Minutes of the Banco de la República Board of Director's meeting on May 27, 2010

On May 27, 2010 the regular meeting of the Board of Directors of the Banco de la República was held in the city of Bogota.

Present were:
Oscar Ivan Zuluaga, Minister of the Treasury and Public Credit
Jose Dario Uribe, the General Director

Full-time Board members present:
Carlos Gustavo Cano
Juan Jose Echavarría,
Fernando Tenjo,
Cesar Vallejo
Juan Pablo Zárate.

The inflation and economic growth situations as well as the outlook for both were discussed and decisions were made in relation to monetary policy. Below is a summary of the main topics dealt with in this meeting.

1. BACKGROUND

a. <u>Recent developments in inflation</u>

Annual consumer inflation stood at 1.98% in April, which was 14 bp more than in March. Inflation for the month was 0.46% and all of the indicators of annual core inflation declined.

The annual change in food prices went from 0.34% in March to 0.93% in April due to the rise in prices for perishables.

The annual increase in the prices for regulated goods went from 3.4% in March to

3.9% in April. This was the result of the adjustments that were made in fuel and energy.

The annual change in the prices for non-tradable goods excluding food and regulated goods was 3.9% in April compared to 3.8% in March.

The annual change in the prices for tradable goods excluding food and regulated prices fell from 0.3% in March to -0.3% in April. This rate is the lowest seen since a record has been kept for this indicator.

Based on the preliminary data from May 19, inflation expectations derived from the negotiations for 1, 5, and 10 year public debt lowered and stood at 1.87%, 3.56% and 4.09% respectively.

Inflation expectations from the quarterly and monthly surveys done by the Banco de la Republica at the beginning of May continued to show declines and were within the long term target range set by the Board of Directors.

In April, annual inflation of producer prices (PPI) was 0.3%, which is 45 bp higher than that of March. The PPI rose primarily as a result of the prices of imported goods.

b. <u>Growth</u>

The indicators which are available show that consumption is recovering at a pace that is faster than what had been predicted especially in the case of durable goods. The indicators that are associated with the gross formation of fixed capital other than public works and construction still show negative annual growth.

The following are some of the relevant indicators:

– The Fedesarrollo Consumer Confidence Indicator (CCI) with data up to April continues to show an improvement in household expectations with regards to the short and medium term economic situation.

– The commercial sales measured by DANE ended the quarter with a growth that is higher than what has been seen in the last two years. The high correlation between the growth in commercial sales and domestic household consumption makes it possible to trust a surge in this type of expenditure in the first quarter of 2010.

– The annual change in the industrial production index was 6.4% which is similar to what was expected by the Bank's technical team.

– The total demand for energy –regulated or non-regulated– excluding exports grew 4.6% in annual terms in April which is added to the 5.1% annual growth in the average for the first quarter.

– According to DANE, total industrial sales grew 3.2% annually in the first quarter.

Total exports for the month of March registered an annual rise of 19.4% and so far this year, 19.1%. Exports from mining grew 33%; agriculture, 25%; and industry, 9.4% with respect to the same month last year. However, when the main products such as coffee, nickel-iron, petroleum derivatives and gold are discounted from industrial sector exports, an annual fall of 8.1% is seen.

The main export products (coffee, coal, nickel-iron, oil and its derivatives which represented 57% of the total foreign sales in March) showed an annual growth of 39.8% in dollars and a drop of 5.8% in volume.

By country of destination, the largest demand on our total exports is made by the United States, which represented 44% of our total sales in the month of March. Venezuela's share dropped when it went from 18.2% in March, 2009 to 4.7% in the same month this year. The other destinations (except for the European Union) have gained a larger share of the total amount exported by Colombia. Specifically, there were higher sales to Asia which went from 5.6% in March last year to 12.2% in March, 2010. The higher sales registered for the United States, India and China are mainly due to the increase in exports of petroleum and its derivatives, coal and gold.

The lower exports from the industrial sector excluding main products are the result of the drop in sales to Venezuela which plunged 68% annually in March. Sales from this sector to other destinations rose in annual terms. Those to the United States rose 46% and to the remainder of the countries, 36%.

In March, the value of the total imports in dollars (CIF) grew 24.7% with respect to what was observed during the same month last year and 19% in relation to what was registered in February, 2010. The upswing in imports was caused by the increased purchases of consumer goods, especially durable goods (31.4% annually) and intermediate goods (29% annually). Imports of capital goods grew 16.5% annually.

In the moving quarter ending in March, the national unemployment rate (UR) stood at 13% and the rate for the 13 areas, at 13.7%.

c. Foreign context

The various indicators of real activity in the US and in emerging countries in Asia and Latin America confirm that the world economy is still recovering.
Global financial markets showed a significant rise in the levels of uncertainty and volatility due to the growing problems of sovereign debt in various European countries. This situation led to a upsurge in the perception of worldwide risk in spite of the 750 billion euros in support measures adopted by the European Union and the IMF for the most indebted countries (PIIGS). In this environment, plunges in the stock markets in developed countries, especially in Europe, have been occurring and the euro continues to depreciate in comparison to the dollar and other currencies (based on the numbers as of Friday, May 21).

