Minutes of the Banco de la Republica Board of Director's meeting on August 19, 2011

On August 19, 2011, the regular meeting of the Board of Directors of the Banco de la Republica was held in the city of Bogota.

Present were:
Juan Carlos Echeverry, Minister of the Treasury and Public Credit
Jose Dario Uribe, the General Director

Full-time Board members present:
Carlos Gustavo Cano
Juan Jose Echavarria
Fernando Tenjo
Juan Pablo Zarate and
Cesar Vallejo

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

1. BACKGROUND

a. Recent developments in inflation

Annual consumer inflation in July was 3.42% (monthly was 0.14%), which was 19 basis points (bp) higher than in June. This number was in line with what was projected by the Bank's technical team and similar to what the market expected on average.

The main upward pressures came from the prices for perishable food. Larger increases in the prices of some vegetables and fruit were seen and are explained by the lagged effect of the recent La Niña weather condition on this group of food items. As of July, the annual change in food prices was 4.8%.

Inflation excluding food remained stable (2.9%). In this basket, there were no unexpected changes and the variations in the different groups compensated for each other. The tradables (-0.02%) showed a less negative change (compared to -0.13% in June) and this was the component that exercised the most upward pressure on the CPI excluding food (due to household items and cell phones). The change in prices of non-tradables remained at the same level as in June (3.8%). In spite of the stability of last month, this group has been demonstrating an upward trend since March mainly due to the performance of rent. In July the rise in rent prices (6 bp with respect to the level in June) was offset by the decline in the prices for other items that this basket is made up of.

The regulated prices (5.7%), in turn, registered a 26 bp drop in July mainly because of the decrease in the annual variation of the CPI for fuel which offset the rise in prices for electricity.

The measurements of core inflation (with the exception of inflation excluding food) continued their rising trend. This slow but continuous trend has been common to all of the measurements of core inflation since mid-2010. Thus, the average of the four published measurements has already surpassed the midpoint of the target range.

The different measurements of inflation expectations (market expectations and expectations calculated based on public debt securities) were within the long term target range (from 2% to 4%).

The variation in producer prices (PPI) showed a slight recovery in July and adjusted to an annual rate of 4.8% compared to 4.7% in June. The rises were concentrated in the import component of the indicator.

b. Growth

The available activity indicators for the second quarter confirm that the Colombian economy has maintained a positive rate of growth for that period. Just as in the first three months of 2011 the growth in the second quarter was driven by domestic demand, especially household consumption.

In the second quarter, private consumption was still favored by the improvements in the labor market. During the period, the rate of unemployment continued to fall and for the 13 areas it was at 11.5%. This decline was accompanied by an increase in the TGP for the second consecutive month. The preceding was more than offset by the rise in the employment rate and because of that the unemployment rate dropped.

Imports also confirmed the strength of domestic demand in the second quarter. Purchases abroad in dollars grew 46% annually in June driven by the purchases of capital goods (58%) and raw materials (45%). Imports of consumer goods, in turn, grew 31% annually.

With respect to exports, the new results showed an upsurge in foreign sales in dollars. In June, exports in dollars grew 54% annually, a figure that is higher than the one registered in May (34%). This increase was due to higher sales of commodities from mining (crude oil and its derivatives, coal, gold and nickel-iron) that contributed 82% of the total growth.

With respect to the productive sectors, the indicators announced by ANDI and Fedesarrollo suggest that the industrial sector maintained the dynamism seen in the first quarter. The production measured by ANDI registered an annual expansion of 6.4% for the year as of June. Fedesarrollo's supply and demand indicators showed a small setback in June but remained at favorable levels. Fedesarrollo's 3-month production expectations indicator stayed at high levels.

With respect to construction, cement production saw a growth of 17% annually during the second quarter. The strong trend in building permits from the beginning of the year to May also indicates a positive performance in construction activity in the coming months.

The new information that is available for the second quarter is consistent with the forecast of 4.2% to 5.6% annual GDP growth for that period. The limited information available suggests that the annual growth in the third quarter will be above what had been estimated in the first half of the year. This is what is shown by the consumer confidence indicators, indicators of credit set aside for families and businesses and indicators of total demand for electricity.

To conclude, if the situation abroad does not deteriorate abruptly, the growth for all of 2011 will be within the projected range (between 4.5% and 6.5%).

c. Financial Variables

Total loans continued to surge. As of July, all of the types of credit including both those for households and those for businesses registered growth that was well above the growth estimated for the GDP in 2011. Specifically, the annual growth was 24.8% for the consumer loan portfolio, 22.9% for the commercial portfolio and 17.4% for mortgages. Following the same order, these levels are 78 bp, 53 bp and 67 bp higher than last month.

