Minutes of the Meeting of the Board of Directors of Banco de la República of July 25th, 2008

The ordinary meeting of the Board of Directors of Banco de la República was held in Bogotá on July 25, 2008, in the presence of the Minister of Finance and Public Credit, Oscar Iván Zuluaga, the General Manager, José Darío Uribe, and the permanent members of the Board, Fernando Tenjo, Carlos Gustavo Cano, Juan José Echavarría, Juan Mario Laserna, and Leonardo Villar. The situation of inflation and economic growth and their perspectives were discussed in the meeting, and decisions were made regarding monetary policy. The following is a summary of the main issues addressed in the meeting.

1. Background

a. Recent developments in inflation

The annual consumer inflation was of 7.18% in June, 79 bp above the one observed in May. The accumulated inflation in the course of the first six months of the year rose to 6%. Some of the indicators for basic inflation increased in June, and remain over the inflation goal.

The acceleration of inflation during the month of June is explained by the behavior of the prices of food products (12% increase in June vs. 9.7% in May), especially that of potato and rice. Other supplies, perishable as well as processed, continue to present yearly adjustments of very high and increasing prices.

The yearly inflation not including food products was of 4.9%, lightly superior to the 4.8% of May. Inflation pertaining to sub-groups of tradable and non tradable goods not including food nor regulated products remained stable as compared to May.

The inflation of the group of regulated products increased from 8.3% in May to 8.8% in June as a result of increases in the rates for electricity and gas and in the prices of fuels.

The expectations of inflation in one, five, and ten years, as measured by the polls addressed to analysts and by the prices of the titles of internal debt, increased to over 5.5%.

The annual increase in the index of growth of the PPI rose from 5.4% in May to 8%.

b. Internal growth

The information available on the behavior of production, aggregate demand, and income, reveals the following:

- DANE revealed the growth in production for 2007 based on the new base 2000. According to this information, Colombian economy (excluding illegal crops) expanded at a rhythm of 8.2% in 2007, not 7.6% as had been initially indicated. The greatest growth rate took place during the first trimester (9.1%), but the fourth trimester also presented a very high yearly variation (8.4%). With the new base, 2007 has been the year of greatest expansion in economic activity in the last five decades.

- The figures of DANE for the growth of the GNP during the first trimester register 4.1%. The downturn of growth was the result of diverse factors, regarding supply as well as demand, some of them punctual. The most important corresponds to the direct impact of the decrease in civil works, as has been pointed out before, probably obeying to changes in local and regional public administrations. A second factor was the lower number of working days in the trimester, given that the Easter holiday was in March. The strike in *Cerromatoso* as well as the reduction in the exportations of automobiles to Venezuela also affected the growth of GNP importantly.

- Colombian economy, as well as economy worldwide, has been facing an important increase in the costs of production and transportation during the last trimesters as a consequence of the strong increase in the prices of oil as well as of some raw materials. These circumstances affect the product negatively and raise the prices.

- Considering demand, the increase in the prices of fuels and of food products affect the real available income for households, slowing down present and future consumption, the latter especially given the consumers' loss of confidence.

- The figures of DANE reveal that the net formation of capital was the component that registered a greater deceleration, associated more to the fall of investment in civil works carried out by the public sector than with a deterioration of private investment.

- Household consumption also slowed down, turning from a 5.6% growth in the fourth trimester of 2007 to 3.9% in the first trimester of 2008. According to the new series (base 2000), consumption would have begun to slow down since the second trimester of 2007, contrasting previous information, which did not reveal an important slowdown during last year.

- Total exports increased 15% in real pesos in the beginning of the year. This expansion took place in spite of the appreciation of the type of exchange and obeys to the strong demand from Venezuela of manufactured products and food products as well as to the increase in the production of mining products such as coal.

- The final domestic demand grew at an annual rhythm of 5.4% during the first trimester, which implied a slowdown against what was observed in 2007, yet still over the historic average. On the other side, the annual growth of the aggregated demand to March was 6.7%, facing 11.1% of the fourth trimester of 2007 and 10.3% in all of last year.

- The behavior of the indicators of industrial production, of retail commercial sales, and of consumer confidence to May, once again suggests a smaller growth in the second trimester than the one observed in 2007.

- All these circumstances led to a reduction by the technical team at Banco de la República in the projection of growth for 2008 to a range of 3.3% to 5.3%, versus the previous one, which stood between 4.0% and 6.0%.

- The salary indicators available do not show a homogeneous tendency by sectors. While the average salaries in heavy construction accelerated until June, registering high readjustments, the annual growth in the salaries of the industry and commerce remained stable around the rates of 5.3% and 7.5% respectively.

c. Foreign context

Employment in the USA continued falling during the last months, revealing that the productive activity is weakened. Simultaneously, the housing sector does not show any signals of recovery and, on the contrary, its situation could deteriorate still more. As a result of the increase in arrears of mortgage credit and seizure of housing, the prices of housing continued to reduce in April and could continue doing so in the following trimesters.

