Minutes of a Meeting of the Board of Directors of Banco de la República on February 22, 2008

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá on February 22, 2008.

Present:

Mr. Óscar Iván Zuluaga, Minister of Finance and Public Credit

Mr. José Darío Uribe, Governor of Banco de la República

Full-time Members of the Board of Directors:
Mr. Fernando Tenjo
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Juan Mario Laserna
Mr. Leonardo Villar

Inflation and economic growth, and their prospects for the future were discussed, and monetary-policy decisions were reached. The following is a summary of the principal issues addressed during the meeting.

1. Background

a. Recent Developments in Inflation

Annual inflation was 6% at the end of January, which amounts to an increase for the fourth month in a row. This figure is 31 b.p. above the annual rate of inflation registered the month before and 150 b.p. above the top of the target range for 2008.

Higher inflation in January was due fundamentally to the way food prices behaved. During that month, annual inflation in non-tradables, excluding food and regulated prices, remained stable at around 5.2%.

The various core inflation indicators stayed close to 5%. The non-food inflation indicator went from 4.4% in December to 4.5% in January.

With respect to food inflation, the sharp rise in January is explained by perishables, particularly potatoes, vegetables and eggs. Processed food inflation declined slightly. Even so, annual inflation in that sub-group remained high (9.7%). Processed foods are being affected by high international prices, which have been hit by the shift in agricultural supply towards bio-fuel production and by soaring demand in China, India and other emerging economies.

b. Local Economic Growth

Local economic growth remains strong. This fact supports the estimates developed by the Bank's technical team, which place GDP growth at around 7% in 2007 and 5% in 2008.

The figures on industrial production show a 7.7% average increase in growth between October and November. This is high, but less than the figure for the third quarter (8.5%). Commercial retail sales behaved similarly.

The consumer confidence indicator based on the FEDESARROLLO survey was historically high during the final quarter of 2007.

Imports increased by 24.5%. The build-up in imports of capital goods was particularly important. This suggests that investment remained strong towards the end of the year. Imports of consumer goods increased by 28.4%, but have slow somewhat since April 2007.

Traditional and non-traditional exports continued to expand during October and November. The momentum in traditional exports was due to higher international prices. The crucial point in terms of non-traditional exports was the 84% annual increase in sales to Venezuela, as opposed to 70% at the end of the third quarter (accumulated figure for 12 months). Non-traditional exports to Venezuela now account for 8.44% of GDP.

c. The International Situation

The news about the US economy in January and February to date supports the lower growth forecasts. In fact, January's job creation figures were negative for the first time since mid-2003. The leading indicator for the service sector suffered a major setback that same month, something not seen since the previous recession in 2001, while the consumer confidence index in February dropped to levels not registered since the early nineties. Moreover, the figures for the housing market up to November 2007 point to added deterioration at the end of last year.

As to the Fed's interest rates, the market expects to see further cuts in the coming months, specifically to the tune of about 75 basis points. This would place the benchmark rate for federal funds at approximately 2.25% in June. However, the relatively high figure for US core consumer inflation in January (2.5% in annual terms) could curb those reductions.

The slowdown in economic growth in the United States has yet to have a palpable impact on world demand or on prices for raw materials. In fact, raw material prices continued to rise at the start of the year and are now at historically high levels. The increases have been particularly significant in the case of agricultural products, including coffee, and in goods exported by Colombia, such as coal and gold.

c. Financial Variables

M3 is up by about 18% since September. The build-up in deposits in the form of CDs is a high point, having registering an increase of nearly 35% in January.

In the financial system, loan portfolio growth continued to slow. By January, the annual increase in total credit was 23.5%. This is less than the figures registered in December (24.5%) and September (28.2%), but is still more than expected nominal GDP growth. The most pronounced slowdown in the last six months has been in retail loans (by approximately 31%), although they continue to grow at a high rate.

The interbank interest rate (TIB – the acronym in Spanish) stayed at around 9.40%, which is slightly below Banco de la República's benchmark rate. Most other nominal rates increased in January, particular those on credit card, retail and ordinary loans.

Although the difference between the Fed's interest rates and those of Banco de la República increased by 125 b.p, the decline in relative interest rates in the United States was offset by the increase in Colombia's risk premium.