The above has occurred in a context of real interest rates that are historically low. In July, the real interest rates (discounting the CPI excluding food) was at 15.1% for consumer loans, 9.9% for mortgage loans and 7.5% for ordinary commercial loans. These figures are lower than the averages seen since 1998.

As of July, banking credit (NC and FN) rose 23.2% annually, a number that is 63 bp higher than what was registered in June.

d. Foreign Context

In the last few weeks, the probability of a deterioration in the global economy has risen significantly as a result of the economic problems that are currently affecting the developed economies. These problems have worsened due to the slow economic growth, the high public indebtedness, the markets' loss of confidence and the stagnation in macroeconomic policy in those economies. This has called into question the viability of the recovery of advanced countries thus indirectly complicating the economic panorama for emerging countries.

The recently revealed figures on the performance of the United States in the second quarter the year were discouraging. The annualized quarterly growth between March and June, 2011 was 1.3% below what the market had expected (2.3%) and lower than not only the growth in the same quarter of last year (3.8%) but also the growth for all of 2011 (3%). The sluggish growth in the second quarter is partly due to a relapse in personal consumption which, after reaching a growth of 2.0% in 2010, has been falling since the beginning of this year to the point where the growth in the second quarter was practically zero. At the same time government expenditures have been shrinking in the last three quarters and accentuating the tightening of domestic demand. The only components of demand that have shown any strength are exports, which have been stimulated by the depreciation of the dollar, and non-residential fixed investment in response to the low interest rates. However, the better performance of these items has not been sufficient to offset the drop in the rest of the components of demand.

The economic panorama in the Euro Zone is equally worrying. Between the first and second quarters of 2011, its economic growth fell from an already low level of 0.8% to 0.2% which, in practice indicates a totally stagnant economy. The slowdown was significant in almost all of the countries. Germany, for example, which grew 1.3% in the first quarter, grew only 0.1% in the second. Something similar occurred in France, which saw its growth slump from 0.9% to 0% during the same period. In the case of the United Kingdom, the news is no better. From a poor growth of 0.5% in the first quarter, it went to a growth that was barely 0.2% between this past March and June. In addition, the countries on the periphery of the Euro Zone –Greece, Portugal and Spain– remained stagnant or were shrinking.

The combination of slow growth and high public debt in the developed countries raises doubts about the sustainability of the latter. This is explained by the extremely complex vicious cycle that some of these countries have fallen into. In this cycle the high indebtedness does not allow the economy to grow and the fact that it is not growing does not allow the debt to be paid. Under those conditions, the danger that the debt will be unsustainable rises and this is reflected in an increase in real volatility, greater financial fragility and a loss of economic strength. The financial markets have seen this danger clearly which explains the stock markets' sharp plunges in the last few weeks and the steep rise in risk premiums, primarily in the countries on the periphery of the Euro Zone.

Under these conditions, the outlook for the worldwide economy is becoming more and more uncertain. The markets are beginning to fear a double dip recession that will cause all of the progress that has been made through the slow recovery that started in the second half of 2009 to be lost. This pessimism is not unfounded. The slowdown in the advanced economies and the negative effect that this represents for the expansion of emerging economies has begun to undermine consumer and businessmen's confidence who react by restricting their plans for consumption and investment. This weakens demand and with it the possibility of recovery. This situation is particularly obvious in the case of the US where the consumer confidence indicator calculated by the University of Michigan has fallen over the last few months to the same level that was seen between the end of 2008 and beginning of 2009. This has led to a stagnation of personal consumption as has already been stated. In addition, the high unemployment registered in the United States and in some European countries such as Spain and Greece is another factor that depresses confidence, consumption and demand thus creating a vicious cycle that accentuates the shrinkage of economic activity.

