Minutes of Banco de la Republica (Central Bank of Colombia)

Board of Directors' Meeting of August 24, 2012

On 24th August 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. Jose Dario Uribe, and the exclusive full-time dedicated directors, Messrs. Carlos Gustavo Cano, Juan Jose Echavarria, Juan Pablo Zarate and Cesar Vallejo, at which inflation and economic growth circumstances and perspectives discussed, and decisions relating with monetary policy are adopted.

1. Background

a. Recent developments in inflation

Annual consumer inflation in July stood at 3.03%, which means 17 basis points (bp) below last month's figure. This result can be explained by a reduction in the annual CPI without foods, which shifted from 2.80% in June to 2.74% in July, and a 43-bp decrease in the annual CPI for food (3.79%) as compared with the previous month's record. Year-to-date, the cumulative CPI increase amounts to 1.98% against 2.67% registered in the same period of 2011.

In the CPI without foods, this decrease in the annual variation was explained mainly by the regulated item component having shifted from 3.92% to 3.48%. This reduction was concentrated in utilities – specifically electric energy - charges (from 5.1% to 3.0%). Another important fall for a second consecutive month took place in the price of household gas which would be reacting to the lower international prices for fuels observed between April and June this year. For the same reason, the domestic price of gasoline continued to decline.

In the other two CPI sub baskets without foods – tradables and non-tradables without regulated items, changes from one month to another were minimal. In the first case, the annual 1.03% variation, though low in comparison with total inflation, is high if compared with the previous year's situation. This behavior would be associated with the lower exchange-rate appreciation in the year to date. In the second case, the slight 6-bp increase in July (to 3.68%) was in part motivated by readjustments in entertainment services (soccer). The annual variation in the CPI for leases, the main component, remained stable around 3.8% for the first time after 16 months of gradual increases. Other services exhibit relatively low annual adjustments giving reasons for concluding that demand pressures as of July were scarce.

The annual variation in the CPI for foods dropped from 4.22% in June to 3.79% in July. This result was explained again by perishable products where a wide set of this type of items showed low price adjustments or reductions. Factors such as the favorable weather conditions prevailing in most part of the first semester, as well as some high prices in the previous quarters would have fostered demand. Likewise, in July, a reduction took place in the annual variation of the CPI for processed foods, among them some of imported origin, which suggests that rises in the international prices in the past few months have not affected consumer prices in Colombia. Finally, the annual variation in the price of meals eaten away from home was reduced down to 5.37% for a second consecutive month.

Core inflation remained stable in July as opposed to what was observed in the previous month. The average of the four core inflation indicators monitored by Banco de la Republica shifted from 3.02% per annum to 3.04% in the last month. Since November 2011, the upward trend exhibited by this variable was interrupted.

The annual variation in the PPI did show reductions in July as well, with a figure that stood in negative terrain (-0.39%) for the second consecutive month (since it had been -0.69% in June). The local PPI went up slightly and remained in negative terrain while the imported component did not show any important changes and, likewise, remained in negative terrain.

In July, the decline of inflation expectations was significant: those deriving from the 2, 3, and 5-year Treasury Bonds TES continued to go down, and stood at 2.4% for the three cases. Those obtained from the monthly survey show an expected inflation of 2.93% and 3.27%, 17 bp and 10 bp respectively for August 2013, less than what was reported a month ago.

b. Growth

The most recent industry, commerce, and exports and imports indicators suggest a slowdown in Colombian economy during the second quarter as compared with the first, although data showed a better performance in June than in the previous months.

With regard to household consumption, the behavior of commerce retail sales, imports of consumer goods, and unemployment indicate a reduction in the consumption growth rate in the April-June period. According to the information published by the DANE, retail sales in June grew at annual rate of 4.0%, higher than that registered in April (-2.85%) and May (0.93%). Annual expansion for the full second quarter was 0.8% lower than that observed during the first quarter (6.1%).

On their side, imports of consumer goods in dollars in June grew 13.3% in annual terms. Although this growth is higher than in April (5.6%) and May (11.4%), this did not prevent a significant slowdown in growth between the first and the second quarters (annual rate of 18.3% and annual rate of 10.1% respectively). As for the unemployment rate, it continued to show a downward trend in May and June, but each time with a more reduced rhythm in annual terms.

With respect to investments other than construction and civil works, imports of capital goods (with an annual growth rate of 5.1%) suggest that their growth might remain at similar rates than those observed at the beginning of the year. However, in the construction and civil work lines, it is not clear if some improvement has taken place, given the behavior of cement production and construction licenses.