In spite of the above, the Latin American economies have not been significantly affected by the financial turbulence. The sovereign risk premiums showed small increases compared to previous periods of crisis. The currencies of the majority of the countries depreciated last month with this trend being much stronger in Brazil and Mexico. In the latter, the depreciation for last month was around 7% while in Colombia it has been around 2%.

The main impact of the European crisis has been seen in the prices of commodities, especially oil. If this trend continues, it will negatively affect countries that export raw materials, in particular, since it will affect their terms of trade and, thus, the GDP. However, it is still premature to talk about what the impact of the crisis in Europe will be on the global economy.

d. Financial variables

The M3 and Liabilities Subject to Reserve Requirements, which had registered a stable annual growth of close to 7% from the beginning of the year up to April, surged to rates that were somewhat above 9% in the first week of May. This trend, which is transitory in character, is due to lower government deposits in the Bank.

In April and the first week of May, 2010, the annual growth of the total gross portfolio (M/N) stabilized at a rate of close to 5%. Going by modality, the slowdown in the commercial loan portfolio has been offset by the higher rates of increase in the mortgage and consumer portfolios. Even though the balance of the commercial portfolio has been relatively stable over the course of the year so far, its trend is more favorable when the bonds issued by the real sector are added in. In April, this credit aggregate reached COL$101.6 t, a number which is COL$683 b higher than what was seen a month ago and COL$2 t higher than that registered last December.

With respect to disbursements, the spread for those going to the commercial loan portfolio surged (between April and mid-May) but their levels are similar to those registered a year ago. The disbursements of loans for households (consumption and mortgage) continue to have sharp rises in both the spread and in annual terms.

After the Banco de la Republica's benchmark rate was reduced 50 bp, the deposit rates dropped and lending rates showed a mixed trend. Consumption rates, which had also exhibited a decline in April, fell 28 bp the first week of May. During this last period, the treasury and prime commercial interest rates fell 54 bp and 26 bp respectively. The rates for housing loans, in turn, including both construction and purchase rose.

Concerning the prices of assets, the General Index for the Colombian Stock Market (IGBC in Spanish), which had reached a historical maximum at the beginning of May, showed a slight decline in value as a result of the crisis in the European Union similar to what has occurred in other countries in the region. In the case of fixed income, the negative impact has been very low.

Between April 30 and May 24, the rates for the public debt securities registered negative changes of 59 bp, 36 bp and 13 bp in the short, medium and long tranches respectively.

2. DISCUSSION AND POLICY OPTIONS

Over the course of the discussion the following points stood out: (i) the result of inflation up to April which stood within the projections made by the Banco de la Republica's technical team; (ii) the annual change in tradable goods excluding food and regulated prices which began to decline again thus reinforcing the trend that has been seen since August 2009; (iii) a new fall in the core inflation indicators and in inflation expectations; (iv) the faster than expected economic recovery in the first quarter; (v) improvements in businessmen's and consumer's expectations; (vi) stable growth in the monetary aggregates; (vii) the growth of the financial system portfolio in legal currency at levels similar to the estimated rise in the nominal GDP for 2010; (viii) the recent trend in the prices for assets; (ix) the trend in the market interest rates in response to the reduction of the Bank's benchmark rate; (x) the effect of the exchange rate on inflation and the growth of the product for the tradable sectors; (xi) the interest rates for public debt securities which fell during the month and (xii) the recovery of the world economy and the severe uncertainty generated by the crisis in some European countries.

The Board members' main points of analysis centered around the following aspects: (i) the inflation projections for 2010 and 2011; (ii) the reduced variation in prices for tradable goods due to the appreciation of the peso compared to the dollar; (iii) the lagged effect of monetary policy measures on production and prices; (iv) the projections of economic growth for 2010 which suggest a recovery that is faster than predicted; (v) the recent movement in the financial system portfolio and in the prices for assets; (vi) the drop in inflation expectations; (vii) the balance of risk between growth and inflation in a context of a recovering economy and inflation that is slightly below the long term target range; (viii) the uncertainty generated in the world economy by the European crisis and (ix) the need to maintain the monetary authority's credibility and anchor inflation expectations to the long term target.

The Board of directors emphasized the following regarding the trend of inflation for the month: (i) annual consumer inflation in April was 1.98%, which was slightly higher than in March (14bp) but within the projections made by the Banco de la Republica's technical team; (ii) the core inflation indicators continued declining and are in the lower part of the target range for long term inflation set by the Board; (iii) inflation expectations continued to fall; (iv) the result of inflation last month is in line with the projections made by the technical team which shows, with a high degree of confidence, that inflation will be within the long term target range in 2010 and 2011.

The information received in the last few weeks indicates that the economy is recovering more rapidly than expected without generating inflationary pressures. Factors such as the improvement in agents' confidence and the momentum of various leading indicators confirm the higher growth.

The recovery of the world economy has been affected by Greece's public debt crisis and its possible spread to other European countries. The effects of these crises are still uncertain. It should be emphasized, however, that Asia, the United States and the economies of Latin America demonstrate a recovery that is getting stronger and stronger.

The Board believes that the expansionary monetary policy that has been adopted, including the recent 50 bp reduction of the benchmark rate, is contributing to the growth of the economy in an environment of a healthy financial system.

3. POLICY DECISION

The Board of Directors agreed to keep the benchmark rate of the Banco de la República unchanged and it will remain at 3%.

Bogotá, Colombia
June 11, 2010