Although some improvement was observed in the financial conditions in the USA during the second trimester, this trend was not maintained in the last few weeks. The mortgage crisis continued to strike financial institutions, this time affecting the two major entities backed by the government which cover the sector of housing credits (Fannie Mae and Freddie Mac). Because of these problems, new liquidity pressures have arisen once again in the inter-banking market of this country, as has been registered by the increase in the differential between the cost of indebtedness by the Treasury and that of commercial banks. Similarly, meaningful reductions in the stock indexes have taken place, given that they are not only circumscribed to financial companies, but they also extend to those of the real sector (excluding energy companies).

Growth has also lost momentum outside the USA, Europe being the most evident case, where an important deterioration can be observed in consumers' confidence and company owners. Some emerging countries of Latin America such as Venezuela, Ecuador, Chile and Mexico also presented a slowdown of growth in the first trimester. In spite of this, the growth rate for the region as a whole continues to be relatively high. Particularly for Venezuela, the growth rate in the first trimester was 4.8%, lower than the one observed for 2007 (8.5%). The domestic demand lost momentum because of a strong deceleration of consumption and private investment.

In spite of the lower dynamism of the worldwide economy, the international prices of basic products, particularly oil, continued to be high, which caused inflation to continue rising around the world. Particularly in the USA, total inflation for consumers continued to increase, and as of June it was 5% above analysts' expectations.

It is expected that the prices of basic products will remain high. Although speculation may take place, it is probable that fundamental factors related to the balance of demand and supply may explain the boom of these prices. In these conditions, a meaningful drawback in the prices of raw materials and oil may be possible only if a strong slowdown on world demand takes place, beyond the one foreseen by the market.

Inflation increases as well as increments of inflation expectations took place not only in the USA, but also in a number of emerging and developing economies, the most important case being the one of the Euro zone. This situation has led to increases in interest rates or announcements of possible increases in the future issued by a number of central banks, notwithstanding that perspectives of growth have diminished.

d. Financial Variables

The growth of broader monetary aggregates has become stable in the last trimester on levels higher to the growth of nominal GNP estimated for the present year. By the second week of July, the M3 grew at an annual rate of 12.5% and the liabilities under statutory reserve requirements increased by 13.3%. A re-composition of liabilities in favor of Certificates of Deposit continues to be observed.

The debt portfolio of the financial system has been growing this year at an annual rate close to 18.9% versus 20% in the previous month. Debt portfolio in pesos continues to show greater dynamism, although it has presented a trend towards slowdown for almost a year.

The net debt portfolio in national currency continued to slow down, although at a slower rhythm. Until June, this variable grew 18.9%, while one month before it had grown 20%. The greatest descent in the annual growth rate continues to be registered by the consumer debt portfolio (including micro-credit) with twelve-month variations of 20.6%, followed by commercial at 19.7% and mortgage on 16.1%. Different measures of the trends of debt portfolio suggest that by the end of the year its growth will be around 18%.

The nominal average rates for lending (9.7%- in Colombia, *DTF*) and deposit rates (17.1% - BR methodology) increased slightly in June. These levels are similar to those registered last April. In real terms, the average rate for credit has experienced a decreasing behavior since October 2007, interrupted only in April this year, and its current level is below the historic average calculated since 1986. This last behavior is explained by the descent in the real rate for ordinary credits, and, in a lower measure, by the lower interest rate for consumption.

The average appreciation from January to June this year regarding the same period last year was 13.5%.

2. Discussion and policy options

In the course of the discussion the following issues were highlighted: (i) the rhythm of price growth continues over the goals established by the Board; (ii) the meaningful weight of food products over the behavior of prices in the international context of rising pressures; (iii) the uncertainty over the future behavior of the prices of regulated products, given the mechanisms for indexation incorporated in the determination of rates and the inflation of non-tradable goods; (iv) the costs of production of companies which present important increases in raw materials as well as in labor components; (v) uncertainty over the future behavior of world economy and of our main markets for exportation, particularly Venezuela's; (vi) the effect of the revaluation of Colombian Peso over inflation and the perspectives of growth of the tradable sectors; (vii) the behavior of the expectations for inflation, which continue to be over the goals established by the Board, and (viii) the strong impact of the fall of investment on civil works on the growth of the

GNP in the first trimester and the uncertainty of its possible effects on future growth.

