Minutes of Banco de la Republica (Central Bank of Colombia)
Board of Director's Meeting of 28th September 2012

On 28th September, in the city of Bogota, D.C., the ordinary meeting of Banco de la Republica's Board of Directors was held with the presence of the Minister of Finance and Public Credit Mr. Mauricio Cardenas-Santamaria, the Governor Mr. Jose Dario Uribe, and the exclusive full-time dedicated directors, Messrs. Fernando Tenjo, Carlos Gustavo Cano, Juan Jose Echavarria, Juan Pablo Zarate, and Cesar Vallejo, at which inflation and economic growth situations and their perspectives are discussed, and decisions relating with monetary policy are adopted.

1. BACKGROUNDS

a. Recent developments in Inflation

Annual consumer inflation increased 8 bp in August with respect to July, and stood at 3.11%. For year-to-date through August, the CPI adjustment has been 2.03%, significantly lower than that registered in the period of 2011 (2.64%). The increase in total inflation in August was concentrated in the groups of foods, non-tradable without foods, and regulated items.

With respect to the CPI without foods, its annual variation remained virtually stable at 2.75% resulting from a rise in the non-tradable component and a fall in tradable and regulated items. The increase in the annual variation of non-tradables (shifting from 3.7% in July to 3.9% in August) was explained above all by the behavior of the fun and enjoyment subgroup (soccer tickets). August data is the highest since July of the previous year, and it may establish a new level for this indicator in the months to come. However, this behavior could be due to a low comparison base rather than an increase in demand pressures. With regard to non-tradables, the situation dealing with the annual variation of leases is worth stressing, since it remained at 3.7% just like in the past two months, in this way breaking the upward trend it was maintaining since 2011.

With respect to other sub-baskets, the annual variation in tradables without foods and regulated items has remained close to 1.0% since May, coinciding with slight annual exchange rate depreciation. Regulated items, on their side, exhibited a decline from 3.5% in July to 3.1% in August in their annual variation, mainly due to a reduction down to 1.1% in the annual variation of fuels relating to the lower oil prices observed in the first half of the year.

As for the foods CPI, annual variation showed a slight recovery (up to 4.0%), in this way interrupting the downward trend shown since April. This was basically due to the price rises in the perishable foods group, although, in this case, the annual variation remained in negative terrain. It is worth stressing that commodity prices have not increased much, which suggests that the international price rises in previous months have not yet been transmitted to consumer inflation.

Core inflation did also increase in the last month. According to the four core inflation indicators monitored by Banco de la Republica, it reached 3.12% in August as compared with 3.04% in the previous month. This average has been fluctuating between 3.00% and 3.15% since November last year.

Regarding costs, the PPI kept a very low - though upward - annual variation (0.13%) after two months of negative records. Increases were concentrated in the produced and consumed PPI, particularly in mining, due to the rises registered in the prices of refined oil products.

In this last month, a slight recovery was seen in inflation expectations after several months of falls. According to the monthly survey of financial market operators, inflation expected for December this year is 2.99% (against 2.93% in the previous month); this increase was particularly due to food inflation. On the other hand, expectations deriving from the Colombian Treasury Bonds – TES increased about 25 bp at all horizons. With the exception of the ten-year expectations, the other ones remained below 3.0%, though converging towards this value.

b. <u>Growth</u>

According to the GDP record for the second quarter of 2012 published by the National Administrative Department of Statistics - DANE, Colombian economy grew in this period at an annual rate of 4.9%, just above the ceiling of the forecast range (between 3.3% and 4.8%) submitted by the SGEE (Banco de la Republica's Economic Studies Division) in the June Inflation Report. This result meant a quarterly acceleration of 1.6% (quarterly annualized 6.7%), the highest in the past four quarters and higher than in the first quarter of the year s (0.2%).

