



Minutes of a Meeting of the Board of Directors of Banco de la República on July 27, 2007

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá on July 27, 2007.

Present:

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

Mr. José Darío Uribe, Governor

Directors:

Mr. Carlos Gustavo Cano

Mr. Juan José Echavarría

Mr. Juan Mario Laserna

Mr. Fernando Tenjo

Mr. Leonardo Villar

The situation with respect to inflation was discussed and decisions on monetary policy were reached. The following is a summary of that discussion.

1. The Circumstances

a. Recent Developments in Inflation

Total consumer inflation in the second quarter of the year severed the upward trend observed as of late 2006, ending June at 6.0% (22 b.p. below the rate in April). All the core inflation indicators followed suit.

Annual food inflation in June (9.7%) was 30 b.p. less than in April. As anticipated, the upward pressures generated by the onset of El Niño weather began to subside during the second quarter, particularly the pressure on perishable food prices. Nonetheless, processed food inflation continued to rise, although not as quickly. Still fueled by strong domestic and foreign demand, meat prices were the main reason for the increase. The third quarter is expected to see a further decline in food inflation, provided the weather returns to normal.

The reduction in non-food inflation and in the other core inflation indicators during the last two months reflects the behavior of prices for regulated items and tradables. The downturn, with respect to regulated items, was concentrated in certain public utilities, such as natural gas for residential consumption, and occurred despite major hikes in fuel prices and in public transportation fares. As to prices for tradables, excluding food and regulated items, appreciation also would have influenced the relatively low increases witnessed over the last two months. These largely reflect the drop in prices for goods such as home electrical appliances and automobiles. However, given the extent of appreciation (14.8% so far this year), the impact of the exchange rate on tradable inflation has been minor.

Non-tradable inflation, excluding food and regulated items, ended the quarter at an annual rate of 5.1%, exceeding the figures registered in March (4.9%) and December (4.8%). The increase was concentrated in rentals (4.3%), an item that has seen relatively large increases during the last three months.

b. Growth

GDP growth during the first quarter of 2007 was 8.0%. This is slightly less than the fourth-quarter figure for 2006, but more than in years past. Growth in the nation's economy continued to be bolstered by domestic demand, which was up 11.0%. The sharp rise in public and private investment in machinery and equipment and in residential buildings is a high point in this respect. Household consumption increased by more than 7.0% for the third quarter in a row, while public consumption was down by 0.5%.

Net external demand remained negative (-7.9% of GDP). This was due to the added momentum in imports, which had increased at a real annual rate of 21.8% by the first quarter of the year. At that point, the real annual rise in exports was 9.4%.

The annual increase in imports of capital goods (26%), the sharp rise in building permits at May, and the acceleration in mortgage loan disbursements are a reflection of the vigorous growth in investment. The remainder of the year is expected to see public and private investment perform well, with a combined increase of 21%. The growth in private consumption has slowed somewhat in recent months, but 2007 should see an increase similar to the one in 2006. The various indicators of use of industrial plant capacity remain historically high, despite having dipped slightly in recent months.

c. Costs and Wages

The annual increase in the cost of raw materials slowed considerably during the second quarter of the year, dropping from 4.8% in March to 0.3% in June. This is mainly due to a lower PPI for imported goods. So far this year, the wage hikes in industry and commerce have been similar or slightly less than those in 2006. No inflationary pressures from the job market are forecast for the second half of the year.

d. The International Context

During the second quarter of 2007, the international situation was marked by more growth in the world economy and higher commodity prices than were forecast a few months ago. Once again, inflation in a number of countries is on the rise. This could boost interest rates and reduce international liquidity, primarily during 2008. However, these increases are expected to be moderate and part of a normalization of liquidity in international markets.

The external context remains favorable for the Colombian economy. The current situation allows for expectations of better terms of trade, partly due to recent increases in the price of oil. Furthermore, the demand from our trading partners remains extremely robust, especially in Venezuela, and the flow of foreign investment into Colombia is expected to continue.

e. Financial Variables

The annual pace of growth in monetary aggregates slowed in recent months. In April, the annual increase in the M3 aggregate was 21%; in June, it was approximately 17%. The bulk of the slowdown originated with the demand for cash, which has grown at an increasingly slower rate since mid-2006. The last two months also saw a reduction in deposits with the financial system, following several months of steady, accelerated growth.

