Minutes of a Meeting of the Board of Directors of Banco de la República Held on March 18, 2011

A regular meeting of Banco de la República's Board of Directors was held in the city of Bogotá on March 18, 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 decisions on monetary policy were reached. The following is a summary of the main topics addressed at the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in February was 3.17% (0.60% for the months). This is 23 basis points (bp) less than in January.

The decline compared to January was due to the variation in prices for food and regulated items. Annual food price inflation went from 4.8% in January to 4.4% in February, largely because of perishable foods. Annual inflation in regulated items declined from 7.0% in January to 6.3% in

February, thanks to less of an annual change in the price of gasoline, which was not adjusted in February. Inflation in tradables, excluding food and regulated items, was even more negative in February.

The annual difference in prices for non-tradable goods and services, excluding food and regulated items, rose slightly and was 3.42% in February, having been 3.37% in January.

As to the core inflation indicators, their average in February remained stable at 2.5%. With an annual rate of 1.7%, the lowest indicator was still the CPI, excluding food and regulated items. On the other hand, the annual modification in producer prices (PPI) was 4.6% in February, which is more than in January (4.3%). In terms of the make-up of the PPI, the annual variation in its imported component increased.

Banco de la República's monthly expectation survey with data at February points to 3.5% inflation by the end of 2011, which is slightly less than what was anticipated in January (3.6%). In the case of expectations further out (five and 10 years ahead), which are based on government bonds, the decline was clearer, but these expectations are still over the ceiling of the long-term target range (2% - 4%).

b. <u>Growth</u>

Available figures for the end of 2010 suggest more of an increase in GDP growth during the final quarter of the year compared to third-quarter growth and to what was forecast previously by the Bank, in which case the Colombian economy would have expanded by nearly 4.2% for all of 2010. This better- than-expected performance is largely the result of the indicator for civil works and coffee production.

The momentum in economic activity so far this year is akin to what it was at the end of 2010, with internal demand performing well in terms of both consumption and investment. As for consumption, consumer confidence rose in February, breaking the trend. Added to this is the continued expansion in consumer lending at high rates in January and February, the 12.3% annual increase in retail sales by January, and a job market that is showing signs of improvement. Therefore, it is still reasonable to expect good growth in private consumption during the first quarter of 2011.

As for investment, imports of capital goods were up by quite a bit at the end of the year, suggesting this expenditure remains strong. By the same token, the sharp increase in building permits during November and the acceleration in cement sales during December point to an improvement in home construction at the start of 2011, along with added momentum in civil works.

With regard to foreign trade, the annual variation in total exports in dollars at January came to 29.5%, largely due to the mining, energy and coffee sector, which posted an annual increase of 30%. The cumulative 12-month increase in total exports is 22.3%. At December, annual growth in total imports in dollars came to 39.8%. The cumulative 12-month increase in total imports was 27.3%.

On the supply side, real indicators of industry's expectations and confidence show this sector is still on the road to recovery. According to the DANE Monthly Manufacturing Sample, annual industrial growth was 6.2% by January 2011. This exceeds the cumulative rate for all of 2010 and is similar to what was reported by ANDI. Another source, Fedesarrollo, cites continued growth in the volume of industrial orders during January; however, it remains slow and a long ways from record highs. In contrast, the measure of inventory availability (counter-cyclical) is already near to its record low. Industrialists' expectations for production at three months returned to a high level and the confidence indicator (which combines, orders, expectations and inventories) rose once again.

For 2011, macroeconomic conditions continue to support an important economic growth. In fact, the expectation is still one of rising demand, high terms of trade, which will increase more than in 2010, important FDI flows, a continued recovery in jobs, and broad terms for internal lending, with relatively low real interest rates. Accordingly, GDP is expected to perform favorably in 2011, at around 4.5%. Nevertheless, a great deal of uncertainty surrounds this expectation, since the world faces a number of economic and political risks.

c. Financial Variables

In February, nominal interest rates on consumer and ordinary lending averaged 17.5% and 9.8% respectively, with consumer lending up 4 bp and ordinary lending down by 27 bp, compared to the month before. The mortgage lending rate was 12.4%, which is 7 bp higher than in January.

The annual increase in the total gross loan portfolio in domestic currency was 15.5% in February, as opposed to 14.9% the month before. The consumer and mortgage loan portfolios remain the most dynamic, posting respective annual variations of 20.9% and 17.5%. In February, the annual increase in the commercial loan portfolio came to 13.5%.

Interest rates on one-year government bonds were up by 12 bp between February 25 and March 18, 2011; those on five-year government bonds declined by 23 bp during the same period. Interest on the 10-year bonds was 8.7% by the same date, which is 20bp less than the rate posted on February 25.

d. The External Context

An important factor in the external context is the impact the earthquake in Japan has had on that country's economy and on international markets in general. For the past week, equity and commodity markets have registered major losses in market value. These have slowed the rise in international commodity prices, at least in part, and accentuated the stock market declines already witnessed due to the tensions in the Middle East and North Africa. Oil prices, in particular, fell after having risen sharply with the advent of the crisis in the Middle East and North Africa.