The behavior of the economy in the period was due to the domestic demand dynamism which did highly offset the external demand deterioration. Indeed, domestic demand in the second quarter recorded an annual growth rate higher than in the preceding quarter (6.9% vs. 6.0%). In contrast, the annual growth rate of exports was only 2%, this being significantly lower than the 6.6% record observed in the first quarter and the 11.4% average rate of growth for 2011. On their side, imports grew at an annual rate of 9.5%, also lower than that registered in the first three months of the year and the average for 2011 (12.4%, and 21.5% respectively). Overall, net exports contributed negatively (-2.2%) to GDP growth.

Domestic demand acceleration was mainly explained by the dynamics of investments in construction and buildings, and civil works. Among the latter, growth rates registered for those destined for mining and the construction of railroads and runways stood out. Other investment components such as transportation equipment, and machinery and equipment, continued to exhibit important annual growth rates.

Government consumption did also contribute to domestic demand dynamism. This item showed higher annual variations than those expected and those registered in the first quarter of the year (4.6%, against 3.1%). Its growth was the highest observed since the middle of 2010.

In contrast, household consumption continued to slow down. Its annual variation was 4.0% (equal to its average since 2000) while in the first quarter it has been 5.7%. Likewise, at a disaggregated level, lower growth rates were registered in all of its components where those in the consumption of durable of non-durable goods stood out.

By activity branches, sectors showing the highest growth rates during the second quarter of 2012 were construction (18.4%) in both buildings and civil works, mining (8.5%), and financial services (5.1%). The only sector having recorded an annual fall was industry (-0.6%).

For the third quarter, indicators suggest less growth in economic activity. Particularly, in the case of household consumption, an annual growth lower than that observed in the first part of the year (5.0%) might have taken place. Indeed, in July, commercial retail sales reported by the DANE showed an annual variation of 1.3%, lower than the 4.0% registered in June. Along this line, the most recent data concerning vehicle sales would indicate that also consumption of durable goods in the third quarter might have grown less than as observed in the first half of the year. According to information published by '*Econometria'* in August, vehicle purchases exhibited negative annual variations around 10%. In addition, a fall in the Fedesarrollo consumer confidence indicator for August was noticed, although its level still remains above the historical average.

Despite the above, the labor market indicators, which are an important variable in predicting consumption behavior, do not show clear deterioration in the past few months. Therefore, the number of salaried and total occupied persons, with figures as of July, continued to grow at rates close to 4.5%. For this reason, the unemployment rate has continued to fall nationwide in annual terms. For the thirteen major metropolitan areas, the rate has shown a slight increase, the first in two years, accompanied by a significant augmentation of job offers.

On the supply side, the few indicators available for the third quarter of 2012 suggest a weak growth of industry and commerce. In the first case, production increased 1.5% in July, and the Fedesarrollo orders, stocks and entrepreneur indicators maintained a slow deterioration pace, though they remain at relatively good levels. On the other hand, demand for industrial electric power slowed down in August from 5.8% to 2.4%, this being a variable sharply correlated with the IPI. Nevertheless, it has to be noted that the regulated energy demand grew 4.7%.

In the case of commerce, the merchants consulted by Fenalco in July pointed to a fall in their sales perception as well as deterioration in their 6-month perspectives. Something similar was yielded by the Fedesarrollo survey which, for the same month, did also register a drop in the perception of the current and future situation of the entrepreneurs' business in the sector.

On the other hand, total Colombian exports in dollars fell 4% in July on an annual basis, and reached an amount of US$4.694 billion. This was fundamentally due to the 9.4% fall in mining exports, since, in contrast, agricultural and industrial and other foreign sales grew 30.6% and 5% respectively. In the case of goods of mining origin, the only item having decreased was oil and oil by-products (-18.5% per annum). The explanation for increased exports of agricultural products lies in the augmented exported values of banana (104%) and flowers (58%) serving to offset the 1.4% reduction in coffee exports.

c. Financial Variables

In August, total credit in national and foreign currencies ("MN" and "ME" credits) exhibited an annual growth rate of 16.35%, therefore lower by 83 bp and 334 bp than the levels respectively observed in the previous month and in March.

