Minutes of a Meeting of the Board of Directors of Banco de la República Held on January 31, 2011

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá on January 31, 2011.

Present:
Mr. Juan Carlos Echeverry, Minister of Finance and Public Credit
Mr. José Darío Uribe, Governor, Banco de la República

Full-time Board Members in Attendance:
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Fernando Tenjo
Mr. César Vallejo
Mr. Juan Pablo Zárate

Inflation and the economic situation were discussed with respect to growth and prospects for the future, and monetary-policy decisions were reached. The following is a summary of the main topics addressed during the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in December was 3.17% (0.65% for the month), which is 58 basis points (bp) more than in November and within the target range set by the Board of Directors for 2010 (2% - 4%).

The rise in inflation compared to November was due to upward pressure from food and regulated prices, as well as less favorable performance by tradables, excluding food and regulated items. The annual variation in food prices went from 2.4% in November to 4.1% in December, propelled by both perishables and processed foods. The annual variation in regulated items went from 6.3% in November to 6.6% in December, and was concentrated in fuels. Lastly, the annual variation in prices for tradable goods, excluding food and regulated items, went from -0.5% in November to -0.3% in December.

The annual variation in the price of non-tradable goods and services, excluding food and regulated items, stood at 3.5% in December, after having increased in November.

As for the core inflation indicators, their average went from 2.4% in November to 2.5% in December. The lowest indicator is still the CPI, excluding food and regulated items, with an annual rate of 1.8%. The annual variation in producer prices (PPI) was 4.4% in December as opposed to 3.7% in November, with a monthly variation of 1.6%.

Inflation expectations at one year increased and were in the upper half of the target range for 2011. The long-term expectations (at five to ten years), measured with government bonds, surpassed the ceiling of that range.

b. Growth

In the third quarter, GDP rose at an annual rate of 3.6%, which is less than was expected by the market and by Banco de la República. This was explained primarily by the downturn in building construction and civil works, and to a lesser extent by low growth in coal and by less favorable performance than was expected for coffee.

On the demand side, the lower figure was the result of limited growth in investment, particularly for construction, coupled with export performance that did not live up to expectations. Household consumption performed well and accelerated compared to the figures for the first half of the year. The increase in consumption, plus strong investment in machinery and equipment and in transport equipment kept imports up.

The performance of the Colombian economy during the final quarter of 2010 is expected to be similar to what it was during the third quarter, spearheaded mainly by external demand. Winter weather, which intensified towards the end of the year, had serious negative effects not only on agriculture, but also on gross fixed capital formation and on certain mining exports, which were not carried out due to problems with extraction and/or transport.

The consumer confidence indicator remained high during the fourth quarter, despite having fallen on several occasions in recent months. This would indicate household consumption continued to perform well during the fourth quarter. The foregoing, in turn, is reflected in the behavior of the commerce indicators. According to the latest data released by DANE, they showed an annual increase of 21.4% by November, while consumer imports, in dollars, were up 51.3% by that same month.

The investment indicators reflected mixed performance during the fourth quarter. By November, imports of capital goods, in dollars, showed high growth rates. However, construction had yet to demonstrate favorable performance, partly due to the effects of the weather and to problems with contracting and carrying out works.

In the case of foreign trade, total exports in dollars by November showed an annual variation of 19.5%, largely due to the mining, energy and coffee sector, which posted an annual increase of 30.0%. The cumulative 12-month increase in total exports comes to 20.0%. Total imports in dollars posted an annual variation of 34.5% by November. The cumulative 12-month rise in total imports is 20.8%.

The supply indicators available for the fourth quarter show mixed performance and suggest growth could slow in various branches of the economy such as industry, energy, gas, water and transport. In contrast, the information from the Fedesarrollo business opinion survey shows industrial orders remain at high levels and inventories are down. Both these situations are associated with favorable performance in the sector. However, the same survey also reflects a drop in expectations for production and sales at three months.

The rise in formal employment for workers with the most education could imply an increase in their earnings, which could be partly responsible for the improvement in consumption. There was a certain amount of recovery in formal employment during the course of 2010 up to December, particularly in the final part of the year.

Historically low real and nominal interest rates on lending, coupled with a build-up in the consumer and mortgage loan portfolio throughout the last half of 2010, are the factors that contributed to growth and lead one to expect more momentum in consumption and a recovery in investment in buildings during the final quarter. There has been an important increase in the commercial loan portfolio as well.

c. Financial Variables

In December, nominal interest rates on consumer and ordinary lending averaged 16.9% and 9.3%, in that order, with respective increases of 6 bp and 11 bp compared to the month before. The interest rate on mortgage lending was 12.2%, which implies no variation with respect to the figure on record for November.

