# Minutes of the Banco de la Republica Board of Director's meeting on July 29, 2011

A regular meeting of Banco de la República's Board of Directors was held in the city of Bogotá on July 29, 2011.

Present:

Mr. Juan Carlos Echeverry, Minister of Finance and Public Credit
Mr. José Darío Uribe, Governor, Banco de la República

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

The inflationary and economic growth situations 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 June was 3.23% (monthly was 0.32%), which was 21 basis points (bp) higher than in May. This number surpassed what was projected by the Bank's technical team and higher than the market expected on average.

The main upward pressures came from the prices for food–specifically the perishables and those most affected by the climate and, secondly, imported food. As of June the annual variation for food was 4.1%. In the case of imported food items, the surges in the international prices at the end of 2010 continued to be transferred slowly and moderately to domestic prices. The peso's accumulated appreciation had partly compensated for these external pressures. With respect to perishables, the rises in prices have been concentrated in vegetables and fruit and could be the result of the heavy seasonal rain in March and April as well as the normal supply cycle for these products.

Inflation excluding food (2.91%) just like the average of all of the indicators for core inflation rose. The annual variation in the prices for non-tradable goods excluding food and regulated prices rose 33 bp and came to 3.83% in June. The annual variation of the CPI for non-tradable goods excluding regulated prices has been climbing slowly since March even after discounting for the effect of amusement, cultural, and vacation activities in June.

In contrast, the change in the prices for regulated items and for the subgroup of tradable goods excluding food and regulated prices declined 19 bp and 5 bp respectively going to 5.96% and -0.13% in June.
The variation in the producer prices (PPI) dropped in June and was at an annual rate of 4.7% compared to 4.8% in May. The reductions were concentrated in the imported component of the indicator.

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

b. Growth

In the first quarter of 2011, the GDP grew 5.1% in annual terms and rose 1.9% with respect to the immediately preceding quarter. Household consumption was the aggregate that contributed the most to the expansion of the GDP. In the first quarter it grew at a rate that was above the average for the last decade driven above all by the purchases of durable and semi-durable goods.

The contribution of the total investment was equally important since it registered a rate of growth that was higher than the average for last year and completed a year and a half of continuous expansion. However, net exportations continued to contribute negatively to the GDP because, even though exports grew at a good pace, imports grew at an even higher rate.

In the area of supply, the significant expansions that the commerce, mining and agricultural sectors registered stood out as all of them expanded at annual rates that were above 7%. However, the sector of financial services was the one that contributed the most to growth because of its greater weight in the GDP. In the first quarter, the GDP for industry grew 5.1%. The sectors of construction (due to public works projects), and electricity, gas and water were the only ones that showed annual contraction rates.

For the second quarter of 2011, the economic activity indicators suggest that growth will be similar to that of the first. By type of expenditure, household consumption will probably show a momentum that is even better than what was seen in the first quarter according to what is suggested by: the consumer confidence index, which recovered after the slump in April and May; retail sales which showed an average growth in the months of April and May of 17%; the imports of consumer goods which had expanded an annual 35% in dollars as of May; and the growth of consumer credit which had a real annual rate of growth of 19%.

Positive performance is also expected for investment in the second quarter. This can be inferred from the performance of imports of capital goods, which grew 59% on average in April and May. This investment has probably been supported by the strength of commercial credit in a context of low interest rates. As of June, the rates for ordinary and preferential loans were at 7.4% and 4.6% respectively. These numbers are lower than the averages since 1998 (11.8% and 7.5%). Likewise, in June, the commercial loan portfolio maintained an annual growth of around 19% at constant prices just as it did in the previous two months. This performance is similar to that of the total portfolio.

In the area of supply, the fact also stands out that even if the growth of industrial production in May (4.3%) turns out to be lower than expected, its trend is still positive. In construction, licenses showed a sharp rise in the months of April and May with an average annual growth rate of 86%.