The monthly slowdown was led by the commercial portfolio, the annual increase of which declined 132 bp by shifting from 15.56% to 14.24% between July and August. On its side, the household portfolio remained close to that observed in the previous month (it shifted from 19.54% to 19.45%), because the August increases registered by the consumption and mortgage portfolios (20.76%) and (15.91%) respectively, in that order declined only 11 bp and 5 bp as compared with July.

With respect to March, moderation shown in the commercial and the household portfolios has been similar, with reductions of 322 bp and 364 bp, respectively, in their growth rate.

In August, real interest rates (excluding the CPI without foods) for consumption, mortgage and ordinary commercial credits, in that order, stood at 16.3%, 10.2% and 9.4%, these being rates below their respective averages calculated since 2000 (excluding the mortgage rate, the average of which is measured from May 2002). On the other hand, real interest rates for credits granted with credit cards, and for the preference and treasury modalities, stood at 26.9%, 6.2% and 5.8%, which are higher than their averages calculated since 2000.

d. External Context

The recent decisions of the central banks in the major developed economies around a widening of the lax monetary policy that they have been maintaining during the past few years let think that the policy interest rates of the advanced countries should remain at levels close to zero beyond 2014, and global liquidity is bound to increase in the next few months. Therefore, in the Eurozone, the European Central Bank (BCE) announced the unlimited purchase of government debt bonds to those countries asking for aid and submitting to an adjustment plan. On its side, the Federal Reserve of the United States (FED) implemented a third round quantitative ease (QE3), this time conditional on the evolution of the labor market. At the same time, the central bank of Japan extended its expansionist policy. The above might increase capital flows to the emerging economies, thus generating currency appreciation pressures.

The measures adopted by the European Central Bank (BCE) would allow time for the other authorities in the region to progress in economic integration and reactivate their economic growth. In this sense, the German Constitutional Court ratified in the past month the legality of the European stabilization mechanism expected to start working in the next few months. Likewise, the European authorities have maintained their dialogues regarding the creation of a centralized banking supervision agency; nevertheless, their steps in these directions are still slow.

Global economic activity has continued to slowdown in the past few months, especially in the economies of the Eurozone and those more exposed to it. In great part this fact is explained by the lessened dynamism affecting industry and foreign trade.

With figures as of July, some real activity indicators in the Eurozone (industrial production, consumer credit, and retail sales) continued to contract in annual terms. On the other hand, the entrepreneur and consumer sentiment indices remained depressed in August, and this may imply further deterioration of the real activity in the months to come.

To the extent that policies adopted by the European authorities begin to bring good effects on confidence in the region, it would be possible to observe their positive influence on growth. However, it can be predicted that the response of the economic activity will hardly materialize in the remainder of the year.

Industrial production in the United States showed a sharp contraction in August and slowed down as seen in the annual comparison; this situation might be repeated in the next months as anticipated by the Purchasing Managers Index (PMI) in the manufacturing sector. Likewise, the last exports and labor market figures have evidenced that the stagnation seen in these indicators would have continued to be observed in the third quarter. Despite the above, the service sector, and real retail sales, as well as the real estate sector, they went on expanding according to the last figures available. In this context, economic expansion in the United States has been expected to keep a moderate rhythm during the third quarter.

With respect to the emerging countries, real activity has continued to decelerate in the main Asian economies, particularly in China and India. In the first case, this slowdown appears to be higher than expected by the Chinese authorities and they have been compelled to implement additional policies in order to encourage domestic demand.

In Latin America, real activity in the second quarter continued to expand at a favorable pace in Mexico, Chile and Peru, as supported by the dynamism of domestic – and mostly public – demand. In Brazil, the most recent information available shows signs of a better performance probably relating to the stimuli implemented in previous months by the Brazilian economic authorities.

The international oil prices have declined in the past few weeks. Apparently, some OPEC countries are willing to increase their production in order to ensure lower prices below those prevailing in the past three months, and also more consistent with the current economic situation. Nevertheless, despite these falls, the average price of oil is still relatively high.