Financial institutions seem to be less bent on shifting the composition of their portfolios from TES to loans. If this new trend gains force, it could mean fewer resources to expand the loan portfolio. This would speed the pass-through of monetary policy to credit and interest rates in the market.

The second quarter saw a bit of a slowdown in the credit growth rate, although it was still high in nominal terms. The annual increase in the total gross loan portfolio came to 31.2% in March; in June, it was 29.5%. Most of the slowdown has been in the commercial loan portfolio and, to a lesser extent, in the consumer portfolio. However, it has been offset by the accelerated growth in mortgage loans. However, the increase in the commercial and consumer loan portfolios is still high in annual terms (25.1% and 44.2%, respectively) and in annualized monthly terms (18% and 38%).

Interest rates have been on the rise. In fact, the average rate for certificates of deposit (CDT in Spanish) was 8.35% in June, as opposed to 7.79% in May. Interest on loans averaged 15.3%, following 14.8% in May, partly because of a higher usury rate. The average rate on certificates of deposit (CDT) has accumulated an additional 220 b.p. since April of last year. Compared to April 2006, the rates on consumer and ordinary loans show less of an increase (71 b.p. and 151 b.p.) than the policy rate; the interest rates on preferential and treasury loans have experienced more of an increase (357 b.p. and 409 b.p.).

2. Discussion and Policy Options

The following points were raised during the course of the discussion. (i) Prices continue to increase at an annual rate in excess of the targets set by the Bank, despite the break in the upward trend in inflation, which was anticipated by the Board of Directors. (ii) Inflation in non-tradables shows no sign of a decline. (iii) The Bank's technical team raised its forecast for GDP growth during the year, which has an effect on the size of the output gap. (iv) Appreciation of the Colombian peso has yet to exert a major impact on the price of tradables. (v) Although reduced, expectations for inflation are still above target.

Nonetheless, the Board of Directors believes the intervention interest rate hikes and the changes in reserve requirements have begun to have the desired effect on price performance, credit growth and monetary aggregates. This indicates a quicker pass through of the Bank's interest rates to the rest of the economy. Factors such as the recent shift in bank investments towards TES and the added room provided by the usury rate could speed the pass through of rates in the months ahead.

The main points of discussion involved: (i) the speed and intensity of the impact of the monetary policy measures adopted up to now; (ii) uncertainty about the behavior of inflation during the remainder of the year and the possibility that it might decline less than anticipated initially; (iii) developments in the current account and, particularly, the possibility that changes in the international context might cause abrupt changes in aggregate demand and output growth; and (iv) the impact of the output gap on inflation.

Several Board members emphasized that the factors responsible for the high rate of economic growth remain in effect. Real interest rates are still historically low, external demand continues to be strong, terms of trade remain favorable, and credit is growing at even higher rates. Moreover, higher prices for housing could reinforce the growth in spending. These factors, as a whole, make for a scenario where aggregate demand will continue to be high.

Most of the Board members felt the risks posed by these factors warrant an increase in intervention interest rates. They indicated that action in this direction is consistent with the goal of sustainable economic growth and convergence towards the long-term target for inflation.

Others suggested a pause, recommending that any decision on a new hike in the Bank's intervention interest rates be postponed until the next meeting, which is scheduled for August. They argued this would allow time for more and better information on the real impact of the measures taken up to now. In this respect, several Board members indicated that the effects of the monetary policy measures put in place throughout the year might be underestimated, considering the reinforcement provided by decisions such as the cutback in public spending, the hike in usury rates and the increase in commercial loan portfolio provisions, thanks to the application of SARC in the financial sector. It was stated that the anticipated growth in output does not necessarily generate inflationary pressure, given the large increase in investment and productivity in the economy, and in imports of capital and intermediate goods, which denote excellent performance mirrored in the growth in installed capacity. Also, there have been no bottlenecks or inflationary pressures in the job market.

3. Policy Decision

By a majority of votes, the Board of Directors agreed to raise Banco de la República's intervention interest rates by 25 basis points.

Bogotá D.C., August 10, 2007