With respect to foreign trade, Colombian exports grew at an annual rate of 36% in dollars from the beginning of the year to May. The rise in exports is basically explained by the 48% growth of commodities (petroleum and its derivatives, nickel-iron, coal, coffee, gold, bananas and flowers). For the same period, the rest of the exports increased 6%. Total imports in dollars showed an annual change of 55%. The accumulated 12-month growth for total imports was 33.9%.

The growth of the GDP in the first half of 2011 is expected to be mainly driven by domestic demand and, to a lesser degree, by world demand. On the domestic front there should be an improvement in the performance of public consumption and in the investment in public works projects that will be added to a positive performance in private demand. In the foreign context, as long as the crisis in the developed countries does not get worse, no changes in the factors that affect the performance of economic activity are anticipated; high terms of trade, relatively positive growth for trading partners and abundant capital flows, especially in direct foreign investment. Thus the growth of the GDP for all of 2011 is expected to be within a range between 4.5% and 6.5% which is 50 bp higher than the range presented in the last Inflation Report.

c. Financial Variables

Total credit in national (NC) and foreign currency (FC) continued rising. As of June, all of the types of credit, including not only households but also companies, registered growth that was much higher than the 2011 GDP estimate. This has occurred in a context of real interest rates that are historically low.

As of June the real credit (NC and FC) rose 22.5% annually, data which is 20 bp higher than that registered in May. The consumer portfolio (NC and FC) registered an increase of 164 bp with respect to the previous month having reached 24.0% in June. The mortgage and commercial portfolio showed an annual variation of 16.7% and 22.4% slipping 24 and 42 bp respectively with respect to the data from the month of May.

In June the real interest rates (discounting the CPI excluding food) for consumer, mortgage and ordinary commercial loans were at 14.9%, 9.7% and 7.4%. These numbers are lower than the averages seen since 1998.

d. The External Context

Since the last quarterly report, worldwide economic activity has deteriorated as the result of different shocks it has been hit by such as the rise in petroleum prices, the natural disaster in Japan and the deterioration in confidence associated with the debt problems in the United States and Europe. For the rest of the year and 2012, the developed economies are facing an outlook of limited growth. The rate of expansion will probably remain below its historical average as a consequence of the high levels of indebtedness and the growing financial costs. The need for fiscal adjustment in Europe and the United States will affect the performance of demand in those countries and could complicate the labor panorama even more. In contrast, the emerging countries will continue to grow at a positive pace.

In the United States the economic activity indicators are showing mediocre performance and one that is lower than was expected three months ago. The labor and housing markets are still stagnant. In the Euro Zone, in turn, the differences between the countries with low levels of debt that are growing well, led by Germany, and the countries with high levels of debt that are virtually stagnant are becoming deeper. In the last few months, the problems with sustainability on the European periphery are getting worse. A recovery after the natural disaster in March is beginning to be seen in Japan. That shock affected other economies in Asia and probably the United States. Reestablishing the supply chain could help world growth.

The recent dip in the prices for petroleum and of commodities is a collateral effect from the drop in the strength of the global economy. This price trend could have a positive effect on the purchasing capacity of consumers and reduce inflationary pressures.

With respect to emerging economies, China has grown more than was predicted and its cut back is very slow. So far, the monetary policy squeeze has not had significant effects on economic activity. For other Asian countries (India, South Korea and Taiwan) there are indications of a slowdown in the second quarter but the pace of growth is still high. The economies in the region continue to expand at high rates.

It is to be expected that with the reduction in inflationary pressures, the international interest rates will remain low. As a result, the high liquidity in developed countries together with the differential in return and the perception of low risk in Latin America will continue to stimulate capital flows to this region.

With respect to the growth of Colombia's trading partners, it is necessary to emphasize the fact that the lower growth of the United States has been compensated for by a better performance in Latin America and especially in Ecuador, a country that has been surging (8.6% annually as of March, 2011). The forecast assumes a better rate of growth for the United States in the second half of the year and a moderate slowdown in China as a consequence of the restrictive posture of monetary policy.

