Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on October 24, 2008

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on October 24, 2008.

Present:

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

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

Permanent Board Members:
Mr. Carlos Gustavo Cano
Mr. Juan José Echavarría
Mr. Juan Mario Laserna
Mr. Fernando Tenjo
Mr. Leonardo Villar

The situation and prospects with respect to inflation and economic growth were discussed and decisions on monetary policy were reached. The following is a summary of the main topics addressed at the meeting.

1. BAACKGROUND

a. Recent Developments in Inflation

Annual consumer inflation in September was 7.57%, having declined by 30 basis point compared to August. Accumulated inflation in the first nine months of the year came to 6.5%, while the various core inflation indicators rose during the past month.

The reduction in inflation during September was due to food prices, with vegetables, fruits, tubers and milk exerting the least upward pressure. Annual inflation in regulated prices was 10.5% versus 9.4% in August. In this category, fuel prices and public utility rates, especially for gas and electricity, continued to exert upward pressure.

Inflation in tradables declined from 2.3% in August to 2.2% in September. Non-tradable inflation, excluding food and regulated prices, came to 5.1%, after having dropped to 5% in August. The increase was concentrated in rentals and services related to entertainment and recreation.

The various measurements of inflation expectations based on local government bonds (at 1, 5 and 10 years) continued to ease, but are still above the long-term target for inflation.

Annual producer inflation, measured by the total PPI, went from 9% in August to 9.8% in September.

b. <u>Internal Growth</u>

The data at hand shows the following:

- The annual GDP growth rates in the first and second quarters were 4.5% and 3.7%, respectively. This meant growth during the first half of the year was 4.1%.

- Weakening internal demand was the factor that contributed the most to the decline in economic growth between the first and second quarters. The slowdown and low level of growth in household consumption (3.1% in the second quarter) were particularly conspicuous. Investment in civil works dropped again in the second quarter, by nearly 14%. Investment without civil works was the most dynamic component of internal demand, having risen substantially by almost 17% in the second quarter, which is very similar to the rate observed during the first quarter.

- As to third quarter, the various available indicators suggest the economy continued to slow, as illustrated by industrial growth figures for the month of August (-8.8%) compared to the same month in 2007 (-0.8% for the year to August). Retail sales dropped in August (-0.7%), and consumer sentiment was down again as well.

- During the period from January to August, the annual increase in Colombian imports came to 22.7%, reaching a value of U.S. $ 25,785 m (CIF). This is evidence of a slowdown compared with the same period in 2007, when the annual increase was 26.8%.

- Consumer goods provoked the reduction in import growth, having registered an annual variation of 11% in the first eight months of 2008 compared to 31.7% during the same period in 2007.

- Between January and August, imports of raw materials and capital goods registered respective annual increases of 29.1% and 21.5%. The increase in raw materials, in US dollars, particularly raw materials for industrial activity (20%), could be a reflection of the rise in international commodity prices, since the information shows less imported volume with respect to this item.

- During the course of the year to August, the dollar value of total Colombian exports came to U.S. $ 26,142 million, with 41% annual growth. This increase is led by sales of traditional products, which had increased at an annual rate of 61% by August, bolstered mainly by high international prices, particularly for oil and coal. Non-traditional exports saw an annual increase of 22% between January and August 2008.

- On a country basis, during the course of the year to August, exports to the United States accounted for 39% of total exports and 21% of non-traditional exports. Exports to the United States have maintained their momentum, registering an increase of 54%, largely due to sales of petroleum and derivatives. Non-traditional exports to that market continued to recover, as they have since late 2007. During the year to August, the annual increase in those exports, without non-monetary gold, was 9.8%.

- Sales to Venezuela continue to slow, reporting 31% annual growth by August, which is lower than the figure observed by the same month in 2007 (75%). This was mainly due to fewer sales of transport equipment.

- Exports to the rest of the world have remained dynamic (35% annual growth by August), largely because of traditional products (50%) and non-traditional exports (18%). Using the latest breakdown, namely, for the year to July, sales of industrial products to countries other than the United States, Venezuela and Ecuador, grew at annual rates of 18%.

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

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

At the international level, the events of the past month reveal a more profound financial crisis. This spells financing problems for a wide range of developed and emerging economies, which can have lasting effects on global economic performance. The rescue plans adopted by economic authorities in the United States and Europe have met with limited success and have failed to fully restore credit channels or to make borrowing less expensive.

The prospects for world economic growth have fallen sharply in the current environment. Some indicators already show a great deal of deterioration, which seems to indicate that economies such as the United States and Europe are in a recession. The consumer confidence indexes and the manufacturing production index have declined sharply in recent months. Likewise, in the United States, commercial credit has begun to tighten a rate similar to what was observed in past recessions.

This situation could aggravate problems for the financial system in many countries and jeopardize the stability of public finances, inasmuch as governments have announced guarantees to ensure deposits in the financial system.

On par with the lower forecasts for global growth, commodity prices have fallen sharply in recent weeks.

Given the actual and expected drop in prices for raw materials and the slowdown in growth worldwide, there is significantly less risk of inflation throughout the world. Therefore, the central banks of the developed countries are likely to lower their intervention rates in the coming quarters. In fact, during early October, the central banks of the developed economies acted in a coordinated way by lowering their benchmark interest rates to tackle the problems caused by the crisis. Even so, interest rates on short-term money markets in some countries were well above the intervention rates set by the central banks.

This situation was coupled with an interest rate hike on loans, especially on commercial paper in the United States and Europe, which is exerting pressure on relevant interest rates for emerging countries.

d. Financial Variables

Annual growth in the primary monetary aggregates declined during the past month. For example, the increase in M3 went from 16.3% to 14.6%.

