Minutes of a Meeting of the Board of Directors of Banco de la República on August 15, 2008

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá on August 15, 2008.

Present:

Mr. Óscar Iván Zuluaga, Minister of Finance and Public Credit

Mr. José Darío Uribe, Governor, Banco de la República

Permanent Board Members:
Mr. Fernando Tenjo
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Juan Mario Laserna
Mr. Leonardo Villar

Inflation, economic growth and their outlook for the future were discussed and monetary-policy decisions were reached. The following is a summary of the principal issues addressed at the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation was 7.52% in June, having increased for the third month in a row. Accumulated inflation in the first five months of the year came to 6.5%. This figure is 181 basis points (bp) above what it was last year. Some of the core inflation indicators increased in June and remained above the target for inflation.

The build-up in inflation during June was due to food prices, with rice and oils exerting the most upward pressure. Regulated price inflation went from 8.8% in June to 9.5% in July, mainly because of fuel and transportation.

Tradable and non-tradable inflation, excluding food and regulated prices, declined last month. In particular, the non-tradable CPI, excluding food and regulated prices, was 5.1% in July as opposed to 5.3% in June.

The intermediate and long-term inflation expectations implicit in TES market performance declined in the wake of the Board meeting on July 25, which put an end to the upward tendency observed since April. In addition, intermediate and long-term rates on TES fell during the period between July 25 and August 12, by 59 bp and 90 bp, respectively.

In July, producer inflation measured by the total PPI accelerated once again, going from 8% in June to 9.6%, which is the highest it has been since 2003.

b. Internal Growth

The available figures do not suggest changes in the GDP growth forecast developed by the Bank’s technical team for this year, which is between 3.3% and 5.3%,

The information on industry for the last two months indicates the sector continues experience less momentum, even more than expected. According to the ANDI Combined Opinion Survey, the annual increase in industrial production for the year to June was 1.2%. This is less than it was in April and May (2.8% and 1.9%, respectively). The industrial confidence indicators and the extent of inventories and orders at June confirm these tendencies.

The commerce indicators are not conclusive with respect to the tendencies in the sector. The balance of the Fenalco opinion surveys suggests that sales continued to loose momentum, although not as quickly as during the first quarter. On the other hand, the different Fedesarrollo indicators, such as the indicator of the current economic situation in the sector and the indicator of economic expectations at six months, denote no additional deterioration in the last two months.

The latest figures show the strong momentum in exports continues, with an increase of 42.4% in dollars and 22.9% in non-traditional exports.

The data on energy demand at June and July reflect an improvement, following the low figures in recent months. For example, the annual increase by July was 2.8%, which is more than the rate for the year to June (2.1%). Internal VAT collections showed nominal growth rates above two digits throughout the first six months of the year, having climbed to 35.7% in June.

c. The International Scene

World inflation has accelerated in recent month as a result of high food and energy prices. At the same time, economic growth has slowed. This phenomenon has been more pronounced in Japan, England and the Euro Zone. Those economies have begun to feel the effect of high prices for raw materials and the slowdown in the United States.

In the case of the United States, annual growth was 1.9% during the second quarter. However, this does not change the unfavorable outlook for this year and the next. Analysts have lowered their forecasts for U.S. growth in 2008 and 2009.

The consumer confidence and manufacturing production indexes in the Euro Zone have fallen sharply in recent months, weakening the GDP growth projections for 2008 and 2009. These indicators have been even less favorable in the case of Japan and the United Kingdom. The same has happened in some of the region's emerging market economies, such as Venezuela, Ecuador, Chile and Mexico, which continue to experience a slowdown in growth.

In that context, the dollar has gained strength against a large number of currencies. Coupled with the prospects of weaker world demand, this situation has led to a drop in prices for raw materials in recent weeks, especially oil prices.

d. Financial Variables

The annual increase in the principal monetary aggregates by July showed a declined during the last month and a half. For example, between June and July, M3 growth went from 14.5% to 11.5%. Deposits with the financial system continue, largely in the form of time certificates (CDTs).

