Minutes of a Meeting of the Board of Directors of the Central Bank of Colombia on October 23, 2009

A regular meeting of the Board of Directors of the Central Bank of Colombia was held in the city of Bogotá on October 23, 2009.

Present:
Mr. Oscar 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 September was 3.21%, which is 8 bp more than in August. Accumulated inflation during the course of the year up to September is 2.12%, which is well below the rate posted last year (6.53%). The core inflation indicators continued to decline.

Annual food inflation rose from 1.46% in August to 2.2% in September.

The annual increase in the price of regulated items dropped from 3.5% in August to 2.5% in September, thanks to fuel and public utility prices.

Annual inflation in non-tradable items, excluding food and regulated prices, declined from 4.9% in August to 4.8% in September. Particularly striking was the drop in items with low indexing and in rentals. The annual variation in the price of highly-indexed items remained at around 7%.

The annual increase in the price of tradable goods, without food and regulated prices, dropped from 2.8% in August to 2.7% in September.

With the preliminary data available at October 20, inflation expectations based on government bonds negotiated at one, five and 10 years showed variations of 88 bp, 1 bp and -50 bp compared to the average figures for September, and were 3.71%, 4.55% and 4.58%, respectively.

The annual variation in producer prices (PPI) went from 1% in August to -1.5% in September.

b. Growth

Most indicators of productive activity registered less of an annual decline during the third quarter of the year, but showed no signs of a significant increase in their levels.

- According to the figures released by DANE, industrial production in August of this year was 3.3% less than in August 2008. This is favorable compared to the situation in past months.

- In terms of levels, industrial production (seasonally adjusted) was down in August with respect to July. However, the same series adjusted by the number of working days showed a higher outcome for August compared to July.

- ANDI reported that IPI growth during the course of the year to August (-7.5%) would have declined, despite being at a better level than in July (-8.1%). It is important to point out that there have been considerable discrepancies between DANE’s series and those released by ANDI, specifically with respect to year-to-date growth rates and trends.

- The total demand for energy (both regulated and unregulated) was up 3.0% in September in annual terms. During the third quarter, this indicator posted a 2.2% annual increase, which is better than in the first and second quarters (0.8% and 0.3%, respectively).

- The level of building permits increased during July and August.

- Real retail sales levels rose during the period from May until August and the annual slowdown has declined (-0.9% annual in August compared to -3.7% in July).

- The Fedesarollo consumer confidence indicator fell slightly in September with respect to August, but the average for the third quarter was higher than the average for the quarter before.

During the course of the year until August, the country had a trade surplus of US$874 m, which is less than the surplus a year ago (US$1.112 b). This is the result of 19.4% fewer exports, which is more than the drop in imports (-16.5%). At a monthly level, the trade balance in August posted a US$260 m surplus, thanks to trade surpluses with the United States, Venezuela and Ecuador.

During 2009 up to August, total exports in dollars (CIIU classification) fell 19.4% with respect to the same period in 2008. Industry was down 22.1%, the mining sector -17.2% and farming -12.1%. In spite of these reductions, the levels were close to those for the same period in 2007, with the exception of the mining sector, which has improved with respect to that year.

Total exports in dollars to Venezuela, which account for 16%, are down 9.8% so far this year, primarily due to industrial sales (-12.5%). Sales to Venezuela during August declined -45.7% compared to the same month in 2008. This is more of a reduction than in past months.

Sales to the United States, which accounts for 38% of total exports, declined 22.5%, during the course of the year up to August. This is the largest contraction among Colombia’s trading partners and originates with fewer exports in dollars from the mining sector (26.2%) and the industrial sector (19.7%).

During the course of 2009 up to August, imports (CIF) came to US$21.293 b, having fallen 17.4% in annual terms. The largest reduction was in imports of intermediate goods (28.8%), particularly those from the United States.

According to the Comprehensive Household Survey (GEIH), employment rose during the June-August 2009 moving quarter at an annual rate of 6.6% nationwide and 3.6% in the 13 major areas. However, the labor supply (GPR) grew even more. The result was an increase in the unemployment rate (UR), which was 11.9% nationwide for the moving quarter ended in August and 13% in the 13 areas.

c. External Context

Economic conditions in the developed countries have improved during the last few months, thanks to the actions taken by governments and central Banks. These initiatives made it possible: (i) to improve liquidity conditions and to stabilize the interbank markets by reducing risk perception; (ii) to reinforce consumer and business expectations; and (iii) to avoid an even larger slump in economic activity.

The emerging economies also showed signs of recovery, particularly the Asian economies. In China, growth is expected to reach 8.5% this year and 9.0% in 2010. For Colombia's major trading partners in the region, 2010 is expected to be a better year, although the forecasts are less optimistic in the case of Venezuela and Ecuador.

The recovery in China and in several other Asian economies has rekindled the demand for commodities so far this year. Coupled with a weak dollar, this has sustained commodity prices, favoring terms of trade in the case of the Latin American countries.

The Latin American currencies continue to appreciate, particularly those of Brazil and Colombia. Since March 2009, the Colombian peso has appreciated against most currencies.

d. Financial Variables

The annual nominal increase in the monetary base during September was 6.1% compared to an annual rate of 15.3% the month before. This slowdown is explained by less of an increase in bank reserves due to a statistical effect associated with the sharp increase during September 2008 due to the increase in the bank reserve requirement and the increased perception of risk in the financial system sparked by the failure of Lehman Brothers.

