Minutes of the Banco de la República Board of Director's meeting on November 25, 2011

On November 25, 2011, the regular meeting of the Board of Directors of the Banco de la República 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 Echavarría
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 October was 4.02% (0.19% monthly), which is 29 basis points (bp) more than in September. The adjustment of accumulated prices over the course of the year is 3.15%, which is higher than what had been registered during the same period last year (2.31%).

Just as in September, the most important upward pressures in October came from food. The annual change for this basket rose to 6.6% in October compared to 5.7% in September. The upsurge was concentrated in the prices of perishable foods, especially potatoes, as has been seen for several months. There were also rises in less perishable food items. Using the subdivision of the food basket into food affected by weather, imported food, and the remainder, the products affected by the weather were seen to lead the price rally for the basket with an increase of 15.1% recorded in October compared to 12.2% in September while the imported food (6.5%) did not show significant rises compared to the previous month. The rest of the food items (4.7%) rose 70 bp compared to what was registered in September. Supply problems associated with the heavy rain in the first half of the year as well as the normal price and production cycle would explain these registers.

Inflation excluding food in October was 3.03% with a slight increase (5 bp) with respect to the data from September. Since October 2009, the indicator has not been above the mid-point of the target range.

In October, the performance of the sub-baskets of the CPI excluding food was uneven. There was a significant increase in the annual variation of the CPI for tradables excluding food and regulated prices. This indicator, which registered 0.4% for the month, seems to be establishing itself in positive territory after 16 consecutive months of showing negative figures. That is partly related to the depreciation in the exchange rate in the last few months. The annual variation for non-tradables excluding food and regulated prices remained at 3.5%. Rent has been showing a stable annual variation for several months and one that is close to 3% which offsets higher prices in educational and health services. With respect to the annual change in basket of regulated prices (6.3%), there was a decline due to the electricity fees that, nonetheless, was much less than predicted. The rises in the prices for residential natural gas continued in October due to the increases in the international prices for fuel in the first half of the year.

The indicators for core inflation continued to show a rising trend over the last month. The average for the three indicators announced by the Banco de la Republica was 3.27%, 14 bp more than a month ago. Even if all the indicators rose, they would still be within the target range.

The increase in inflation affected the expectation indicators. Those obtained on the basis of the TES climbed for all of the horizons with the ones for 10 years surpassing the top of the target range a little. The measurements done through surveys show less pronounced increases. For example, according to the monthly survey, the inflation expected for December, 2011 is 3.6% and that expected for 12 months from now is 3.4%. In the quarterly survey, the expectation for 12 months from now is 3.7%.

The change in producer prices (PPI) continued to rise in October and adjusted to an annual rate of 7.9% compared to 6.6% in September. The increases, as in previous months, were concentrated in the import component of the indicator.

b. Growth

Growth in the third quarter, like that in the first half of the year, will still be driven domestic demand as can be inferred from the most recent information on retail sales measured by DANE. Their annual growth in September was 7.2%. Moreover, imports of consumer goods in dollars grew in September at an annual rate of 26% and the consumer loan portfolio registered an annual growth of 25.8% in the month of September.

Investment, in turn, also showed a good performance in the third quarter. With respect to that, the growth registered for imports of capital goods in September (25%) suggests that the expenditures on machinery and equipment remain strong. Developments in commercial loan portfolio, which expanded at a rate of 22.2% in the same month, point in the same direction. Investment in construction would also have continued growing based on the developments in building licenses.

With respect to the supply, in September the annual variation in the industrial production index was 5.2%. The annual growth of production for the entire third quarter was high (6.2%) mainly influenced by what had been registered in August. The indicators associated with the manufacturing industry such as Fedesarrollo orders and inventory remained stable as of September and even at levels that suggest a significant expansion rate for the sector.