## 2. DISCUSSION AND POLICY OPTIONS

The board members focused on the following points: (i) the growth of the GDP in the first quarter, (ii) the international uncertainty due to the problems of public debt and banking systems in some of the industrialized countries, (iii) the bad indicators for economic activity of the United States, (iv) the historically low level of the Bank's benchmark interest rate and of a large part of the real interest rates as well as their possible future effect on the soundness of the financial system if they are continued for an excessively prolonged period, (v) the constantly expanding growth of all of the credit components and of household debt, (vi) the historically high level of the terms of trade and its contribution to the growth of national revenue, (vii) the dynamic performance of private demand not only in consumption but also in investment in machinery and equipment, (viii) the better indicators in the labor market of a higher quality of employment, (ix) the high probability that the output level will be close to its potential in the second half of the year, (x) inflation expectations for the short and medium term that have corrected downward and are within the target range, (xi) the recent appreciation of the peso, (xii) the high international prices for petroleum and food in many countries as well as the increases in the policy interest rates in some of them, and (xiii) the importance for the economy of measures that will contribute to consolidating financial stability.

Some members of the Board expressed their opinion that, in spite of the suitable trend seen in inflation and expectations for it, the Bank's benchmark rate should be raised 25 bp for the following reasons: (i) the strength of the Colombian economy led particularly by household consumption and the strength of investment other than public works projects, (ii) the recent information related to economic activity on the side of both the supply and demand as well as consumer and industry expectations which indicate that the growth of the GDP in the second quarter could be similar to that registered at the beginning of the year. For the second half of the year, the technical team expects that economic activity will surge and because of that they raised their prediction for growth for this year and next to an interval of between 4.5% and 6.5%. In this they were partly influenced by the good terms of trade, (iii) the information available so far, including the data on GDP growth (5.1%), suggests that the output gap will close in the second half of the year, (iv) the growth of credit continues to climb. All of its components, not only that for businesses but also that for households show real rates of growth that are significantly higher than the increase in the GDP. This is occurring in a context in which a large part of the real interest rates is at historically low levels, (v) the fact that as of March, the prices of used housing continued to climb and were approaching their highest level seen since 1995. The indicator for new housing prices also rose in the first quarter, (vi) the current real rate is below its probable long term equilibrium and is inconsistent with the close to potential growth expected in 2011 and 2012 as well as a projected inflation that is near the midpoint of the long term target range, (vii) the consecutive and timely increases in the Bank's interest rates which have contributed to keeping inflation within the target range and to reducing the risks of financial imbalances which would later lead to an unnecessary volatility in interest rates, output and employment.

Another member of the Board thought that it would not be suitable to raise the Bank's interest rates at this time since, as of June, the indicators for the total and core consumer inflation and inflation expectations for one, two, three and five years have been anchored to the target. The accumulated rise in the CPI is very similar to that for the same period in 2010. Inflation excluding food and regulated prices is very close to the floor of the target range. And the readjustments in wages have been compatible with it. The concentration of exports and of DFI in petroleum and mining continues to rise. Both came to 80% of the performance of the former and 85% of the latter even though they generated only 200,000 jobs. In contrast, industrial exports have stagnated. The monetary authority of our main trading partner, the United States under the pressure of stagnation, the fears of a double-dip recession and the persistent and high unemployment will undoubtedly not begin to raise its rates before 2013.

Finally, he added that the sensitivity of domestic demand in view of the foreign conditions is much higher today through the capital account and its effects on liquidity and loans. Fortunately the expansion of demand has been, in large part, a counterpart to the capital inflows which have been creating obstacles to the transmission of the readjustments in the Bank's rates to lending rates. Therefore, additional increases will attract larger inflows and credit supply which will slow down the transmission of the monetary policy even more. Thus, we could end up feeding what we want to control: inflation. Consequently, what is appropriate now is the adoption of macro-prudential regulation measures that are coordinated with the government.

## 3. POLICY DECISION

The Board of Directors agreed by majority to raise the benchmark rate of the Banco de la Republica by 25 basis points which will put it 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 D.C. August 12, 2011