This uncertainty becomes accentuated in view of the doubts about the ability of the governments in advanced economies to be able to carry out sufficiently effective counter-cyclical macroeconomic policies that could reverse the negative trends and restore the confidence of the markets. It can be seen that in several of these economies the response capacity has not just fallen drastically but that it is exhausted. In the case of the US, the government's high indebtedness, which is closing in on 100% of the GDP, the size of the fiscal debt which has reached 10% of the GDP, and the restrictions that the debt ceiling imposes does not leave space for fiscal policy to play an active role like it did during the crisis in 2009. The monetary policy in that country is also restricted by the zero limit on the interest rate although a third quantitative easing could still be carried out. Nevertheless, the risk of greater inflationary pressure that have been registered in that economy in the last few months could impede a quantitative easing that would be as strong as the ones that were produced to dodge the previous crisis. In the case of the European countries, the same thing has happened due to the complication which is implied by the management of an economy that includes a variety of countries where some of them have reached the point where their public debt is unsustainable and others are exposed to this contagion which could put them in the same situation.

Meanwhile, the emerging economies are still the engine of worldwide growth although they are not free from risk. In a globalized economy, there are multiple channels for contagion as the experience from the crisis in 2009 demonstrated. One of them is the prices of commodities. So far we have seen that the price for petroleum has begun to decline and this will undoubtedly affect the oil-exporting countries including Colombia. The prices of other commodities such as grain and oil have not fallen yet although the rising trend that they showed in 2010 has been interrupted which is a symptom of the weakening of dlobal demand. Another channel of contagion is that of confidence which acts much more rapidly as the fall in the stock markets in emerging markets has shown as they duplicated what happened in the developed economies. In an environment of higher uncertainty, the emerging economies in Asia and Latin America have begun to lose strength although the majority are still growing at high rates. The question is to what point this growth can be sustained if the markets in the advanced economies –which absorb most of the exports of emerging countries– continue to weaken.

2. DISCUSSION AND POLICY OPTIONS

The board members focused on the following points: i) the growth of uncertainty in international financial markets, ii) the growth of the GDP in the second quarter, iii) the strong performance of domestic demand which is reflected both in the increase in consumption and in private investment, iv) the better indicators of quality employment in the labor market, v) the upsurge in loans to households and businesses in a context of real interest rates that have risen but that are at levels that are lower than their historical averages, vi) the historically low level of the Bank's benchmark interest rate and of most of the real interest rates and their possible future effect on risk-taking in the economy if they are maintained for an excessively prolonged period, vii) the high level of the terms of trade and their contribution to the growth of national revenue, viii) annual inflation iin July rose for the third consecutive month (3.42%) especially due to the performance of food prices. The average of the measurements of core inflation, in turn, started rising again and surpassed the midpoint of the target range (3% +/-1 percentage point), ix) inflation expectations for different maturities and the inflation projections for the end of 2011 and 2012 are within the target range, x) the high probability that the output level will be close to its potential in the second half of the year, xi) the monetary policy of other countries, xii) the drop in international prices for petroleum, xiii) the performance of the exchange rate.

The Board of Directors of the Banco de la Republica decided to keep the benchmark interest rate unchanged at 4.5% mainly considering the following:

i) since the last meeting, the series of events on the extenal front has raised the uncertainty with respect to the global economy. The plunge in the stock markets partly started by the drop in the credit rating of the US debt and the fiscal difficulties of some countries in the Euro Zone was added to a lower growth in the second quarter for the main developed economies (United States, Germany, France, Japan). In Asia and Latin America, regions that are very strong, growth has slowed down due to supply factors or because of policy actions directed towards preventing an overheating of their economies. As a consequence, the risks of lower growth in the world economy have risen, and ii) the problems of sovereign debt in Europe and the debate about the debt ceiling in the United States sharply increased uncertainty and volatility in the international financial markets.

In contrast, the international context is still very recent and their consequences are still difficult to set. Even if it is clear that the worldwide slowdown will have a negative impact on income and the country's external demand there is a lot of uncertainty about its size and duration. However, the board emphasized that i) the available indicators of economic activity confirm that the Colombian economy is maintaining a positive rate of growth driven mainly by the strength household consumption, ii) the indicator of consumer and industry confidence remain at high levels and iii) loans to companies and families continue to rise with increases that are much higher than the increase in the nominal GDP estimated for this year. This is in a context of real loan rates that are below their historical averages.

On balance the Board thought it would be prudent to suspend the increases in the interest rates especially due to the high uncertainty in the international financial markets and their potential negative effect on the growth of the global economy in general and the Colombian one in particular.

3. POLICY DECISION

The Board of Directors unanimously agreed to keep the benchmark interest rate unchanged at 4.5%.

The Board will continue to monitor the international situation (especially the risks associated with the handling of the debt problems in a large number of the advanced economies), the inflation trend and projections, growth, the performance of the asset markets carefully and reiterates that the monetary policy will depend on the new information available.

Bogota DC, September 2, 2011