As for Colombian exports, total sales in dollars in June fell at an annual rate of 2.3% as a consequence of the lower nominal growth of exports of mining origin: oil and oil by-products, coal, ferronickel, and gold (0.7%), and of a contraction in the exported value of agricultural products: coffee, bananas and flowers (-21,4%), and industrial items (-3,8%). In the case of goods of mining origin, their growth was affected by the drop in external sales of oil and oil by-products (annual rate of -7.30%), mainly by a price effect. The reduced external sales of agricultural products are explained by a decrease in the values of exported coffee (-26%) and flowers (-39%). Therefore, during the second quarter, annual external sales growth (1.8%) slowed down as compared with that of the first quarter (21.2%), to a large extent due to a reduction in commodity prices.

On the supply side, the industrial production index without coffee threshing grew at an annual rate of 2.8% in June. Despite the fact that this figure accounts for an acceleration with respect to the two previous months (-2.54% in April and -0.24% in May), for the second quarter overall it means an annual growth of 0%, lower that that observed in the first quarter (2%). The chemical sectors continued to report raw-material availability problems, while other sectors such as vehicles, clothing, sugar, and beverages, among others, contributed to the sector's upturn in the month.

The construction sector indicators show that the cement production showed an annual growth of 0.83% in the second quarter as opposed to 8.3% in the first quarter, and construction licenses continued to contract at a fast rhythm.

In contrast, in the case of the agricultural sector, the recovery in coffee production, which grew at an annual rate of 18% in the second quarter as well as the expansion registered in cattle slaughtering in April and May, let expect the sector to reverse the negative growth records of the past two quarters. Likewise, given the behavior of credit, the financial services sector should grow at a similar rhythm than in the previous quarter, which was high.

The poor information of the third quarter gives mixed results. Consumer confidence recorded a slight increase in July after the falls occurring in June. This indicator exceeds both its historical average and the average of the full year 2011. This shows that household consumption has continued to expand.

Nevertheless, on the industry side, leading indicators such as those referring to three-month orders, stocks, and production expectations in the "*Encuesta de Opinión Empresarial*" (Business Opinion Survey) – EOE of June continued to impair, though from still high levels. This came along with a drop in industrial confidence, which may be announcing a poor performance of industry in the next few months. Despite the demand for both regulated and non-regulated energy, it grew and accelerated at a good rhythm in July, as compared with the second quarter.

Besides, in July, vehicle sales reported by Econometrics fell in annual terms (-2,6%), in this way continuing the downward trend having been observed for a whole semester.

This fall can be explained by a decrease in the sales of private cars, utility vehicles and pick-ups that play an important role in household consumption of durable goods. In contrast, the sales of vehicles of commercial use (cargo and passenger transportation) grew at important annual rates; this suggests a good performance of investment in transport equipment.

Given the above information, the growth forecast between 3% and 5% for the full year 2012 is maintained.

c. Financial Variables

En July, total credit in national and foreign currencies ("MN" and "ME" credit) showed an annual growth rate of 17.2%, lower that the previous month rate (17.6%) and than the rate observed in March (19.7%). A year of credit moderation is accumulated, given that in July 2011 it was growing at an annual rate of 23.3%.

Monthly and quarterly deceleration was seen mainly in the household portfolio modalities. For the consumption portfolio, the annual increase in July was 20.9%, therefore lower than in the previous month (22.3%) and in March as well (25.4%). For the mortgage portfolio, the annual variation was 16.0%, lower than that of the previous month (16.5%) and that of March (17.2%). On its side, the commercial portfolio had an annual growth of 15.56%, therefore with similar dynamics than in the previous month (15.53%), as the result of an offset between the deceleration of the portfolio in national currency and the acceleration of the portfolio in foreign currency. However, growth in July was lower than in March (17.5%)

Moreover, real interest rates (excluding CPI without foods) in July for consumer, mortgage and ordinary commercial credits, in that order stood at 16.5%, 10.0%, and 9.3%, these being rates lower than their respective averages estimated since 1998 (excluding the mortgage rate, the average of which is measured from May 2002 onwards).

Since early May 2012, the "*TIB*" (the 1-day interbank rate) began to deviate above the BR reference rate, in this way attaining the higher 30-bp deviation on July 30. Subsequently, to the extent that the liquidity needs in the market have been reduced, that deviation has also shown a correction and, as of August 23, it stands 16 bp above the reference rate.

d. External Context

Economic activity results in the second quarter confirm the weakening of growth worldwide. The Eurozone GDP fell as compared with the level observed in the first quarter, and growth in the United States and some emerging countries in Asia was slightly weaker. International financial markets are still volatile, and risks deriving from Europe continue to affect entrepreneur and household confidence.

The Eurozone contracted in the second quarter of the year as a consequence of the recession confronted by the economies in the periphery, and null growth in France. Germany's positive growth was not sufficient to offset the fall of economies like those of Spain and Italy, this added to the sharp contraction witnessed in the United Kingdom. More recent indicators point that the European economies might continue to deteriorate in the second quarter of the year. This can be inferred, for example, from the strong fall in entrepreneur and consumer expectations in July, in this way completing an eleven-month period with a negative balance.