With respect to foreign sales, the effect of the weaker foreign context had not been important up until September. That being the case, total exports in dollars rose at an annual rate of 36%. This growth came from higher sales of crude oil and its derivatives, coal, and gold. The boost in exports from mining was due to the trend in both price (32%) and quantities (4%). Exports of agricultural commodities have not shown any recovery. In fact, they registered an annual drop of 4.1% in September. The indices of price and calculated quantities suggest that this reduction was explained by the tightening registered in the quantities (-16% annually), which was not offset by the price increase (12% annually). The fall in quantity came from the lower foreign sales of coffee (-21%) and flowers (-19%). Finally, foreign sales of industrial goods and other agricultural products (excluding commodities) showed an annual growth of 4.3% in September. The rise was seen only in prices (9%) while the quantities registered a contraction (-5%).

With respect to the labor market, the unemployment rate continued its declining trend in September. Its reduction responded again to a growth in the demand for labor (measured by the employment rate) that is greater than the supply (measured by the overall rate of participation). For not only the 13 areas but also the national total, the number of people working continued to rise at rates close to 5% which is in line with what has been registered throughout 2011.

The above mentioned indicators with information up to the third quarter confirmed the forecast given in the last Report on Inflation when an annual expansion of the economy was projected to be between 6% and 7% for that period.

For the fourth quarter of the year, the few indicators available suggest a slight slowdown in private consumption in comparison to the third quarter which will be concentrated in the durable goods component. This was deduced from the reduction in consumer confidence for the fourth consecutive month that was seen in the month of October (together with the willingness to purchase cars and housing components) and due to the slowdown in automobile sales in the same month. This trend, however, is in line with what was expected in the estimates from the previous report. In this, the growth of the economy for all of 2011 would be between 5% and 6%.

With respect to the loan situation and finances in the real sector, the aggregate indicators calculated on the basis of the intermediary reports as of the third quarter of 2011 is not showing signs of excess yet in spite of the fact that the portfolio is maintaining a high pace of real growth. However, information from some segments such as consumer credit are signaling a significant increase in household indebtedness and a slight deterioration in the latest harvests (according to the most recent data available at the Financial Superintendency).

c. <u>Financial Variables:</u>

The total loans in national currency (NC) and foreign currency (FC) are staying at high rates of growth with a slight moderation in October. All of the types of loans for both homes and businesses continue to register growth that is well above the growth of economic activity. This has occurred in a context of historically low, real interest rates.

As of October, the total growth of credit (NC and FC) registered an annual rate of 22.7%, which is 118 bp lower than what was observed in September. The consumer loan portfolio showed the highest rate of growth, 25.4%, which is 32 bp lower compared to the previous month. The commercial loan portfolio, in turn, showed an annual rate of growth of 22.0%, which is 113 bp lower than what had been registered in the month of September while the mortgage portfolio remained at a growth rate of 17.3% annually as has been seen since August.

In October, the real interest rates (not counting the CPI excluding food) for consumer, mortgage, and ordinary commercial loans were at 14.9%, 10.0%, and 8.1%, figures that are lower than the averages seen since 1998.

d. Foreign Context

In the third quarter of 2011, the main developed economies registered a GDP growth that was better than expected. Nevertheless, the probability that there would be a recession in Europe rose while the market consensus is that the economy of the United States may expand at a moderate rate for a prolonged period. In view of this panorama and with the large emerging countries growing at rates that are close to their potential, the forecast for 2012 indicates that worldwide activity will continue to slow down but without reaching the point of recession.

The improved growth seen in the main developed countries could be associated with the reestablishment of production conditions in Japan and a reduction in the price of fuel. In Germany, France, and Japan, growth in the third quarter surged with respect to what had been registered between March and June. In spite of the revision of the GDP in the United States which was corrected from 2.5% to 2.0%, there was a similar situation there that was announced recently. In spite of the above, the international markets continue to show a high aversion to risk due to the situation in Europe.

