Minutes of Banco de la Republica (Central Bank of Colombia)
Board of Director's Meeting of 27th July 2012

On 27th July 2012, in the city of Bogota, D.C., the ordinary meeting of Banco de la Republica's Board of Directors was held with the presence of the Minister of Finance and Public Credit Mr. Juan Carlos Echeverry, the Governor 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 are discussed and decisions relating with monetary policy are adopted.

The following is a summary of the most significant matters addressed at this meeting.

1. BACKGROUND

a. Recent developments in inflation

Annual consumer inflation in June stood at 3.20%, which means 24 basis points (bp) below last month's figure. This result can be explained by both a reduction in the annual variation of CPI without foods, which shifted from 2.94% in May to 2.81% in June, and a 50 bp decrease in the annual variation of the Consumer Prize Index (CPI) for food (4.22%) as compared with the previous month record. Year-to-date, a cumulative increase of 2.01% in CPI has been observed, lower than what was seen in the same period of 2011 (2.53%).

In the CPI without foods, this decrease in annual variation was explained mainly by the regulated item component and, particularly, the domestic price of fuels which has been reacting to the lower international oil prices observed since April. The CPI for fuel shifted from 3.7% to 1.8%.

Though of minor significance, falls were also suffered by the other regulated item components (i.e. utilities and public transportation).

Likewise, in June a reduction of 3.74% to 3.2%) was seen in the annual variation in the CPI for the non-tradables without foods and regulated items; it can be attributed in good part to a high comparison basis. However, a new increase of up to 3.7% was experienced in the annual variation of leases (8 bp more than in May). It had been 3.4% in December of the previous year and, since February 2011 (at 3.0%), has continued to rise interruptedly. Worth noting is the fact that leases account for about 19% in the total CPI. With respect to tradables without foods and regulated items, their result in June was 1.0%, similar to that in May though higher than the percentage observed in the first quarter of the year (about 0.7%). The lower annual peso appreciation in the past few months may be related to this phenomenon.

The annual variation in the CPI for foods dropped from 4.72% in May to 4.22% en June. Perishable foods more generally affected by weather conditions were those having experienced the most noticeable decreases (from 1.1% to -2.0%), as explained in part by a recovery in the farming supply propelled by the relatively high prices of several of these food items until past year's third quarter. In the case of processed foods and meals eaten out of home, no significant changes were seen. The annual variation in this component stood relatively high at 5.5%, this suggesting some kind of demand and/or salary cost pressures in this sector.

In the last month, a decrease in core inflation was noticed as well. The average of the three indicators watched over by Banco de la Republica stood at 3.35% as opposed to 3.20% in the previous month.

The annual variation in the PPI did also exhibit significant reductions in June with a figure standing in negative terrain (at -0.69%) for the first time in over two years. For December 2011, while the record was 5.5%, it stood at 0.8% for May. An important part of this fall is associated with the decrease in oil prices and the other fuels. Should this behavior prevail, it would point to diminishing non-salary cost pressures in the next months.

Inflation expectations deriving form the TES (treasury securities) at different horizons declined in June; 5-year expectation stood below 3% after several months with higher records. 2 and 3-year expectations remained below this figure in a slowdown trend. Those obtained from the monthly survey show an expected inflation of 3.1% for the end of this year and of 3.32% for July 2013, i.e. 17 bp and 14 bp respectively, below the record reported one month ago.

b. Growth

The most recent information for the second quarter of 2012, especially with relation to private consumption and industry, suggests economic deceleration.

Indicators relating to consumption, among which retail sales stand out, indicate that consumption during the second quarter had grown at a significant lower rate than in the first quarter of the year. In April and May, according to the DANE (the National Administrative Department of Statistics), retail sales contracted down to an average annual rate of 1,0% (the first annual fall registered in almost three years). If vehicle sales are excluded, the behavior is similar although, in this case, the average annual growth rate for April and May is 0.5%. Moderation observed in imports of consumer goods having shifted from a growth rate of 19% in the first quarter to an averaging 8% in April and May do also suggest deceleration in this type of spending.

According to Econometrics, with data as of June, vehicle sales decreased 1% in annual terms and 0.6% on average for the quarter. Likewise, with figures as of June, a drop in the consumer confidence index was witnessed as measured by Fedesarrollo, this suggesting lower growth in consumption for this period as well.

The lower growth in consumption for the second quarter coincides with a deceleration in the annual growth rate for credit with 25.1% in March to 21.2% in the first week of July, the above in an environment of stable interest rates remaining even below their 2000 averages (with the exception of the credit card rate).

On the other hand, information relating to investment shows that although figures of capital goods imports as of May (having grown in the two-month period April May at an annual rate of 12% as opposed to 8% in the first quarter) indicate that this spending might be growing at a stronger pace than previously, the overall outlook for investment is uncertain due to the fact that it depends upon the speed of civil-work recovery.

Regarding Colombian external sales in dollars, they grew 1.2% in May with respect to the same month in the previous year. This growth rate is lower than that observed in the past few months (17.6% on average per annum between January and April), and it can be explained by the 1% reduction in mining exports and a 12.4% fall in the foreign sales of major agricultural products. On their side, external sales for the remaining - particularly industrial - goods (accounting for 22% of the exported total) grew 14.6% in annual terms.

