of December on imports also makes it possible to expect positive results for investment. In the last month of 2011, the dollar value of imports of capital goods expanded 36.6% with respect to the same month the previous year and is well above the average since 1994 (12.7%).

With respect to supply, the industrial production data published by ANDI which showed a growth of 5.9% in 2011 stands out. Other sectors such as commerce, transportation, and construction are also expected to have continued a positive momentum to the end of 2011. For example, the regional survey done by the Banco de la Republica (businessmen from various sectors are included in this) showed a very favorable perception of sales growth in December. The production of cement also continued to grow in December which suggested that construction was doing well.

Sales abroad continued growing in December. In dollars, the value of the exports again registered a sharp surge (43% annually) which was primarily due to exports from the mining sector (petroleum, coal, nickel-iron and gold) which jumped 55.3% annually. Foreign sales of the main agricultural products (coffee, bananas, and flowers) dropped 8.3% annually due to the poor coffee harvest. The rest of the exports climbed in December and came to 43% annually.

For the first quarter of 2012, the limited information available points to a production performance that is similar to what had been seen towards the end of last year. According to Fedesarrollo, household confidence grew for the third consecutive month in January 2012 and was close to its historical maximums from the series (since 2001). Car sales, in turn, grew at an annual rate of 13% in January. This was an upswing for the second consecutive month and a new record in sales for the month. Likewise, the Fenalco survey for January showed that businessmen's perception of sales remained high while their expectations for six months from now are even better.

In addition, households in January continued to have a real interest rate for consumption that is lower than the average has been since 1998. As a result, household consumption is expected to continue its positive trend.

With respect to investment, positive growth can be expected although a little lower than was expected for the second half of 2011. The above is inferred from the developments in the commercial loan portfolio, which rose at an annual rate of 17.2% in national currency and 36.5% in foreign currency in the first month of 2012. At the same time, businessmen still had real interest rates that were lower than the averages since 1998 in spite of the rise last month (40 bp).

Given all of the above, the growth forecast for the fourth quarter of 2011 is still within a range between 5% and 6.2%. With these estimates, the possibility that growth for 2011 will be within the forecasted 5.6% to 6% range remains feasible.

For the first quarter of 2012, the scant information points to growth that will be similar to or slightly lower than that of the fourth quarter of 2011.

c. Financial Variables

Total loans in national (NC) and foreign currency (FC) remain at high rates of growth with a slight moderation starting in July 2011. All of the types of loans, including those for households and businesses, continue to show growth that is well above the growth of economic activity. This has occurred in a context of real interest rates that are historically low.

As of January, total loans (NC and FC) registered an annual rise of 20.9%, which is 27 bp lower with respect to December and 247 bp compared to July. The performance of the commercial loan portfolio, which saw a growth of 19.1%, a rate that is 40 bp lower than the one for the previous month, gave it an accumulated reduction of 425 bp in the last six months. The consumer and mortgage loan portfolios, in turn, saw growth rates that were 24.8% and 17.3% respectively. These levels have been close to their averages since July 2011 (25.1% and 17.2%).

In January, the real interest rates (discounting the CPI excluding food) for consumer, mortgage, and ordinary commercial loans were at 16.9%, 10.2%, and 8.8% respectively. These figures are lower than the averages that have been seen since 1998 (except for the rate for mortgage loans for which the average has been calculated only since May 2002).

d. <u>Foreign Context</u>

The new data on worldwide economic activity show a slowdown in foreign demand in line with what has been expected as a result of two important factors: on the one hand, the high levels of government debt and, on the other, the process banks are going through to reduce leveraging. This is limiting access to credit in the advanced economies and affecting the strength of consumption and investment for the private sector. In this context, the forecast for 2012 is negative economic growth in Europe while, in the United States, the rate could be somewhat lower than its potential. There will also be a lower pace of economic activity in the emerging countries as a result of the weakening of global demand. Because of the above, it is probable that the average growth of our trading partners this year will be lower than what was observed in 2011.

In the specific case of the United States, the growth of output rose in the last quarter of the year as it went from 1.8% (a/q) in September to 2.8% (a/q) in December. The labor market continues to improve and industrial activity is still expanding. Nevertheless, the slowdown in exports and weakening in household expenditures indicates that the economy is not on the path to sustainable growth yet. For 2012, the economic growth of this country is expected to be lower than its historical average.

In the Euro zone, in turn, the weakening of productive activity was generalized and, with the exception of France, the largest economies contracted in the last quarter of 2011. During this period, the output shrank 1.3% (a/q), a trend that could even extend into the first half of 2012. However, so far this year, some signs have been seen that suggest that the deterioration will not continue to worsen and that it will be in line with what was predicted. First of all, the increase in the liquidity support on the part of the European Central Bank has contributed to reducing the interest rates for Spain’s and Italy’s government bonds. Interbank liquidity and risk perception also improved. In the case of Germany, the business and consumer confidence indicators showed a slight recovery in January. With respect to Greece, the new rescue package was approved by the European economic authorities. In spite of all of the above, the uncertainty about the depth and duration of the recession in Europe remains high. Credit is still restricted and the unemployment rates in some countries in the region, which were already historically high, have continued to climb. Moreover, the risk that poor results from the economic activity will push the risk indicators up again and raise doubts about the euro’s stability persist.