In the United States, the little information available for the fourth quarter shows that real activity continues growing though slowly. This eases fears of a possible recession in the short term. However, the risks are being kept low and damage in the European situation could have a considerable affect on the growth of this country. In this context, the forecast in the September Report on Inflation of moderate growth for this country over a prolonged period remains the same.

In Europe, the economic activity indicators continue to deteriorate, especially in the countries on the periphery. Furthermore, the agreements and measures directed towards solving the public debt and financial system problems have not had the expected impact so far. All of this has had repercussions in a deterioration in consumer and investor confidence and has infected the largest and most stable economies in the region. Given this, it is probable that the growth forecast for the Euro Zone in 2012 will be reduced with respect to what was presented in the previous report.

The emerging economies are still losing strength. In China, real activity has continued to slow down and this has been confirmed by the latest industrial data. There is a similar situation in India and Brazil although the deterioration in the indicators has been more pronounced in these countries.

The financial markets have been paying close attention to how the public debt is being handled on the periphery of Europe. In the last few weeks, the interest rate spreads for the government bonds of Italy and Spain rose. The contagion is also reaching France and Germany. In the economies of Latin America, the risk premiums have not risen significantly and their exchange rates have tended to depreciate moderately compared to the dollar.

The weak foreign demand and the more limited outlook for worldwide growth have reduced the pressures on the international prices for food which eased a little in the last few months. In the case of petroleum, in spite of the rises in the WTI seen in the last two months, the levels are still lower than those reached in April, 2011. Starting from this last date, the Brent quotation has had a declining trend. All of the above has made a reduction in inflationary pressures possible in the developed economies and various emerging economies (with the exception of India).

Monetary policy remains very lax in the developed countries. The European Central Bank reduced their benchmark rate by 25 basis points in their November meeting while the central banks of Japan and England kept their benchmark rates close to zero. With respect to the emerging economies, except for the case of India, the central banks tended to keep their policy rates the same.

The international quotations for the main commodities that Colombia exports have also been affected though moderately. Nevertheless, their levels remain high and continue to drive the national income. This situation could partly explain the performance of exports in dollars in September. These grew at high rates, especially those from the mining sector. In industrial sales abroad, there has been somewhat of a slowdown, but it is still too early to conclude that this is a result of a lower foreign demand.

2. DISCUSSION AND POLUCY OPTIONS

Some of the members of the Board expressed their opinion that the Bank's benchmark rate should be raised 25 bp for the following reasons: (i) Even if the foreign situation has deteriorated, the main scenario of the forecast is that economic activity in Europe continues to weaken but without a chaotic situation or collapse occurring. At the same time, the market consensus is that the United States economy is expanding at a moderate pace over a prolonged period. (ii) Even if the foreign situation has deteriorated and some domestic indicators are showing moderation since the last report, inflation and inflation expectations rose. This could put the target and credibility of monetary policy at risk in a context in which the policy interest rate seems to reflect an expansionary monetary policy. The decisions on wages and other prices at the beginning of 2012 will be made in the context of a supply shock with inflation below but close to 4% and a tight labor market. In addition, depreciation of the peso seems to be affecting the prices of tradables. (iii) The deterioration in external conditions and the moderating of some domestic indicators do not seem to be enough to offset a domestic performance characterized by excesses of demand that possibly could threaten the inflation target and output stability even in the medium term due to financial imbalances. In spite of the slowdown in some indicators, they are remaining at high levels and others are staying high and not slowing down. (iv) Commercial lending continues to grow at a high annual rate. The strongest portfolio is that of household consumption. Households seem to be significantly raising their degree of leverage. Price indices for new and used housing are at their maximums. Commercial lending at a higher interest rate would contribute to an appropriate measurement of the risk. (v) In making policy decisions, the risks and costs of mistakes should always be pondered. Given the lags in monetary policy, doing nothing if the economy remains strong would imply risking the credibility and reputation of the policy itself and could lead to creating unnecessary volatility in interest rates and the GDP. Given the same lags, increasing the rates today might not bring about a heavy cost if the foreign situation suddenly deteriorates in the near future. This is easily detectable and the policy would be reversed.