On the supply side, indicators available suggest a backwards step for GDP in industry in annual terms in the second quarter. In April and May, also in annual terms, the industrial production index without coffee threshing contracted 1.3% on average, with its levels trending down. Although this fall was explained to a large extent by the chemical sectors reporting raw-material availability problems, even without these branches industrial production had contracted (annual 0.1% on average) in these months

Other industry indicators did also point to a weak behavior for the sector. Fedesarrollo indicators such as orders and stock as of May showed backward steps, although they still remain above their last 20-year averages. The foregoing caused a fall in the industrialist confidence index which, nevertheless, is smaller in its significance than the deceleration seen in the industrial production growth.

Likewise, in the construction sector no indicators available suggest significant dynamism. In annual terms, cement production fell 0.8% on average in April and May while construction licenses showed an average annual contraction of 33% in the same months. In the case of the later, this strong fall is due to the atypically high levels they are being compared with.

As per the farming sector, the recovery of coffee production having growth 18% per annum in the second quarter, as well as the increase in slaughtering of cattle in April and May let expect the sector to reverse its negative growth records from of the two previous quarters.

All the above leads to think that GDP growth in 2012 would stand between 3% and 5%. Although consumption and investment will continue to be the major source of growth, they would grow less than in the previous year. By activity branches, mining and financial services would continue to be the most dynamic sectors, just as it was in the first quarter, while industry and construction would exhibit the lower performance. For 2013, growth similar to that of 2012 is projected.

c. Financial Variables

Total credit in national and foreign currencies ("MN" and "ME" credit) recorded in June an annual increase of 17.15%, this percentage being lower by 53 bp in the previous month and 254 bp in the previous quarter. Monthly and quarterly deceleration took place in all types of portfolios, the growth rates of which in June were as follows: 21.6% for consumption, with a monthly reduction of 105 bp and a quarterly reduction of 376 bp; 16.11% for mortgage, with a monthly reduction of 57 bp and a quarterly reduction of 113 bp; and 15.17% for commercial credit, with a monthly reduction of 11 bp and a quarterly reduction of 230 bp.

On its side in June, real interest rates (excluding CPI without foods) for consumer, mortgage and ordinary credits stood in this order at 15.85%, 10.02% and 9.27%, which were lower than their respective averages as estimated since 1998 (excluding mortgage, the average of which is measured from 2002 onwards).

d. External Context

During the second quarter of the year, the global economic activity weakened more than expected mostly due to increasing uncertainty generated by the European public debt crisis. For this reason, the likelihood of global deceleration and its deepening in 2013 is growing. For the next year, the most recent predictions of the major international agencies continue to point to a worldwide growth recovering as compared to 2012, although at a slower pace than estimated in previous months.

Real activity indicators for the eurozone show that, likely, the economy had contracted more than foreseen in the second quarter of the year. Along this line, preliminary estimations of government agencies for France and Spain evidence that economic growth was negative between April and June. The poor behavior or peripheral economies in the region has significantly affected entrepreneur and consumer confidence and begun to reduce dynamism in the regional economies having showed sounder results until now. With respect to the labor market, the unemployment rate for the overall eurozone stood at 11.1% in June. This figure evidences an increase as compared with previous months. In addition, credit conditions have continued to narrow, this proving commercial banks' reluctance to reactivate credit.

The most recent measures passed by the European authorities, such as the possibility of direct capitalization for the Spanish banking system through the use of resources from the region's rescue funds, and the 120.000 billion euros (equal to 1% of the region's GDP) to foster economic growth have temporarily reduced uncertainty; but they have not yet managed to persuade markets of the likelihood of a fast regional recovery. For instance, despite these announcements and the new fiscal austerity in Spain, pressures in the Spanish public debt prevail, partly due to doubts regarding the viability of this program, thus substantially increasing the risk premium.

In the case of the United States, economic growth continued to be weak. In addition, recent consumption and manufacturing activity indicators went through a slowdown in the pat few months. The most recent register of the manufacturer sentiment index fell into negative terrain, in this way giving clues about probable deceleration in production in the next months. Although the housing market has showed some recovery signs, these are still incipient and take place at very low levels, thus not being able to indicate production acceleration. The worsening of the European situation may jeopardize economic growth in the United States through further deterioration in household confidence and credit restrictions impairment at a global level.

The lower expansion rhythm in the developed economies has limited growth in the emerging ones, particularly in the Asian countries, where the commercial ties with Europe are stronger in this context, GDP growth decelerated again in China in the second quarter of the year by shifting from to 8.1% to 7.6% in annual terms.

With regard to the Latin American case, no growth reactivation can be seen in Brazil despite the encouraging measures. Other economies like Mexico, Chile and Venezuela show a better performance in their indicators, though in May some deceleration was seen in the Mexican and Chilean industrial activity.

In this environment, with the exception of some agricultural prices, international quotes for basic goods have decreased but they still exceed their past few years' averages.

