Minutes of the Banco de la República Board of Director's meeting on April 30, 2010

On April 30, 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 Iván Zuluaga, Minister of the Treasury and Public Credit
José Darío Uribe, the general director

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

The inflationary situation and economic growth 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. Recent developments in inflation

Annual consumer inflation in March stood at 1.84%, 25 bp lower than in February. Monthly inflation was 0.25% and all of the annual core inflation indicators declined.

The annual change in food prices went from -0.1% in February to 0.34% in March, which was lower than what was projected by the technical team.

So far this year, there have been upswings in the prices of perishables as a result of the Niño phenomenon though not as intensely as was expected. However, other components of the basket have declined due to the following factors: (i) a fall in the price of meat due to the weakness of domestic demand and the closing of exports to the Venezuelan market, (ii) moderate adjustments in the prices of eating out also because of the weakness in domestic demand and the moderate adjustment in the minimum salary, and (iii) stability in the prices of imported food as the result of the revaluation of the peso compared to the dollar.

The annual increase in the prices of regulated goods went from 4.2% in February to 3.4% in March due to the lower annual growth in the CPI of utilities and public transportation.

The annual change in the prices for non-tradable goods excluding food and regulated goods dropped from 3.9% in February to 3.8% in March thus consolidating the falling trend that has been seen since September last year.

The annual rise in the prices for tradable goods excluding food and regulated goods fell from 1% in February to 0.3% in March. This level is the lowest one seen since a record for this indicator has been kept. The fall is determined by the accumulated appreciation of the peso compared to the dollar over the last few months, a domestic demand that is still weak, a foreign demand that is lower than was projected by the technical team, etc.

With preliminary data for April, the inflation expectations derived from public debt negotiations for 1, 5 and 10 years declined and stood at 2.61%, 3.91% and 4.18% with drops of 105 bp, 78 bp and 29 bp respectively.

Inflation expectations from the quarterly and monthly surveys done by the Banco de la República at the beginning of April declined and were within the long term inflation target fixed by the Board of Directors.

The annual change in producer prices (PPI) was -0.17% in comparison with -0.4% for the month before.

b. <u>Growth</u>

The available indicators for the first quarter of 2010 showed an expansion in economic activity and an upsurge in the annual growth rates. Specifically, those related to the demand pointed to private consumption continuing to have the favorable momentum that has been seen for the last two quarters. The indicators associated with the formation of gross fixed capital other than public works and construction still show negative annual growth.

Some of the relevant indicators are as follows:

– The Fedesarrollo Consumer Confidence Indicator (CCI) with data as of March show that agent confidence grew for the third consecutive month and was at its highest level since 2008. The increase is explained by an improvement in household expectations for the economic situation in the short and medium term.

– Up to February, retail sales maintained the growing trend that has been seen since the middle of last year. The high correlation between the growth in commercial sales and domestic consumption by households makes it possible to be confident of an upswing in this type of expenditure for the first quarter of 2010.

– The retail sales of vehicles for household consumption as of March grew at an annual rate of 28.3%.

– The annual change in the production index excluding coffee threshing was 3%, which is higher than what was expected by the Bank's technical team (2.5%).

– The building construction sector shows signs of growth. Construction licenses grew in January and February at a rate of close to 8% annually. As a result, the number of licenses remained at levels that are similar to those of five years ago.

The total demand for energy (regulated and non-regulated which excludes exports) grew at an annual rate of 7.2% in March, the highest rate for the entire decade. In the first quarter, the annual growth for this was 5.1% which is above the rate recorded in the fourth quarter of last year (2.6%).

– The imports of capital goods are falling in dollars and in real pesos (-21% annually as of February) which suggests that this expenditure will continue to show a contraction in annual terms during the first quarter.

In February, 2010, total exports in dollars registered a growth of 22.9% with respect to the same month last year. This is due to the rise in exports from the mining (94.6%) and agricultural (7.6%) sectors. Industrial sector exports fell 7.9% annually in February. When the main export products are discounted (coffee, nickel-iron, petroleum derivatives and gold), industrial exports declined 26.3%.