In the United States, GDP growth decelerated in the second quarter. As of July, some real activity indicators like industrial production and retail sales evidence that the economy has continued to expand slowly. Nevertheless, entrepreneur and consumer confidence remains at low levels.

Other developed economies like Japan showed weakening signs in the second quarter of the year. The effects of the external trade deterioration, particularly with respect to the Eurozone, lie to a large extent behind this phenomenon.

The emerging – particularly Asian - economies, have moderated their expansion rhythm as well as a consequence of the reduced demand from the Eurozone. Figures as of the second quarter of the year show that the annual GDP growth decelerated in

China and other countries in the region like Singapore and South Korea. This trend was maintained in July, as shown by some real activity indicators. Thus, the expansion of retail sales, industry, and exports, weakened again in China and something similar occurred in other Asian countries.

The economic slowdown trend was also observed in Brazil, where industrial production continued to contract in annual terms in June while, in contrast, in other countries in the region like Mexico, Peru, Chile, and Venezuela, GDP expansion kept a good pace because domestic demand has continued to be dynamic. Even so, exports and industrial production are also exhibiting weakening sings in these countries.

The international prices for some basic agricultural and oil products rebounded after having shown decreases in July. In the first case, the intense draughts suffered in the United States and other cereal producing countries explain the price increases experienced by these goods. On the oil side, geopolitical factors, a reduced production and inventories lower than expected generated upward pressures on their quotations. Despite these facts, if the global economy slowdown continues, oil prices might go down again.

In the past few months, global inflation has remained contained, and this has allowed the developed economies to maintain their expansive monetary policy. Some central banks in emerging countries like Brazil, China, and South Korea, among others, have adopted a less restrictive policy in the face of real activity deceleration. Even though an inflationary risk associated with the recent increase of food and oil prices exists, international benchmark interest rates are expected to remain at low levels during the remainder of the year and good part of 2013.

In the rest of 2012, problems in Europe will probably continue to be transmitted to other economies as already suggested by the latest foreign trade and industry figures worldwide. This heightens the likelihood of an even weaker global growth in the future.

Just like it is occurring in many emerging countries, the weakening of global economy affects the growth of Colombian economy through several channels the action of which could be seen in the previous crisis, such as the fall of export volumes and prices, the reduction of workers' remittances, the deterioration of the terms of trade, and the loss of entrepreneur and consumer confidence.

2. POLICY DISCUSSION AND OPTIONS

By unanimity, 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 4.75%. This decision was made upon taking the following factors into account:

(i) The results of the second quarter confirm the weakening of global growth. The eurozone GDP fell in comparison with the level observed in the first quarter, and growth in the United States and some emerging Asian countries was slightly weaker. The international financial markets are still volatile, and confidence continues to be affected by Europe-deriving risks.

(ii) The latest foreign trade and industry figures worldwide do also suggest the increasing transmission of European problems into the rest of the economies. This heightens the likelihood of an even weaker world growth in the future.

(iii) The international prices for some basic agricultural products have risen as a result of droughts registered in producing countries, Likewise, the oil price rose after having experienced a reduction in the second quarter of the year.

(iv) In Colombia, the value of commodity exports of mining origin continues to slow down; its annual growth of 0.7% can be essentially explained by lower international prices. In turn, agricultural exports, as well as those from the other sectors, particularly in the industry, fell 21.4% and 3.8% per annum respectively.

(v) Although industry and commerce figures in June were slightly better than expected, growth was low. In the same month, the Fedesarrollo industry survey reflected deterioration in confidence and order volume again, as well as an increase in stock. Consumer confidence rose slightly in July and is standing above the average observed in 2011.

(vi) Credit growth is still slowing down, thus reducing the risk of financial imbalances. The recent moderation has been concentrated in household credit, which continues to grow at high rates. Real interest rates are at levels close to the average observed since 2000, and the interbank interest rate is standing above the intervention interest rate.

(vii) The observed and expected inflation in December 2012 fell at rates close to 3%. Core inflation measures remained relatively stable, and the average of the four indicators calculated by the Bank stood at 3%.

(viii) All term inflation expectations declined, while those deriving from the 2, 3, and 5-year Treasury Bonds – TES – stood around 2.4%.

According to the assessment of the current balance of risks, the Board of Directors deemed that reducing the intervention interest rate is appropriate. The new information will serve to introduce future actions of monetary policy concerning both the development of events in the advanced countries and their impact on confidence, global demand and international prices of basic goods, and internal dynamics.

In addition, in order to provide the economy with more permanent liquidity, the Board has decided that, in the remainder of August and in September it will buy $700 million US dollars through the daily auction mechanism with minimum price of US$ 20 million dollars.

3. POLICY DECISION

The Board of Directors has unanimously agreed to lower the intervention interest rate by 25 bp.

The Board restates that Banco de la Republica has both the proper tools and sufficient resources to meet local and foreign currency liquidity needs regularly required by the economy, as well as those likely to occur in an environment of international financial turmoil.

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