Excess global capacity and lower international prices for commodities (with the exception of some agricultural goods) have moderated inflationary pressures and permitted the introduction of expansionary monetary policies in a significant number of countries. For instance, in the emerging economies, the Central Banks of Brazil, China and South Korea have recently lowered their interest rates in an attempt to counteract the effects of a deceleration in demand. In the advanced economies, monetary policy continues to be lax; if the global environment deteriorates further, the central banks of this group of countries might decide to implement more encouraging measures.

In brief, in the remainder of 2012 similarly to what is taking place in several emerging countries, the weakening of world economy is expected to affect the growth of the Colombian economy in a negative manner through less external demand and lower international prices for the main export products.

2. POLICY DISCUSSION AND OPTIONS

By a majority of its members, the Board of Directors agreed to reduce by 25 bp its intervention interest rate. In this manner, the base rate for expansion auctions will be 5%. This decision was made upon taking the following factors into account:

(i) Economic growth worldwide continues to weaken more than expected. Information suggests a slower growth rhythm in the United States while it keeps contracting in the eurozone. In China and other emerging economies, the slowdown in growth has been worse than predicted, thus mirroring the weakening of both world demand and the previous political actions.

(ii) Excess global capacity and lower international prices for basic products (with the exception of some agricultural goods) have moderated inflationary pressures and allowed the introduction of expansive policies in a significant number of countries. In the emerging economies, for example, the central banks of Brazil, China and South Korea have recently lowered their interest rate in an attempt to counteract the effects of deceleration in demand.

(iii) The weakening of global economy is negatively affecting Colombian economic growth as a result of less external demand and lower international prices for its major export products. These factors are likely to continue working in the same direction in the next few quarters. Although both consumption and investment are to be the main source of GDP growth in 2012, these components of internal demand will growth less than in the previous year and are very likely to reduce, even eliminate, the current production capacity pressures.

(iv) Generally, with the new information available, a 3% to 5% growth in the GDP has been projected. This range width is due to uncertainty around the size of global slowdown and its impact on the Colombian economy, as well as with respect to the recovery of civil works and the overcoming of some negative supply shocks currently affecting the industrial and mining sectors. Growth similar to 2012's is projected for 2013. As would be expected, uncertainty levels increase as the forecast horizon grows.

(v) Annual growth in the commercial portfolio continues to slow down, while for consumer credit – though moderated – is still high and the mortgage portfolio grows at a good pace along with a new-house price index remaining at historically high levels.

(vi) In June, annual inflation was 3.2%, below the figure projected by the Bank's technical team. All core inflation measures have dropped and their average stood close to 3.0%. Inflation expectations did also go down: 3.1% is expected for December 2012 and about 3.3% for July 2013, while those deriving from the treasury ‘TES’ bonds at horizons between two and five years are around 2.5%.

A majority of Board members considered that lowering the intervention interest rate by 25 bp was appropriate. Excess spending in the economy has been reduced at a higher speed than expected, and credit growth has become more moderated. Likewise, both inflation and inflation expectations have fallen. Although some of the factors having weakened internal spending growth are expected to reverse soon (like, for instance, the notorious decline of investment in civil works), those associated with external factors will likely prevail in the next few quarters. With respect to the future behavior of inflation, goal deviation risks are low and, up to now, they are limited to a temporary increase of food prices in 2013 to be corrected in the second semester of that year. Moreover, at this time the risk of a reduction of 25 bp in the intervention interest rate would unlikely increase financial unbalance risks subsequently threatening to jeopardize employment and product growth.
This reduction in the intervention interest rate evidences a change in the monetary stance; it shows the Board’s commitment to maximizing employment and product growth in harmony with the attainment of inflation targets, and it has been defined by envisaging its effects in several markets simultaneously, taking into account the presence of uncertainty and carefully assessing its risks.

Other members deemed appropriate a 50 bp reduction in the Bank’s intervention interest rate since, according to information available, it has been confirmed that international economic deterioration is much worse than foreseen in the past few months, while the likelihood of further accentuation of this negative trend grows day after day. In the domestic environment, it can be seen that industry is in the path of contraction; according to indicators available, consumption in the second quarter might have grown significantly less than in the first quarter, like the GDP, which would register deceleration for a third consecutive quarter while there is an increasing perception of risk at the local level and both consumer and entrepreneur confidence indices have fallen. This indicates that economic activity would to continue to loose strength.

3. POLICY DECISION

According to the assessment of the current balance of risks, the Board of Directors agreed to reduce Banco de la Republica intervention interest rate by 25 basis points.

The new information shall permit to establish new monetary policy actions in both what concerns the development of events in the advanced countries, their impact on global confidence and demand, and the international prices for commodities and from internal dynamics.

The Board confirms that Banco de la Republica has both the tools and sufficient resources to meet the liquidity needs in local and foreign currencies usually required by the economy, as well as those likely to be felt in an environment of international financial turbulence.

The Board will continue to keep a close eye on the international situation, inflation behavior and projections as well as growth and the performance of asset markets; and it restates that monetary policy will depend upon the new information available.

Bogotá DC, August 10 2012