Bearing in mind the forecast described before, and the risks of financial imbalances, it would be prudent to raise the benchmark interest rate 25 basis points. It is believed that through this movement, a monetary posture that would contribute to maximizing a growth of output and employment that would be consistent with reaching future inflation targets could be achieved. This decision also incorporates the possibility of detecting a substantial change in foreign economic conditions on time and reacting to them rapidly.

Other members of the Board thought it would be advisable to keep the Bank's interest rates stable bearing in mind the facts that: (i) Even if it is true that annual inflation hit the ceiling of the target range as of October, the cause is a transitory food supply shock due to weather conditions. As a matter of fact, the price rise for food was 6.63% in contrast with 1.69% and 1.64% during the same period in 2009 and 2010 respectively. And those that were the most affected by the weather grew 15% or, in other words, three times more than the imported food items and other national ones. Furthermore, the CPI excluding food has been at the mid-point of the target range (3.05%, 2.57%, and 3.03% in 2009, 2010, and 2011 respectively). At the same time, inflation of non-tradables excluding food and regulated prices, which more faithfully reflects possible demand pressures, has been declining: 4.57%, 3.53%, and 3.49% for October of 2009, 2010, and 2011 respectively. Moreover, the technical team at the Bank continues to forecast declines in inflation over the next six months. (ii) In Europe, the agreements and measures aimed at solving the public debt and financial system problems have not had the expected impact and the situation has continued to deteriorate markedly since the last Board meeting. The credit rating agencies have lowered the ratings of various countries in the zone, the debt spreads have grown markedly, and not even Germany has been immune to market fears. Several analysts are projecting a recession in different European countries in 2012 and do not rule out the possibility that the model that led to the Euro could fail. (iii) In the United States, the Super Committee, made up of Democrats and Republicans to submit a proposal designed to reduce the fiscal deficit over the next ten years, failed and the growth forecast has also declined substantially over the last year. (iv) China will continue to grow at high rates but the news has not been exceptionally encouraging in the last few months. There are symptoms of contraction in industry. The prices for housing are showing the effects of sharp falls and the same thing is happening to the growth of construction. The point has been reached where the monetary authority has started a new phase of expansionary monetary measures. (v) In Latin America, industry has lost momentum and several of the economies have cooled down. The Central Bank of Brazil has lowered their rates in recent months and the ones in Mexico, Chile and Peru have kept them the same with announcements of downward biases if the world economic conditions continue to deteriorate. Why should Colombia be different from the rest of the world except for India or Iceland? (vi) The real repo interest rate in Colombia is below its historical average but the same thing is happening in the majority of the countries around the world. (vii) Different variables have begun to show a lower momentum in recent months possibly as a result of the international situation. In the Fedesarrollo survey, consumer expectations have fallen for four consecutive months; industrial performance declined from 9.7% in August to 5.2% in September; the annual rate of growth for foreign sales excluding commodities in September was 4.3%, which was a slowdown compared to the 41% registered in August; and consumer loans have been dropping from 34.1% in June, 2011 to 23.4% in November when the annualized variations from the last 13 weeks are considered. (viii) The performance of loans and growth of asset value could be due to structural factors and not only to a low interest rate. (ix) In any case, there is justification to think about prudential regulatory measures in addition to the interest rate. The models available in the Bank suggest that an increase of 25 points in the interest rate would lower loan performance marginally. (x) Market interest rates have risen recently which suggests that the economy does not have excessive liquidity.

3. POLICY DECISION

The Board of Directors agreed by majority to raise the benchmark interest rate by 25 basis points which will put it at 4.75%.

The Board will continue to monitor the international situation, the inflation trend and projections, growth, and the performance of the asset markets carefully and reiterates that the monetary policy will depend on the new information available.

Bogota, December 9, 2011