Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on December 19, 2008

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on December 19, 2007.

Present:

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

Mr. José Darío Uribe, Governor of the Central Bank of Colombia

Full-time Directors:
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Juan Mario Laserna
Mr. Fernando Tenjo Galarza
Mr. Leonardo Villar

Conditions with respect to inflation and economic growth, and their prospects for the future were discussed and decisions on monetary policy were reached. The following is a summary of the principal topics addressed at the meeting.

1. BACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in November was 7.73%, having fallen by 21 bp compared to the rate in October. Accumulated inflation in the first eleven months of the year came to 7.2%, and the various core inflation indicators declined during the November.

Non-tradable inflation, excluding food and regulated prices, was 5.2% as opposed to 5.7% in October. Most of this reduction was in entertainment, culture and recreation. Tradable inflation, excluding food and regulated prices, went from 2.3% in October to 2.2% in November.

Food inflation declined slightly from 13.2% in October to 13% in November. The reduction was concentrated in perishable foods. Cereals (particularly rice), edible oils and other items experienced price hikes.

The annual increase in regulated prices was 10.9% by November. The price hikes for electricity and urban public transportation were particularly noteworthy.

The inflation-expectation indicators measured on the basis of local government bonds (at 1, 5 and 10 years) declined, but were still above the inflation targets set by the Board of Directors.

The annual variation in producer prices (PPI) went from 11.8% in October to 10.9% in November.

b. <u>Internal Growth</u>

Most of the indicators available by the third quarter show a continued slowdown in economic growth. The main aspects on the demand side were the reduction in export growth in real pesos and weak household consumption. The latter is evident in the limited growth in imports of consumer goods, in pesos, and the slowdown in retail sales at September. The drop in the Fedesarrollo consumption indicator during October and November also is a forecast of low consumer spending during the fourth quarter.

Imports of intermediate and capital goods continued to register good momentum, supporting the expectation that growth in investment during the second half of the year will remain high. This forecast is reinforced by the 8.7% recovery in civil works during the third quarter of the year, as indicated in the DANE census.

On the supply side, industry and commerce did not perform as well as expected. Industrial activity was down by 3.3% in the third quarter, partly because of negative supply shocks (cost increases and strikes in the sugar and trucking industry, among other factors), but also due to the standstill in external demand, especially in Venezuela.

It appears the slowdown in industry will be more pronounced during the fourth quarter. This is according to the latest figures released by DANE, which show -1.9% year-to-date growth by October compared to -1.2% last month. For October alone, the DANE figures show an annual slowdown of 7.5% in industrial production. Various indicators of industrial and business expectations deteriorated sharply during the fourth quarter.

As to the job market, salaried employment is falling, while so-called "self-employment" continues to rise.

c. <u>The External Context</u>

Despite intervention by the governments and the central banks of the developed economies, the credit channel at the international level has yet to be reestablished. The financial crisis in the United States continues and its impact on productive activity reflects a setback in that country. The situation in other developed economies is no different, with growth being weaker than expected.

The drop in housing and stock prices in the United States, coupled with tighter credit markets, is having a serious impact on consumer spending. Industrial production is declining at rates of more than 5%, and business sentiment has plummeted. The economic deterioration has spread to the job market, where applications for unemployment compensation rose to 573 thousand, a figure not seen since 1983. In fact, 1.9 million jobs have been lost so far in 2008. This raised the unemployment rate in the United States to 6.7% by November.

The crisis also is being felt sharply in Europe, as suggested by the downturn in indicators of consumer confidence and business sentiment. In China, industrial production has weakened faster that expected and exports have begun to decline.

The monetary authorities in the developed economies responded to this situation by continuing to lower their benchmark rates. In terms of the emerging market economies, the intervention rates in a number of Eastern

European were cut recently, as they were in several Asian countries. There has been no change in intervention rates in the Latin American countries.

At present, monetary policy in the United States is set in a context of 0% interest rates, and other central banks might reach the same situation in the near future. The effectiveness of monetary policy is becoming increasingly evident. A number of governments have begun to implement fiscal programs.

Economic growth in several Latin American countries is beginning to feel the effects of the international crisis. Meanwhile, inflation continues to rise, although next year is expected to see some relief.

Most currencies in the region, including the Colombian peso, have appreciated during the last two weeks.

d. Financial Variables

Growth in the main monetary aggregates has declined. M3 and liabilities subject to reserve requirements increased at respective annual rates of 14.4% and 15.5%, which is less than the expansion observed in October.