The main issues for discussion among the members of the Board were related to the following aspects: (i) the effect of the measures of monetary policy given the lag in their impact; (ii) the elements which affect the projections of inflation for 2008 and 2009; (iii) the negative projections of inflation in the short term; (iv) the pertinence of adopting measures of monetary policy in a context of increase in the international prices of food products and fuels; (v) the behavior of inflation of non-tradable goods not including food or regulated products, which continues to show a trend of increase; (vi) the lower deficit projections of the current account; (vii) the effects of the appreciation of the exchange rate; (viii) the possibility that the changes in the international scenario, in a context of deficit of the current account, may lead to future adjustments in the exchange rate: (ix) the uncertainty generated by the high volatility of the international markets and the incidence it may have on Colombian economy; (x) the difficulty to evaluate the information available in a situation in which there is a rupture in the sustained cycle of growth; (xi) the balance of risk between growth and inflation in a context of expectations of increasing inflation and slowdown of the economy (xii) the need of strengthening the credibility of the monetary authority and anchor expectations of inflation before the risk of collateral effects of the international prices of food products and fuels.

The majority of the Board considered that the current situation is particularly delicate and requires an analysis with an explicit medium and long term perspective. Although the economy presents clear signals of deceleration and the risk balance indicates that growth this year will be less than in recent years, the risks of an inflation that may endanger growth in the medium term are considerable. Contrary to what was observed in 2007, during the first semester of 2008 the economy has fully received the impact of the clash of prices for food products, fuels, and metals which has been affecting world economy, in addition to the impact of local climatic factors. In fact, the diagnosis of the reasons explaining the slow-down of economy shows that the high levels of inflation, given their relation to these relative clashes in prices, are generating pressures of costs that negatively affect the supply in several productive sectors, among them the manufacturing industry. Additionally, inflation of food and regulated products has eroded the purchasing capacity of consumers of products other than basic goods. Based on the aforesaid, it can be stated that the nature of inflation significantly explains the recent decrease of economic growth.

On the other hand, the expectations of inflation on a short, medium and long term have increased, constituting a serious obstacle for the purposes of the monetary authority and the greater effectiveness of the policy decisions adopted and to be adopted in the future. This is particularly dangerous in times when the measures for the propagation of inflation reach values close to 70%, indicating that the greater inflation of food and regulated goods has already contaminated part of the basic goods, and when the recent increases in the interest rates of intervention have been absorbed by the greatest inflation registered this year, even though it partly reflects transitory increases in prices. It is necessary then to avoid that the monetary policy validates the clashes of relative temporary prices causing them to turn into a greater inflation of permanent nature, carrying enormous economic and social costs.

From the aforesaid it can be inferred that at the time there really is no disjunction between inflation and growth. The dilemma for the monetary authority lies in looking for a greater dynamics of economy in the very short term, probably temporary and which will be eroded by an overflowing inflation, or, on the other hand, consolidating the conditions for a sustained growth of production and employment, returning to a sensible path of inflation towards long-term goals. In order to do so, it is necessary to increase the rates of intervention of the Bank.

Some members of the Directive Board advised that at this moment an additional increase on the interest rates would be inconvenient and untimely, given the following reasons: (i) the recent evolution of the economic indicators confirms that the economy is slowing down since the end of the previous year in a much faster way than the economic authorities had foreseen**.** The very same technical team at the Banco de la República has been forced to reduce its forecasts on the growth of economy for 2008, first from an annual 5,2% to 4,7%, and, according to its latest exercise, from 4,7% to 4,3%. (ii) Colombia, as well as other countries, is facing a clash of supply over inflation given the increase of the prices of food products. In the region, Colombia registers a relatively moderate increase of the total and basic inflation. The change of posture in the monetary policy since the beginning of

2006 and the additional measures for the control of inflation have allowed such posture not to have been eroded in real terms on account of the increase in the rate of inflation. (iii) The government announced a budget cut for 2008 of Col$1.5 trillion, which is equivalent to 0.4% of the GNP and one of whose fundamental objectives is to alleviate the pressure over the monetary policy derived from the increase of inflation. This measure adjusts the fiscal accounts and has an important effect over the growth of the public demand and economic growth in general and, therefore, over the behavior of inflation. (iv) It must be stressed that the monetary policy adopted by the Board since April 2006 has proved on account of its results that it has moved in the right direction. Besides, it must not be forgotten that more than half of the 15 increases in the interest rate of intervention of the Banco de la República took place less than one year and a half ago, which indicates that, due to the natural lag existing between these measures and their impact on domestic demand and credit, there is still a highly considerable number of remaining effects which have not yet been felt, and (v) An additional increase in the interest rate would broaden yet more the meaningful differential existing between the internal and external rates, and would therefore would increase the pressure on the revaluation of the Peso and the subsequent harm on employment in the tradable sectors of economy.

The Board of Directors agreed by majority to increase the interest rates of intervention of Banco de la República in 25 bp, and deemed necessary to continue performing a careful follow-up of the effect that the international economic situation may have over growth, as well as of the inflationary pressures of the international prices of food products and fuels.

3. Policy decision-making

The Board of Directors agreed by majority to increase the interest rates of intervention of Banco de la República in 25 bp, from 9.75% to 10%.

Bogotá D.C., Colombia

August 8, 2008