Annual growth in the total gross loan portfolio in pesos came to 14.1% in December, as opposed to 11.9% the month before. The mortgage and consumer loan portfolios are still the most dynamic, with respective annual variations of 21.3% and 15.5%. By December, the annual increase in the commercial loan portfolio was 12.8%.

The interest rates on one-year and five-year government bonds rose by 11 bp and 41 bp, respectively, between January 3 and January 28, 2011. Interest on the 10-year bond was 8.5% by the same date, which is 19 bp more than the rate posted on January 3.

d. The External Context

One of the highlights in the external context during the past month was the favorable performance of several developed economies such as the United States, with 2.9% growth during the year, and Germany, with an increase of 3.5%. Even so, Europe continued to experience a major slowdown in the second half 2010 compared to the first six months of the year, due to less than favorable performance by the economies in Europe's periphery.

As for the European economies with fiscal problems, the markets would have regarded the debt placed last month by Portugal, Spain and Italy as a positive signal, one that was mirrored in a decline in risk perception, measured through CDs, and in the rate on the five-year and 10-year bonds issued by those countries.

Better economic indicators for the United States, coupled with last month's approval of fiscal plans, have enhanced the prospects for that economy in 2011 and for the world economy in general. Nevertheless, analysts continue to eye the job market with concern, as it has yet to show clear signs of recovery.

In 2011 and after a brief period of calm, the region's emerging economies again experienced pressure for their currencies to appreciate. The soundness of their fundamentals and the good outlook for economic performance in 2011, as well as high commodity prices and low risk premiums, probably will continue to help spur capital flows to these countries.

2. DISCUSSION AND POLICY OPTIONS

The following points were emphasized by the Board during its deliberations:

- i Inflation forecasts for 2011
- ii The variation in prices for tradable goods
- iii The delayed effect of monetary policy measures on production and prices
- iv Forecasts for growth in the economy and employment during 2011
- v The performance of consumer confidence and investment
- vi Recent movement in the loan portfolio in the financial system
- vii The increase in the price of financial assets and housing
- viii Inflation expectations
- ix The recent behavior of capital flows
- x The performance of government bonds
- xi The risk balance between growth and inflation
- xii The need to maintain the credibility of the country's monetary authority and to anchor inflation expectations around the long-term target
- xiii Data on growth and the forecasts for the world economy

The Board of Directors emphasized the following with respect to how inflation performed during the month:

(i) The annual variation in the consumer price index was 3.17% in 2010, which is more than the Bank's technical team and the market expected. The rise in inflation, primarily due to higher food prices as a result of the weather, will be temporary.
(ii) The core inflation indicators increased as well, but at a slower pace, and are still below the mid-point of the target range.
(iii) The various measurements of inflation expectations at one year rose and were in the upper half of the target range for inflation.

Growth in the Colombian economy during the second half of 2010 was less than what was forecast several months back. Fundamentally, this was due to the behavior of investment in civil works and the impact of La Niña weather on farm production, mining output and transport. In contrast, household consumption and borrowing are increasing at high rates, as is corporate debt and investment in machinery and equipment. The latter is partly due to historically low nominal and real interest rates.

The economies of Colombia's major trading partners are growing slightly more than was expected, although there still is a great deal of uncertainty about how some of them will perform in the future. At the same time, the Asian and Latin American countries are showing strong growth and price pressures. Some of their central banks have hinted at changes in the stance of their monetary policy. International commodity prices are at historically high levels.

The members of the Board analyzed the conditions in which, given the probable scenarios in the months ahead, it might be necessary to change the stance of Banco de la República's monetary policy by making it less expansive. The points they stressed as being fundamental for an eventual hike in the intervention interest rate are, among others, growing upward inflation expectations above the target range, the important momentum in internal demand, high asset prices, and the accelerated build-up in lending. On the other hand, low core inflation levels and the recent relative stability in prices for non-tradable goods, excluding food and regulated items, the possible temporary nature of the increase in food prices, the unstable situation with respect to the sovereign debt of several European countries, and the lack of certainty surrounding the forecasts for inflation and growth in the months ahead were underscored as factors in favor of keeping the rate at its present level.

Finally, the members of the Board believe if the economy remains on an upward path, as anticipated, or inflation expectations show signs of deviating from the targets, conditions will be right for gradually withdrawing the monetary stimulus in an effort to strengthen the sustained increase in production and employment.

3. POLICY DECISION

The Board of Directors agreed not to change Banco de la República’s intervention rate, which will remain at 3%.

Bogotá, Colombia
February 14, 2011