With relation to food prices, some cereals have interrupted the rises occurring in the middle of the year. Nevertheless, they still remain at high levels likely to generate inflationary - though in any case temporary - pressures in some emerging economies.

2. POLICY DISCUSSION AND OPTIONS

For the purposes of their discussion, the Board of Directors took into account the following elements:

(i) Economic activity indicators published last month confirm a slight weakening in world economy. In Europe, economic conditions continued to slow down and, likely, the region’s GDP would fell in the third quarter. Growth in the United States is keeping a moderate pace while economy in Japan is also failing. In this context, and with no inflationary pressures, the central Banks in Europe, the United States and Japan have announced further monetary stimuli for a more prolonged period. A common factor in a significant number of emerging countries has been deceleration in both exports and industrial production.

(ii) Although international commodity prices went down, they nevertheless continue to be high. Consequently, Colombian terms of trade remain elevated and are propelling national income. However, according to the most recent data available (from July), the total value of Colombian exports has fallen as a result of a weakened external demand and a decrease in oil prices.

(iii) In Colombia, GDP growth in the second quarter (annual 4.9%) exceeded the range (between 3.3% and 4.8%) estimated by the technical team. This underestimation was due to an increase in internal demand (annual 6.4%) above projections. Economic activity figures in the third quarter suggest that the annual GDP growth will be lower than in the second quarter. For the full year 2012, economic growth seems likely to be above the midpoint of the estimated range (between 3% and 5%).

(iv) In August, credit growth continued to slow down, in this way diminishing financial imbalance risks. Real interest rates are standing at levels close to the average observed since year 2000.

(v) Although inflation and the average of core inflation increased slightly in august, they are standing very close to the midpoint of the inflation range (at 3.1%). One-year inflation expectations remained stable at 3.3%, while those resulting from the Colombian 2, 3, and 5-year treasury bonds – TES – did increase but continued to remain below 3% (the midpoint of the target range).

Some Board members stressed that economic activity figures suggest that the economy is converging to its potential growth level in a context where core inflation measures and expectations are very close to the long-term target (3%).

In addition, they highlighted the dynamism of domestic demand based on construction and civil work investments, the fact that credit is growing at significant rates, as well as the favorable terms of trade that continue to encourage national income, and the good behavior of employment. Real interest rates are standing at levels close to the averages estimated since 2000. The above indicates that the coherent monetary policy adopted by the Board is consistent with a sustainable long-term growth. Nonetheless, the new information will enable the Board to establish further monetary policy actions, both those concerning the development of events in the advanced countries and their impact on confidence, global demand and the international commodity prices, and those originating in domestic demand. Consequently, they have proposed to keep the reference interest rate unaltered.

Other members emphasized the monetary policy needs to look forward. Global economic activity has continued to slow down, particularly in both the Eurozone and the Asian economies. The external context weakness, and especially the behavior of the prices of mining-energy products, make Colombian economy very vulnerable and will contaminate its internal economic performance. In the domestic economic activity, it is highlighted that inflation, as well as the expectations, have continued to converge to the midpoint of the target range.

Although demand has remained dynamic by activity branches, when mining of civil works are excluded from the GDP a slight deceleration is observed and, above all, the poor behavior of industry is disquieting. Household consumption has continued to decelerate, and a fall of the consumer confidence index was observed. Since a good monetary policy lies in the ability to anticipate proper decisions, the Board members deemed that reducing the intervention interest rate is necessary.

3. POLICY DISCUSSION AND OPTIONS

According to the assessment of the current balance of risks, Banco de la Republica Board of Directors, by majority decision, has determined to keep its intervention interest rate unaltered. Therefore, the base rate for expansion actions will remain at 4.75%.

The Board will continue to keep close watch on the international situation as well as on the behavior and projections of inflation, growth, and the asset markets, while reiterating that the monetary policy will depend upon the new information available.

Bogotá D.C., October 12 2012