In the month of February, Colombian exports to different countries showed higher levels than those seen a year ago except for those to Venezuela. These registered an annual drop of 73.2%. Foreign sales to the United States and the rest of the countries (excluding Venezuela and the United States) had an annual growth of 47.2% and 49.1% respectively. Exports to Asia rose 233% and to the European Union, 55.6%. Added together these destinations represent close to 30% of the total exports for February.

For the year up to February, the value of the total exports in dollars grew 19% with respect to what was seen in the same period the year before given the higher exports from the mining (65%) and agricultural (14.5%) sectors. Exports from the industrial sector, in turn, registered an annual drop of 8.5% and of 19.8% after discounting the main products. By volume, the mining sector exhibited a small increase (1.3% annually) due to the higher exports of crude oil (33%).

With respect to imports, the CIF value in dollars (US$2.793 million) in February climbed 10.5% with respect to the same month the year before. Nevertheless, its level remains below the average registered in 2008 (US$3.306 million). In February, imports of raw materials and those of consumer goods registered annual increases of 37.2% and 12.8% respectively. Imports of capital goods, in turn, continue falling (they declined 11.9% in February).

The deficit in the balance of payments current account seen for 2009 was 2.2% of the GDP (US$5.146 m). The greater capital inflows from the public sector and Ecopetrol (US$7.275 m) financed the lower net direct foreign investment (this dropped from US$8.329 m in 2008 to US$4.177 m in 2009).

For the moving quarter ending in March, the national unemployment rate (TD for the term in Spanish) stood at 13% and that of the 13 areas at 13.7%.

c. Foreign context

World growth continued to surge during the first quarter due to the better performance in emerging economies and in the US. It is expected that the world economy will continue to be led by Asia which will keep the prices for commodities at the current levels or slightly above them and continue to favor the terms of trade in Colombia and other countries in the region.

In the case of the US, international analysts foresee a growth that is lower than 3% given the weakness in the labor market, the high level of household indebtedness and the restrictions on bank loans. With regards to emerging economies, the growth of China's GDP, which was 11.9% in the first quarter of 2010, stands out.

Latin American countries and Brazil, in particular, showed significant recovery. Venezuela showed a fall in economic activity at the end of the year which, together with the trade restrictions, continued to weaken our trade with this country which had markedly reduced its participation.

In this environment of growth, prices of commodity products have performed better than the technical team expected. In general, these prices have remained at high levels and this is expected to continue for the rest of 2010.

With respect to annual consumer inflation, this rose in industrialized countries in the last few months. However, this recovery does not seem to be permanent as the reductions that were seen in core inflation in the US and the Euro zone suggest.
With regards to the currencies, the dollar has strengthened in comparison to the euro and pound sterling over the course of the year and the risk premiums for emerging countries have remained stable at levels similar to those that were seen before the bankruptcy of Lehman Brothers.

d. <u>Financial variables</u>

During March and the beginning of April, the nominal growth of the monetary aggregates continued to show stability. M3 and the Liabilities Subject to Reserve requirements (PSE in Spanish) grew at rates between 7.0% and 8.0% in the first week of April.

The total gross portfolio in national currency (with leasing) grew at an annual rate of 5.2% in nominal terms during the same period. This rate is lower than that seen in March given the transitory changes in the seasonal nature of the series due to Easter week being at the beginning of April.

By type of portfolio, the limited slowdown of the last few weeks was concentrated in the commercial loan portfolio, which was affected by prepayments of large companies and the issuing of real sector bonds. If the placing of bonds is included, commercial loans (COL$100.9 t) in March stayed close to what was observed in February (COL%100.8 b). In March, the offering of real sector bonds climbed to COL$900 b, an amount that is 525 b higher than that seen in February.

In March and the beginning of April, the mortgage portfolio continued growing at a suitable rate (18.6% nominal) and the consumer portfolio maintained a slow recovery with an annual increase of 4.6%.

For March, the foreign currency portfolio of the financial system rose US$2.532 m compared to US$2.388 m in February. In contrast, the direct indebtedness of the private sector in February, the last month for which there is information, was US$13.965 million, which is US$158 million more than that seen in December, 2009. In spite of this, as of February the sum of both types of resources still grew at a negative annual rate of -3.9%.

In the last few weeks, the inter-banking rates have reached the level of the policy rate. Consumer interest rates and, to a lesser extent, those of Treasury continue dropping. With the decline in inflation excluding food, all of the interest rates rose in real terms.