Global growth continues at different speeds. On the one hand, in terms of the major developed countries, the United States and Germany have exhibited better than expected performance. On the other, there are the peripheral European economies and Japan, with low growth and even declines in some cases. Finally, there are the emerging economies that continue to grow at a good pace, bolstered by Asia and Latin America.

So far in 2011, the United States has continued to consolidate its economic recovery with slow-moving growth in industrial manufacturing and stronger than expected momentum in sales to consumers. The job market also has begun to show signs of resurgence, as suggested by the January and February indicators. Even so, there are still obstacles to full recovery. First of all, high debt levels and persistently high risk perception have hampered a revival in lending. Secondly, the housing market continues to lag and the fiscal deficit is huge. These circumstances can limit growth in consumption and investment.

The situation in the case of the Euro zone is less clear and shows different trends for its member states. Germany, on the one hand, has exhibited strong recovery, thanks to exports, and has managed to pull off a sizeable reduction in unemployment. On the other hand, growth in the peripheral European economies is less than promising and joblessness continues to be a major concern. Finally, with respect to Japan, economic activity prior to the earthquake showed no sign of performing well and this situation is likely to worsen in the months ahead. However, on a longer term basis, more dynamic growth can be expected as a result of reconstruction efforts.

Despite recent declines in international prices for raw materials, they remain high and could pass through to inflation in both the developed and emerging economies. Moreover, there are still a number of factors bringing upward structural pressure to bear on raw material prices. Added to these pressures are the concerns about the safety of nuclear power and the restrictions on its use announced in some countries around the world.

In the context of good global growth (propelled largely by the emerging economies) and high commodity prices, we can expect the central banks in the emerging economies and in some of the commodity-exporting developed countries to continue the cycle of interest rates hikes. In the major developed economies, despite a considerable amount of surplus installed capacity, international commodity prices have begun to pass through to inflation. For these reasons, one cannot rule out the possibility of the European Central Bank and the Bank of England raising their rates during the second quarter of 2011. In contrast, for the United States, no changes in monetary stance are anticipated for the short term.

Finally, with regard to risk perception, credit default swaps for the peripheral European economies have increased again in recent weeks, and Moody’s downgraded the debt ratings of Spain and Portugal. Risk premiums for Latin America remain low and, in the case of Colombia, its foreign debt rating was raised to investment grade by Standard and Poor’s.

2. DISCUSSION AND POLICY OPTIONS

The members of the Board of Directors weighed the possibility of raising intervention interest rates at this meeting, pursuant to what was announced at the previous meeting with regard to the advisability of gradually reducing the monetary stimulus of past months to make the added momentum in the Colombian economy sustainable over time and to keep inflation within the long-term target range. The following points, in particular, were emphasized:

(i) interest rates at record low levels in nominal and real terms, with signs of stability during the past month;
(ii) the risk extremely low interest rates for too long a period of time can ultimately imply for financial stability, the sustainability of growth and future inflation;
(iii) further reasons to expect the economy to reach near potential levels during the second half of the year, given the continued high growth rate for consumer lending, a better job market, the sharp increase in building permits, and the added momentum in civil works;
(iv) the inconsistency that could result from having an exceptionally low interest rate coupled with near-trend growth anticipated for 2011 and 2012, and inflation forecast at around the mid-point of the long-term target range;
(v) the time it takes monetary policy to have an impact;
(vi) over-target inflation expectations at more than one year;
and
(vii) the stability of the exchange rate in recent weeks and the positive outcome of the foreign currency purchase program.

In terms of risks, it is still too early to gauge the full impact of the earthquake and the tsunami that struck Japan. An initial analysis indicates economic recovery in the developed countries could be slower, but this would not take pressure off oil and other commodity prices. In addition, doubts about the fiscal situation in some of the industrialized countries continue, as does uncertainty with respect to international oil prices, given the political instability in the Middle East and North Africa. Furthermore, international prices for oil, food and other commodities are at record highs and have led to prices increases for consumers in many countries. The central banks of some countries in Latin America and elsewhere have raised their interest rates.

Considering all these factors and the time it takes monetary policy to affect aggregate spending and inflation, the Board felt it was appropriate and prudent to continue to gradually reduce the monetary stimulus. The level of Banco de la República's intervention interest rate still supports short-term growth in output and employment. The intervention rate hikes in February and March will help to make the increase in output and employment more sustainable, to keep inflation within the target range this year and the next, and to preserve the stability of the financial system. Furthermore, these anticipated consequences of monetary policy are expected reduce the level to which the intervention interest rate should increase in relation to the levels observed in previous economic cycles.

3. POLICY DECISION

The Board of Directors agreed to an increase of 25 basis points in Banco de la República's intervention interest rate, placing it at 3.5%.

Bogotá, Colombia
April 1, 2011