September saw the momentum in the loan portfolio continue to slow. During the past eight weeks, the annual increase in pesos went from 19.9% to 18.2%. The slowdown in the commercial loan portfolio during the past month reversed the trend observed since May. By October 3, the nominal annual increase in the retail loan portfolio was 15.5% as opposed to 16.4% at the end of August. The mortgage loan portfolio continued to expand at a rate of almost 16%.

Deposit rates remained close to what they were in August. In real terms, the average interest rate on credit calculated by the Central Bank of Colombia and the DTF were below the historic averages compiled since 1986.

As a result of the uncertainty on international markets, the exchange rate has devaluated 8% since the Board of Directors held its last meeting.

2. DISCUSSION AND POLICY OPTIONS

The Board emphasized the following points in its deliberations:

i The rate of growth in prices still exceeds the targets and the decline this past month was mainly due to lower food prices.

ii International prices for food, raw materials and oil continue to decline. This could have an important effect on total inflation in the next few months, depending on how the exchange rate performs.

iii Regulated prices continued to rise, given the indexation mechanisms used to determine rates and non-tradable inflation.

iv In contrast to past months, the CPI without food and regulated prices ceased to decline in September.

v Economic activity continues to weaken.

vi Companies have seen major increases in production costs, as reflected by the PPI growth rate.

vii There is uncertainty about how the world economy and Colombia's largest export markets, particularly Venezuela and Ecuador, will perform in the future.

viii The impact of the exchange rate on inflation and prospects for growth in the tradable sectors were discussed as well.

ix Intermediate and long-term expectations for inflation continue to exceed the targets set by the Board of Directors, despite a decline this past month.

The discussion among the Board members centered primarily 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; (iii) the behavior of non-tradable inflation, excluding food and regulated prices; (iv) forecasts for the current account deficit; (v) the effects of exchange rate volatility and devaluation observed in recent weeks; (vi) the uncertainty generated by the world financial crisis in international markets and its impact on the Colombian economy; (vii) the difficulty of assessing the data on hand in a situation where there the growth cycle has come to a halt; (viii) the risk balance 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 surplus demand and 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.

The dramatic deterioration in the international situation during the past month was emphasized. It has heightened restrictions on credit worldwide and further slowed economic growth for our major trading partners. Also, available information shows the productive sector in Colombia is feeling the negative effects of high costs and less demand. These negative effects, in turn are reflected in less GDP growth.

The international crisis has led to sustained volatility in asset prices and to an increase in risk premiums and external interest rates for all the emerging market economies. In Colombia, this was echoed by devaluation of the peso, the drop in stock prices and the increase in interest rates on long-term TES.

Food prices, peso devaluation and, eventually, higher wage costs could keep total inflation up in the coming months. However, weak demand and the recent decline in international commodity prices are expected to mean less inflationary pressures in the future.

Nevertheless, several Board members indicated this does not mean the stance of the country's monetary policy should be revised by lowering intervention interest rates, at least for now. There is still a risk of larger increases in the general price level, even though some inflationary pressures have subsided. The same can be said of inflation expectations, which remain high. Above all, it is uncertain how the exchange rate will behave and how it will affect prices and prospects for the wage hikes that are scheduled to be decided in the coming months.

Those members also felt the monetary authority's commitment to the long-term targets for inflation favors the conditions required for sustained growth in production and employment. Moreover, in view of the current situation, the indication is that a premature change in the country's monetary policy could increase inflation expectations. This would raise intermediate and long-term interest rates, which would have a negative effect on economic activity and government bond prices. Any action taken without due caution would make it more difficult for the country's monetary policy to operate in an anti-cyclical way in the future.

Given the downturn in the world economy, the slump in commodity prices, and the subsequent reduction in inflationary pressure, the Board indicated that a change in the stance of the country's monetary policy would be appropriate. As to the local environment, it was pointed out that, among other manifestations of the economic slowdown, the figures reflect a continued decline in output growth; an 8.8% drop in industrial production during August and 0.8% so far this year; a persistent rise in inventories and a reduction in the extent of orders; deterioration in the confidence index; an increase in idle capacity; fading expectations of investment and a decline in consumer sentiment; a weakening commercial sector; an increase in the national unemployment rate and a 6.9% reduction in salaried employment. This situation could become more acute, depending on how the international crisis will affect Colombia's major trading partners. Considering that monetary policy is projected on a time line of no less than 18 months to two years, the best course is to being a normalization process by reducing the Central Bank's intervention interest rate. There were different opinions on this point. Some of the members said the reduction should be 25 basic points, while others felt it should be 50 basic points.

The Board discussed a package of measures intended to help the money and credit markets operate properly and to provide proper liquidity. The aim is to avoid increases that place interest rates above the intervention rates, as has happened in other countries.

Finally, it was noted that the international financial situation will have to be monitored carefully and the monetary policy measures required to deal with its impact will have to be adopted in due course.

3. POLICY DECISION

The Board of Directors decided, by a majority vote, to hold the Central Bank's intervention interest rates steady. It also agreed unanimously on the following measures:

- A reduction in bank reserve requirements from 11.5% to 11% for current and savings accounts, and from 6% to 4.5% for term deposits under 18 months. These reductions will take effect as of the two-week reserve maintenance period that begins on November 19.

- An extension from two to three weeks in the reserve calculation for the end of the year.

- Temporary liquidity granted with repo operations that mature at 14 and 30 days, and the definitive purchase Col$ 500 billion in TES, plus the peso equivalent of the sale of foreign exchange through call options.

- Reverse-repo auctions through remunerated deposits not subject to reserve requirements will be closed temporarily as of Monday, October 27. The Lombard contraction window will be left open.

Bogotá, Colombia
November 7, 2008