Between March 26 and April 28, public debt securities registered negative variations of 9bp, 31bp and 35bp on the short, medium and long tranche respectively.

2. DISCUSSION AND POLICY OPTIONS

In the discussion, the following points were highlighted: (i) the result of inflation up to March which was lower in all of the sub-baskets that the consumer price index is made up of that what had been projected by the technical team of the Banco de la República and the market; (ii) the new drop in the core inflation indicators; (iii) the reduction in inflation expectations; (iv) the lower effect of the Niño phenomenon on the growth of prices; (v) the faster than expected recovery of the economy in the first quarter; (vi) the improvement in business and consumer expectations; (vii) the 7% to 8% growth of the monetary aggregates; (viii) the growth of the financial system portfolio in legal currency going above the nominal GDP; (ix) the trend of the market interest rates in response to the reduction in the Bank's benchmark rate; (x) the effect of the exchange rate on inflation and the growth of the tradable sector product; (xi) the interest rates for public debt securities which showed a drop during the month and (xii) the recovery of the world economy and the strong uncertainty generated by the crisis in Greece.

The Board members' main points of analysis centered around the following aspects: (i) the inflation projections for 2010 and 2011; (ii) a reduction in the risks of rising inflation because of the lower impact of the Niño phenomenon on the prices of food; (iii) the reduction in the variation of prices of tradable goods due to the appreciation of the peso in comparison to the dollar; (iv) the lagged effect of the monetary policy measures on production and prices; (v) the growth projections for the economy in 2010 that suggest a faster recovery than anticipated; (vi) the recent momentum in the financial system portfolio; (vii) the fall in inflation expectations; (viii) the balance of risk between growth and inflation in the context of an economy that is recovering and an inflation that is slightly below the long term target range; (ix) the possible impact of the Greek crisis; and (x) the need to uphold the credibility of the monetary authority and anchor inflation expectations around the long term target.

The Board of Directors emphasized the following regarding the trend of inflation during the month: (i) annual consumer inflation in March was 1.84%, 25 bp less than in February. This result is significantly better than the market and the technical studies of the Banco de la República expected; (ii) the core inflation indicators continued to decline and are in the lower portion of the long term inflation target range fixed by the Board (3% plus or minus 1%); (iii) the reduction in inflation excluding food; (iv) the continued decline in inflation expectations; (v) the new projections done by the technical team show, with a high degree of confidence, that inflation will be within the long term target range in 2010 and 2011; (vi) the risks of an upsurge in inflation have diminished due to the lower impact of the Niño phenomenon on food prices and the fact that the appreciation of the peso has reduced the variation in the prices for tradable goods and (vii) this positive trend on the part of inflation and expectations confirms the credibility monetary policy has with Colombian society, which is incorporating the long term target established by the Board into their decisions.

The information received in the last few weeks indicates that the economy is recovering more rapidly than expected without generating inflation pressures. Factors such as the greater growth of the world economy, the improvements in agents' confidence and the momentum of various leading indicators show the strength of the growth.

The technical work indicates that in spite of the greater growth of the economy, there is still a negative gap that, together with the positive trend of inflation and expectations, allows a more expansionary monetary policy without compromising the inflation targets and macroeconomic stability.

The Board analyzed the following alternatives related to the posture of monetary policy:

i) Reduce the Bank's benchmark rate based on the fact that the technical analysis shows that a more expansionary monetary policy will contribute to economic recovery without putting the achievement of the inflation target for 2010 and 2011 at risk.

ii) Table the above decision until next month in order to wait for the market to incorporate the new inflation projections into its expectations and thus, facilitate the transmission of monetary policy.

iii) Keep the benchmark rate as it is while waiting for information that confirms the new projections and announcing that the Board will not be making increases in the benchmark interest rate in the near future.

The members of the Board reached a consensus to reduce the benchmark rate 50 bp and state the reasons that prompted the decision in detail. It was emphasized that the Bank has no fears concerning the economic recovery and that the new level of rates is suitable and will not generate upward pressure on inflation.

3. POLICY DECISION

The Board of Directors agreed to reduce the Banco de la República's benchmark rate 50 bp which will leave it at 3%.

Bogotá, Colombia
May 14, 2010