The last few months also saw fewer liabilities subject to reserve requirements (LSR). The LSR decline may be related to the slowdown in economic activity and to a shift in agents' portfolio towards government bonds. As a result, the broadest monetary aggregate – M3 – also experienced a slowdown, which was more pronounced during the early days of October. The annual increase in M3 went from 13.2% to 9.7% between early August and October 9, while the increase in LSR went from 14.0% to 10.2%.

The slowdown in the financial system's gross loan portfolio in domestic currency continued. By October 9, the annual increase in this aggregate was 7.3% as opposed to 9.5% a month earlier. Nevertheless, the balances stabilized in recent weeks.

By September, the annual increase in the commercial loan portfolio was 8.4% compared to 12.4% the month before. Consumer lending continued to grow at a very low annual rate (0.2%) and mortgage lending tended to accelerate (from 11.9% in August to 12.9% on October 9).

In August, total external borrowing (direct lending from the private productive sector, plus the banks' portfolio in foreign currency) dropped 8.1% in annual terms (compared to 6.2% the month before). However, despite the negative annual rates, direct external borrowing was up compared to the level in July. September also saw an increase in the financial system's outstanding portfolio in foreign currency with respect to August.

In 2009, the sale of securities was consolidated as a way to supplement financing for the productive sector. During the course of the year up to early October, the productive sector issued COP6.2 trillion in debt, with COP $2.8 trillion outstanding between January and August.

All monthly average nominal interest rates on deposits-taking and lending declined during the past month. The 50 bp policy rate cut by the BDCB on September 25 was passed through entirely to the money market rates (TIB). The rates on deposit-taking and commercial loans, consumer lending and mortgage loans declined as well. Moreover, the usury rate reduction led to a drop in the interest rate on credit card lending. Despite the cut in nominal rates, real rates were up due to the reduction in non-food inflation.

The short, middle and long segments of the TES curve posted respective reductions of 42 bp, 47 bp and 49 bp.

2. DISCUSSION AND POLICY OPTIONS

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

- i The pace of price growth and its downward trend
- ii The variation in food prices, which continues to be low
- iii The effect international prices for food, raw materials and oil could have on total inflation
- iv How the El Niño phenomenon could affect the increase in prices
- v The continued improvement in consumer and business confidence compared to the first half of the year
- vi The decline in monetary aggregates, particularly M3
- vii The peso loan portfolio held by the financial system, which continues to grow in excess of nominal GDP, even though it is declining
- viii Bond issues that have supplemented productive sector financing
- ix How market interest rates have performed in response to the Central Bank's benchmark rate cuts.
- x Negative growth in the United States and less economic growth in the case of Venezuela, Ecuador and Colombia's other trading partners.
- xi Recent appreciation in the exchange rate
- xii The impact of the exchange rate on inflation and growth in the tradable sectors
- xiii The pattern of interest rates on government bonds
- xiv Intermediate and long-term expectations for inflation

The main points analyzed by the Board members centered on: (i) the elements that affect the inflation forecasts for 2009 and 2010, particularly an eventual rise in regulated and food prices due to El Niño; (ii) the lag between monetary policy measures and their effect on production and prices; (iii) forecasts for economic growth during the remainder of the year and in 2010, given weaker external demand than was forecast and less fiscal stimulus next year; (iv) the dive in exports to Venezuela during the last few months; (v) the way the exchange rate has performed in recent weeks; (vi) the decline in monetary aggregates and how it might affect economic recovery; (vii) the recent low momentum in the commercial loan portfolio held by the financial system and its causes; (viii) the need to supply year-end liquidity and whether or not it is appropriate to do so permanently; (ix) the risk balance between growth and inflation in a context of economic slowdown and falling inflation; (x) the relevance of continuing to lower the intervention rate, given the latest available data; and (xi) the need to bolster the monetary authority's credibility and to anchor inflation expectations to the long-term target.

The Board of Directors decided to adopt the 2% to 4% range as the long-term target for inflation in 2010, with 3% as the specific target for legal effects. This range is the long-term target set years ago by the Board of Directors. The members of the Board believe economic conditions allow for future inflation to be within the long-term target range, which would help to anchor inflation expectations at that level. Low and stable inflation is the best contribution monetary policy can make to sustained growth in the economy and employment and the nation's competiveness.

The inflation target that was adopted takes the following into account:

- Inflation near 3% by the end of the year, due to the drop in commodity prices during 2009 and the fact that internal and external demand has been seriously weakened as a result of international financial crisis.
- Expectations of slow growth in the world economy during 2010 and 2011, and the downward trend in global inflation
- Recent developments in international commodity prices, the demand for Colombia's leading exports in a context of low economic growth with respect to our trading partners, and possible future supply shocks to food and regulated prices.
- The delayed effect of the Board's expansionist monetary policy, the forecasts produced by the inflation models, and agents' expectations for inflation.

The Board decided to hold the base interest rate for repo auctions at 4% and believes the inflation target for 2010 will be met without upward pressure from the intervention interest rate in the near future.

It also agreed to supply a larger portion of permanent liquidity to meet the liquidity needs that usually increase at year's end. To do so, the Central

Bank will purchase three billion pesos in TES on the secondary market and foreign currency.

Some directors expressed concern about the decline in monetary aggregates and lending, and its possible connection to economic performance. They indicated the pattern in monetary aggregates and lending may be a reflection of added risk perception, given weaker than expected productive activity. Accordingly, they warned of the need to closely track monetary aggregates and lending, as well as their possible impact on the stance of monetary policy.

3. POLICY DECISION

The Board of Directors decided to make no change in the Central Bank's intervention interest rate, which was left at 4%.

Bogotá D. C., Colombia
November 6, 2009