2. Discussion and Policy Options

The Board emphasized the following points in its deliberations:

(i) The pace of price hikes, which continues to exceed the targets set by the Board of Directors;

(i) The considerable weight of food on inflation in an international context marked by upward pressures;

(ii) The behavior of non-tradable inflation, excluding food and regulated prices, which halted the downward trend witnessed in previous months;

(iii) Available indicators suggesting the momentum in aggregate demand remains high compared to production, but is showing signs of moderation;

(iv) Uncertainty about the future of the world economy and that of Colombia's principal export markets, above all Venezuela;

(v) The trend in inflation expectations, which have increased in recent months to levels that exceed the targets established by the Board of Directors.

According to the Board, a number of indicators show the benchmark interest rate hikes and the change in reserve requirements have had an impact on interest rates for loans and deposits, and have been useful in helping to achieve the objectives with respect to a more moderate increase in credit. However, credit growth rates are still high. Moreover, the increase in local demand has decline, but continues to exceed the growth in national production.

The principal 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 shape the inflation forecasts for 2008; (iii) the appropriateness of adopting monetary policy measures in a context of rising international food and fuel prices (iv) the widening current account deficit, which indicates local demand is growing faster than national production; (iv) the fact that international developments, in the context of a current account deficit, might lead to future adjustments in the exchange rate; (v) the uncertainty sparked by the extreme volatility on international markets and how it might affect the Colombian economy; and (vi) the need for the monetary authority to enhance its credibility as a way to anchor inflation expectations, given the upward trend in prices countries face.

The majority of the Board members felt an increase of 25 b.p. in the benchmark rates is necessary to make certain the inflation targets are met and to maximize the sustainable economic growth rate. That opinion is based on the following factors.

(i) Although the momentum in aggregate demand has slowed, thanks to recent monetary policy decisions, the available figures show it remains strong. The same is true of credit growth. Despite a downward trend, it continues to exceed its historic averages.

(ii) The various indicators of expectations for inflation one year or more from now show they have increased in recent months, making any future reduction in inflation more costly.

(iii) Food and fuel prices could continue to rise sharply, which would keep total inflation high, particularly since some internal price hikes have yet to be incorporated into internal price performance.

(iv) There is still no evidence that the Colombian economy has been affected by the economic slowdown in the United States and Europe. Terms of trade are at historically high levels, the flow of trade remains positive, and the growing influx of foreign direct investment reflects international investor confidence.

(v) It is the momentum in foreign direct investment, not short-term capital flows induced by differences in interest rates between Colombia and other countries, that explains the net capital inflow in the country's the exchange balance.

(vi) The benchmark rate hike shores up the credibility of the country's monetary policy and facilitates the anti-cyclical policy in the future.

In contrast, other Board members felt the benchmark rate should not be increased for the following reasons:

(i) Due to previous increases in the benchmark rate, which has been among the highest in the region for the last two years, interest rates on loans have risen as well, and will continue to do so during the remainder of 2008, thanks to the remnant effects of policy lag. It takes approximately 18 months to two years for monetary measures to work their way through to the economy.

(ii) According to the models, although the output gap has been positive for the past two years, it has begun to change because of the interest rate hikes.

(iii) The Colombian economy is facing the effects of a severe external shock brought on by food and fuel prices, which is reflected in inflation expectations.

(iv) The economy in 2008 is expected to slow to a growth rate of 5%, assuming there is 0.8% growth in the United States economy. However, recent forecasts indicate it would only be around 0.5%.

(v) The reduction in the use of installed industrial capacity is obvious, as is the drop in the industrial confidence index, the slowdown in the demand for energy, consumer durables and housing, the downturn in the demand for household loans and the decline in the loan portfolio, especially retail credit.

(vi) Gross fixed capital formation is still at record historic levels, having reached 27% of GDP.

(vii) Core inflation, without food, which is the inflation indicator that should react to monetary policy through interest rates, is still within the target range.

(viii) The difference between the benchmark rates in Colombia and the United States has increased by 200 b.p. since September 2007. A continuation of that expansion would cause the Colombian peso to revaluate even more. The extent of its revaluation in the last five years has been among the highest of any currency in the world, and further revaluation would seriously jeopardize the tradable sectors and job creation.

In view of the foregoing, the Board of Directors decided, by a majority vote, to raise the Bank's benchmark rate to 9.75%. It also indicated the impact the international economic situation could have on growth, as well as the effect of inflation pressures originating with international food and fuel prices, must continue to be monitored carefully.

3. Policy Decision

By a majority vote, the Board of Directors agreed to raise Banco de la República's benchmark rate by 25 b.p.

Bogotá D.C., Colombia, March 7, 2008