In Japan, the GDP declined in the fourth quarter of 2011 as a consequence of the drop in exports and higher energy imports. The slowdown in worldwide demand and the interruption in the supply chain from Thailand caused by the October floods would seem to be affecting the recovery of this economy. In contrast, the productive activity in the emerging Asian economies, except the case of Indonesia, continued slowing down at a moderate pace in response to the lower strength of global demand and to the adjustments in monetary policy in 2010 and beginning of 2011.

In some Latin American countries such as Brazil, Mexico, Peru, and Venezuela, the indicators of productive activity improved in the last few months of 2011.

The lower strength of world demand has alleviated the inflationary pressures in both the developed and emerging countries. Nevertheless, recent supply shocks such as the droughts in South America and Mexico as well as the rise in geopolitical tensions have pushed up the prices of food products and petroleum.

In conclusion, the new data show a global demand that is slowing down in line with what was estimated and a global inflation that has given way. This new information will contribute to keeping the external interest rates at low levels for a long period of time. So far, the slower pace of economic activity that Colombia’s trading partners have has not been reflected in a decline in the value of exports. On the contrary, foreign industrial sales excluding mineral and agricultural commodities surged.

Furthermore, the upswing in the price of petroleum could lead to the terms of trade remaining at high levels which are above the estimated average for this year.

2. DISCUSSION AND POLICY OPTIONS

The majority of the Board members thought it appropriate to raise the policy interest rate considering the following factors:

(i) Recent information indicates that, in the fourth quarter of 2011, the Colombia economy continued to show strong momentum and that this performance has been maintained over the course of the year as reflected by exports, imports of capital goods, retail sales, etc. (ii) The output gap is probably still in positive territory. (iii) The industrial confidence index is still at high levels while consumer confidence has remained on a rising trend for several months and is at one of the highest historical levels. (iv) Something similar is happening with respect to the terms of trade (fed to a large degree by the price of petroleum), which have also reached unprecedented heights. (v) Even if inflation has recently shown a trend that is more in keeping with the long term target and the measurements of core inflation declined in January for the first time in several months, neither the forecasts nor expectations of inflation show a clear convergence yet towards the mid-point of the target range on the political horizon. (vi) Uncertainty about the future changes in the exchange rate makes it difficult to estimate its impact on inflation in the future. (vii) Even if the transmission of previous adjustments in the policy interest rate to the market ones have been adequate, the recent limited slowdown in the loan portfolio does not necessarily eliminate the risks of a dangerous boom, especially in consumer credit. (viii) The above points make it necessary to ensure that the market interest rates continue to move towards long term levels that will make it possible to ease the trend of both credit and GDP and thus avoid the risks of financial instability with high costs in terms of production and employment. (ix) Even if the risks of a possible uncontrolled adjustment of the situation in the euro zone stay the same, measures that were recently adopted in that region make it possible to give more weight to the local conditions of the Colombian economy in the policy decision. These conditions are characterized by factors that have shown that so far they have not been affected by the situation in the advanced economies

Other members did not think it was appropriate to raise the benchmark interest rate at this time for the following reasons:

(i) The Board's change of posture to reduce the monetary stimulus started as of February 2011 has had the expected effects. These effects will continue to extend, because of their natural lag, into the rest of this year and the next one. Therefore, additional adjustments to the benchmark interest rate could turn out to be inopportune. (ii) In December 2011, annual inflation in Colombia (3.73%) was the lowest among the main economies in the region even though it was in the upper half of the target range. In January 2012, inflation ended up at 3.54% after falling for three consecutive months. All of the core inflation indicators fell for the first time in five months. Inflation excluding food dropped 13 bp and ended up at 3%. Inflation of non-tradables excluding food and regulated prices remained unchanged. There is evidence of lower pressure on non-salary costs given that, in January, they continued the decline that had started three months before. (iii) It is estimated that the investment share of the GDP for 2011 may have reached the historic record of 30%, which makes it possible to infer that the potential GDP has also grown beyond its historical trend and is consistent with the current economic performance. (iv) Global demand continues to slow down. Europe went into recession. The slow recovery of the United States is keeping its economy below its potential GDP. Worldwide inflation is still dropping. The two previous factors have led to the general adoption of lax monetary policies characterized by interest rates that are historically very low and prolonged. (v) Geopolitical factors have begun to cause obvious surges in the prices of petroleum which could begin to have a negative effect on the performance of the North American economy and bring additional recessionary problems on the rest of the world.

Finally one board member proposed that macro-prudential measures be applied to speed up the transmission of monetary policy to demand.

3. POLICY DECISION

Based on the present evaluation of the balance of these risks, the Board of Directors decided to raise the benchmark interest rate of the Banco de la Republica by 25 basis points.

With the recent increases in the benchmark interest rate, the market rates are expected to approach their historical averages more rapidly and inflation expectations to converge towards the mid-point of the target range.

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

Bogota D. C., March 9, 2012