By November, the annual increase in local-currency loans extended by the financial system was 18.6%, which is similar to the rate observed in October. Growth in the consumer loan portfolio was 13.5%, as opposed to 15% the month before. The commercial loan portfolio remained stable, while the mortgage portfolio continued to expand at a rate of 16%, as it has for several months.

Nominal interest rates on lending rose during the last two weeks of November. This increase was important in the case of treasury, preferential and ordinary loans: 131 bp, 83 bp and 60 bp, respectively. In contrast, interest rates on deposits remained relatively stable.

The rates on TES experienced major reductions between November and early December, particularly the long-term rates. In all, interest rates on TES that mature in 2020 fell by 224 bp during that six-week period.

2. DISCUSSION AND POLICY OPTIONS

The Board emphasized the following points in its deliberations:

i The pace of price hikes still exceeds the targets set by the Central Bank.
ii International prices for food, raw materials and oil continue to decline, which could have an important effect on total inflation in the next few months, depending on the behavior of the exchange rate and the country's trade policy, particularly with respect to food imports.
iii The annual variation in regulated prices continues to rise due to the indexation mechanisms used to determine rates and because of non-tradable inflation.
iv Economic activity continues to weaken.
v Companies still face high production costs, despite the sharp slowdown in PPI growth last month.
vi The future of the world economy and that of Colombia's largest export markets, particularly Venezuela and Ecuador, is uncertain.
vii The impact of the exchange rate on inflation and prospects for growth in the tradable sectors are also factors to consider.
viii Intermediate and long-term expectations for inflation have declined since the last meeting, but continue to exceed the targets set by the Board of Directors.

The 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 inflation forecasts for 2009 and 2010; (iii) the behavior of non-tradable inflation, excluding food and regulated prices, which has declined but is still high; (iv) the effect short-term inflation could have on the make-up of prices and wages in 2009; (v) how actual inflation and inflation expectations will be affected by the current restriction imports of certain agricultural products, which has a major impact on the family market basket; (vi) forecasts for the current account deficit; (vii) the uncertainty the world financial crisis has generated in international markets and its impact on the Colombian economy; (viii) exchange market stability in recent weeks; (ix); the improvement in the region's access to external financing in the last few weeks, the reduction in long-term interest rates, and the momentum in the loan portfolio of the financial system; (x) the balance of risk between growth and inflation in a context where inflation expectations remain above target and economic activity has slowed; and (x) the need to bolster the monetary authority's credibility and to anchor inflation expectations.

The Board members highlighted the virtues and effectiveness of the monetary policy decisions adopted as of April 2006 to eliminate surpluses in terms of demand and growth in credit in the economy, to control the influx of foreign speculative capital, to strengthen the balance of international reserves, and to mitigate the effects of higher international commodity prices on inflation expectations.

It was emphasized that the world economy is in sharp decline and most of the developed economies have contracted as a result. The emerging market economies continue to report positive growth, but are slowing as well. If the world economy grows at a rate that is below its long-term trend and international commodity prices drop, world inflation will be substantially less in 2009. If the exchange rate remains stable and an appropriate commercial policy is applied, particularly with respect to food imports, this reduction in international inflation should pass through relatively quickly to consumer prices in Colombia.

The drop in long-term interest rates and inflation expectations since the Board's last meeting was noted, as were the reduction in the exchange rate observed in recent weeks and the improvement in access to external financing for emerging countries.

The new figures on hand confirm that productive activity is weaker, predominantly in industry and commerce. Household and business confidence has been affected by external and internal factors. As a result, growth in internal demand is expected to be low. Added to this situation are the difficulties experienced by Colombia's major trading partners and the drop in international prices for its main exports. Less growth in demand and output means less inflationary pressure.

Accordingly, the Board of Directors agreed unanimously to reduce the Central Bank's intervention rate by 50 bp. This reduction consolidates a change in the stance of monetary policy that had been in the works for several months. The possibility of continuing to relax the country's monetary policy during 2009 will depend essentially on whether inflation behaves as anticipated and on expectations with respect to the targets.

Lastly, the Board reiterated its commitment to supply the liquidity the economy will require at the end of the year. It emphasized the need to continue to monitor the international financial situation, so whatever monetary-policy measures might be required to deal with its impact can be adopted in due course.

3. POLICY DECISION

The Board of Directors unanimously agreed on a 50 bp cut in the Central Bank’s intervention interest rate, placing it at 9.50%.

Bogotá D. C., Colombia
January 5, 2009