Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on August 28, 2009

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on August 28, 2009.

Present:
Mr. Óscar Iván Zuluaga, Minister of Finance and Public Credit
Mr. José Darío Uribe, Governor of the Central Bank of Colombia

Full-time Board Members in Attendance:
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Fernando Tenjo
Mr. Cesar Vallejo
Mr. Juan Pablo Zárate

Inflation and the economic situation were discussed with respect to growth and prospects for the future, and monetary-policy decisions were reached. The following is a summary of the main issues addressed during the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in July was 3.28%, having fallen for the ninth straight month. Accumulated inflation so far this year, up to July, was 2.18%, well below the rate posted last year (6.53%). The core inflation indicators continued to decline.

Annual food inflation dropped from 2.8% in June to 1.58% in July, mainly due to perishable food prices.

The annual increase in regulated prices slowed from 5.9% in June to 4.7% in July, thanks to fuel prices.

Annual inflation in non-tradables, excluding food and regulated prices, was 4.68% in July, which is similar to what it was in June. Essentially, this was due to rentals and items with low indexing. The annual variation in the price of high-indexed items remained above 7%. Inflation in rentals was 4.43%, rounding out five straight months of decline.

The annual increase in prices for tradable goods, excluding food and regulated prices, went from 2.78% in June to 3.0% in July.

The inflation-expectation indicators based on TES are below the mid-point of the target range for this year: between 1.46% (one-year TES) and 4.37 % (10-year TES). However, the 10-year TES are above the long-term target announced the by Board of Directors (2% - 4%).

Annual inflation in producer prices (PPI) declined from 2.7% in June to 1.4% in July.

b. <u>Growth</u>

The information at hand suggests the annual decline in economic activity during the second quarter was close to what it was in the first quarter. This is consistent with the projection by the Central Bank’s technical team. As was the case last month, consumer and business expectations exhibit signs of a recovery:

- The DANE figures on industrial production at June show a 6.6% annual decline. In the second quarter, the annual reduction was 9.4%, which is more than the 7.4% contraction registered for the first half of the year.

- According to the Fedesarrollo Business Opinion Survey (EOE) for industry, activity remains weak. However, industrial confidence continued to recover, thanks to better expectations for production in the next three months.

- Annual retail sales in April, according to DANE, dropped 4.5%. This is more of a setback than the month before (-3.5%), but better than the contraction observed so far this year. During the first six months, the annual reduction in total retail sales was 5.1%, which is similar to the rate observed the previous quarter (-5.3%).

- The Fenalco survey in July continued to reflect fewer sales, but with better expectations six months out.

- The demand for unregulated energy posted an annual decline of 1.0% in July. However, when corrected by the number of working days, the increase was 3.0%.

- In June, the Fedesarrollo Consumer Confidence Indicator showed an improvement for the third straight month and was above the averages reported for the first and second quarters of the year.

- Building permits in June, for housing and other uses, continued to register annual declines in excess of 20%. The annual reduction in cement production during that same month was 15%. Despite the sharp drop in June, annual growth in this indicator during the second quarter (-14.2%) was better than growth during the first quarter (-17.5%).

So far this year, up to July, terms of trade have shown a better average than in past years. Since March, merchandise export prices in dollars have increased at a higher rate than merchandise import prices. Feasibly, this trend could continue during the rest of the year. Moreover, the export and import levels accumulated in the first half of 2009 are less than those registered during the same period in 2008, but more than the levels reported between January and June 2007.

Total exports in dollars were down 19.1% between January and June 2009 compared to the same period in 2008; with a 23.2% drop in traditional exports and 15.0% fewer non-traditional exports. The decline in export value for traditional items (US$2.690b) was due mainly to coffee (-22.5%), crude oil and petroleum derivatives (-40.0%) and ferronickel (-39.4%). In the case of coffee, the contraction was the result of less export volume, while the decline in other products was primarily a question of lower prices. The biggest slowdown in the value of traditional exports originated with the U.S. market.

During 2009 to June, non-traditional exports to Venezuela in dollars, which account for 36% of all non-traditional exports, saw a 4% decline as a result of 13.6% fewer industrial sales. Moreover, sales to the United States, which account for 17% of all non-traditional exports (without gold), were down 25.6%.

Imports (CIF) between January and June 2009 came to US$15.574 b, having fallen 17.7% in annual terms. The largest drop was in imports of intermediate goods (28.3%), especially from the United States. The reduction in total imports also involved consumer and capital goods (-13.1% and -7.3%, respectively). In terms of volume, all imports were down.

During the first half of 2009, the annual decline in remittances in dollars was 10%.

c. External Context

The results posted by the major developed economies led the analysts to predict that global recovery will be slow during the second half of 2009 and above the forecast for 2010. This improvement in growth allowed international commodity prices to continue the recovery phase initiated three months back.

In the emerging market economies, the signals are mixed. China, India and Korea show better indicators for production, internal trade and exports. However, Mexico and Chile reported sharp setbacks in economic activity during the second quarter of the year. The market expects the other economies in the region to experience a less dramatic decline.

Tight credit in the United States, the Euro Zone and the United Kingdom could delay economic recovery and reduce the effectiveness of the macroeconomic stimulus packages. Moreover, unemployment continues to rise. Under these conditions, the recovery in consumption may be affected, despite lower inflation.

d. Financial Variables

The monetary base and M3 continued to grow at rates nearly three times the increase in nominal GDP estimated for 2009.