Growth in the peso loan portfolio in the financial system stayed at 19.4% in July, which is similar to the figure registered the month before. A look at how this aggregate has performed in recent months shows no signs of a slowdown. The restraint in retail loan portfolio growth (18.4% in July) continued to be offset by a build-up in the ordinary loan portfolio (20.4% in July) and, in the last three weeks, by added growth in the mortgage loan portfolio (16.5% in July).

Most nominal interest rates declined during the past month. The largest drop was in rates on credit card loans (40 pb). The usury rate declined as well during the same period (by about 60 bp).

The exchange rate devaluated by 4.2% between July 14 and August 14.

2. DISCUSSION AND POLICY OPTIONS

The Board emphasized the following points in its deliberations:

- i Continued price increases at rates that exceed the Bank's targets, even though some items in the basket have begun to register lower price hikes (e.g. the CPI, excluding food and regulated prices);
- ii Uncertainty about the future of international prices for food and oil, which declined in recent weeks, and the effect they might have on total inflation;
- iii Uncertainty about how regulated prices will behave, given the indexation mechanisms used to determine them, and doubts about non-tradable inflation;
- iv The major increase in production costs for companies;
- v Uncertainty about prospects for the world economy and Colombia's principal export markets, particularly Venezuela;
- vi The effect of the exchange rate on inflation, and the outlook for growth in the tradable sectors; and
- vii The behavior of inflation expectations, which continue to exceed the targets set by the Board of Directors, despite a decline last month.

The main points of discussion among the Board members centered on: (i) the effect of monetary-policy measures, given the time it takes them to work through to the economy; (ii) the elements that influence the inflation forecasts for 2008 and 2009; (iii) the advisability of adopting monetary policy measures in a scenario of high international prices for food and fuel; (iv) the behavior of non-tradable inflation, excluding food and regulated prices, which was down in July compared to the month before; (v) the lower forecasts for the current account deficit; (vi) the effects of accumulated appreciation in the exchange rate and the devaluation observed during the last few weeks; (vii) the possibility that changes on the international scene, in a situation with a current account deficit, might lead to future exchange rate adjustments; (viii) the uncertainty created by highly volatile international markets and how that volatility might affect the Colombian economy; (ix) the difficulty in assessing available data in a situation marked by a break in the cycle of sustained growth; (x) the risk balance with respect to growth and inflation in a context of rising inflation expectations and economic slowdown; and (xi) the need to bolster the monetary authority's credibility and to anchor inflation expectations, given the risk of the side-effects of international food and fuel prices.

It was emphasized during the meeting that inflation continues to rise in many countries and a number of central banks have raised their interest rates. International prices for oil, food and other commodities fell recently, but are still at historically high levels. In Colombia, expectations of inflation at different horizons, measured by the market for domestic government bonds (TES), declined sharply after the Board of Directors agreed in July to raise the Bank's intervention rate by 25 bp. The recent decline in long-term interest rates and the July reduction in non-tradable inflation, excluding food and regulated prices, are important factors as well.

Available figures show growth in local demand and output in Colombia has become more moderate, as it has in other countries; however, the forecast for growth is still between 3.3% and 5.3%. Tighter financial conditions and the effect of higher food and fuel prices on real available income have curbed the increase in demand. Supply has been negatively affected by higher production costs, which mean less growth in production and higher prices.

It is to be expected that annual inflation in 2008 will remain high during the months ahead, due to high food and fuel prices. Afterwards, total inflation and the core inflation indicators may fall off gradually, provided inflation expectations continue to decline and wage increases are moderate. The monetary authority's commitment to the long-term inflation targets encourages the conditions for sustained growth in output and employment.

In view of the foregoing, the Board of Directors agreed unanimously to hold Banco de la República's intervention interest rates steady, and believes it is important to continue to monitor the effect the international situation might have on growth, as well as the inflationary pressures associated with international food and fuel prices.

3. POLICY DECISION

The Board of Directors agreed unanimously to make no change in Banco de la República's intervention interest rates.