On August 7, the loan portfolio denominated in domestic currency showed an annual variation of 11.8%, due to the slowdown in commercial loan portfolio growth, which went from 20.6% to 15.3% during that same period. The reduction in commercial lending has been offset, in part, by more private sector debt issuance. At June 2009, the sum of outstanding bonds issued by the productive sector (COP$10.2 t) and the commercial loan portfolio were up 19.1% in annual terms. In July, the commercial loan portfolio fell by COP$1 trillion, while bond issues by the productive sectors showed an increase of COP$ 0.5 t. So far during August, the productive sector has issued more than one trillion pesos in new debt.

July saw continued low growth in the consumer loan portfolio (1.8% annual), while the mortgage portfolio stabilized at annual increases near 12.5%. However, annualized growth during the last thirteen weeks suggests that both consumer and mortgage lending are in a recovery phase.

The decline in market interest rates on deposits and loans continued. The DTF rate was 5.04% on August 14, 2008, which is 28 bp less than a month earlier and 515 bp less than on December 19, 2008. With respect to interest on lending, the decline has been more pronounced for credit extended to companies, with all types of loans to this group (treasury, preferential, ordinary and construction) showing interest rate reductions of nearly 550 bp since December 2008.

During the first week of August, interest on consumer loans and mortgage lending was 22.4% and 14.7%, respectively. These rates are 39 bp and 23 bp less than those in July, in that order, and 344 bp and 265 bp less than on December 19, 2008.

In real terms, average interest rates for lending and deposit-taking were near their all-time lows for the last ten years.

The TES curve rose by 25 bp, 38 bp and 73 bp in the short, middle and long segments, respectively. The curve steepened, reflecting the difference between the long and short segments.

2. DISCUSSION AND POLICY OPTIONS

The following points were emphasized by the Board during its deliberations:

i The pace of price growth and its tendency to decline steadily
ii The continued drop in annual food inflation
iii The effect international prices for food, raw materials and oil could have on total inflation, depending on the how the exchange rate behaves
iv The continued improvement in consumer and business confidence, despite weak economic activity
v The peso loan portfolio held by the financial system, which continues to grow in excess of nominal GDP, despite somewhat of slowdown in recent weeks
vi Important bond issues to supplement financing for the productive sector
vii The rapid decline in most market interest rates in response to the Bank's benchmark rate cuts.
viii The performance of the inter-bank credit market
ix Negative growth in the United States and less economic growth in Venezuela, Ecuador and other trading partners
x The impact of the exchange rate on inflation and growth in the tradable sectors
xi The behavior of interest rates on government bonds
xii Intermediate and long-term expectations for inflation

The main points of discussion among the Board members centered on: (i) the elements that affect inflation forecasts for 2009 and 2010, particularly an eventual rise in food prices; (ii) the lag between monetary policy measures and their impact on production and prices; (iii) the uncertainty in world markets due to the financial crisis and its impact on the Colombian economy; (iv) the region's access to external financing, direct investment flows, and the reasons for recent limited growth in the loan portfolio held by the financial system; (v) the risk balance between growth and inflation in a context where the economy is slowing and inflation is falling; (vi) the relevance of continuing to lower the intervention rate, given the latest data; and (viii) the need to bolster the monetary authority's credibility and to anchor inflation expectations to the long-term target.

The members of the Board highlighted the drop in annual consumer inflation for the ninth straight month to 3.28% in July. Once again, the reduction was due to food and regulated prices, while the core inflation indicators continued to decline.

The reduced inflationary pressures continued as a result of several factors; namely, weak internal and external demand, lower inflation expectations, which are near the upper limit of the long-term target range set by the Board (between 2% and 4%) and the decline in commodity prices compared to the high point in 2008. As a result, the Board expects annual inflation to end the year below the lower limit of the target range (4.5%).

The world economy is stabilizing. Slow economic recovery is expected for the second half of the year, and the forecasts for growth in 2010 have improved. Most of the Latin American economies continue to experience a moderate slowdown and lower inflation.

Thanks to the reduction in the Central Bank's intervention rate and less demand for credit, interest rates on deposit-taking and lending have declined steadily. The Board of Directors expects the reduction in interest rates to continue and to stimulate economic growth. The performance of financial system is healthy and the productive sector has floated several large bond issues to supplement credit from the financial system.

In addition, business and consumer confidence indicators continue to point towards an improvement during the second half of the year. The latest results for industry, commerce and construction are in line with year-end growth forecast by the Bank's technical team.

Several Board members said they preferred to hold the intervention rate steady, citing a variety of reasons. Namely, (i) the stance of the country's monetary policy is expansionist; (ii) the Colombian economy, unlike that of other countries, has not suffered a financial crisis that justifies extreme policy measures and abnormally low interest rates; (iii) part of the reduction in consumer inflation, especially the drop in annual food inflation, may involve elements that are temporary; (iv) the weight of external factors in the explanation for the country's economic slowdown is such that lower interest rates probably would not have much of a positive impact on productive activity; (v) the figures on loan portfolio growth suggest it is affected not by liquidity problems, but by limited momentum in the credit market; and (vi) the current stance of monetary policy makes the stability in interest rates compatible with the decline in inflation towards its long-term targets.

Other Board members proposed lowering the Bank's intervention rate by 25 or 50 basis points, inasmuch as the forecasts for this year indicate inflation will be below the lower limit of the target range for 2009, while the drop in 2010 will be more than was anticipated initially. One of those directors emphasized the measure also is justified because: (i) there is a growing negative output gap, as reflected by the continued decline in economic activity and higher unemployment; (ii) the trade risks to Colombia posed by Venezuela and Ecuador are growing; and (iii) peso appreciation is pronounced and among the highest in the region, more than that of our major competitors.

3. POLICY DECISION

The Board of Directors decided, by a majority vote, to hold the Central Bank's intervention rate steady at 4.5%.

Bogotá D. C., Colombia
September 11, 2009