



## **Minutes of a Meeting of the Board of Directors of Banco de la República on November 23, 2007**

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá on November 23, 2007.

Present:

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

Mr. José Darío Uribe, Governor of Banco de la República

Full-time Associate Directors:

Mr. Carlos Gustavo Cano

Mr. Juan José Echavarría

Mr. Juan Mario Laserna

Mr. Fernando Tenjo Galarza

Mr. Leonardo Villar

Conditions with respect to inflation and economic growth, and their prospects for the future were discussed and monetary-policy decisions were reached. The following is a summary of the principal topics addressed at the meeting.

### **1. Background**

#### **a. Recent Developments in Inflation**

The consumer price indexed (CPI) saw virtually no change in October, having varied by only 0.01%. Yet, due to the drop in the CPI during October 2006, the downward trend in annual inflation observed since May was interrupted and inflation ended the month at 5.16%, which is 15 basis points above annual inflation at September. The increase was concentrated in non-food inflation, particularly in tradable goods and, to a lesser extent, in regulated prices. Most of the core inflation indicators behaved likewise.

Annual food inflation, which had declined since April of this year, ceased to do so in October and stayed at 7%. Inflation in perishable foods continued to drop, but processed food inflation was up slightly. Higher prices for cereals and oil-seeds, which are linked to international prices and the exchange rate, were mainly what halted the downward trend.

Non-tradable inflation, excluding food and regulated prices, dropped to 5.3%. This is 26 basis point less than the figure registered the month before. The most notable segments were rentals, which were down for the second month in a row, and the sub-group that includes entertainment, culture and recreation.

Annual inflation in tradables other than food rose during October, due to a low basis of comparison in October 2006, when telephone rates were reduced sharply.

Regulated price hikes also helped to speed up annual inflation at October. Public utilities are a case in point, particularly residential natural gas and, to a lesser extent, electricity.

#### **b. Growth, the External Context and Financial Variables**

Domestic economic growth remained strong, although some information suggests it is becoming more moderate. The industrial growth indicators reflect a gradual slowdown as of the first quarter. In terms of retail sales, DANE reported a real increase of 9.4% in September. This is similar to the rate observed since the second half of the year, but less than the one in September 2006. The consumer confidence indicator is comparable to what it was at the same point last year. All of this is consistent with the GDP growth forecasts published by Banco de la Republic in the September 2007 edition of its *Inflation Report*. Those forecasts are based on the assumption that growth during the second half of the year would be less than during the first.

In August, export growth remained high and was similar to what it had been in previous months (16% in dollars). This was due largely to added sales of non-traditional products. Venezuela still is the fastest growing market and offset the drop in exports to the United States during the same period.

#### **The International Context**

The extent and duration of the recession in the US housing market and its impact on world economic growth is still uncertain. A range of leading indicators suggest the US economy is weakening, coupled with the persistence of problems demonstrated by the mortgage sector and various financial institutions. Private consumption might be hurt, in part, by higher fuel prices, but also by the decline in asset prices (real estate and stocks). In addition to the signs of a slowdown, new inflationary pressures have begun to emerge as a result of soaring oil and food prices. International prices for most commodities are expected to remain high, which would keep terms of trade at a favorable level for Colombia.

## **Financial Variables**

The main monetary variables were up in October. In particular, the annual increase in M3 was 17.3%, which is more than in August (15.7%) and above nominal GDP growth.

Annual growth in the total loan portfolio held by the financial system in pesos continued to decline, having gone from 27% in September to 25% in October. The slowdown was particularly evident in the consumer loan portfolio, which saw a reduction in growth from 39.4% in September to 36.7% in October. The commercial and mortgage loan portfolios also lost momentum, but not as much. Their respective growth rates were 20.3% and 18.8% in October, following 22.2% and 19.2% the month before.

Nominal rates on savings and consumer and credit card loans rose in October. The others were down, particularly the rate on term deposits (DTF) (by 30 basis points) and ordinary credit (by 24 basis points).

## **2. Discussion and Policy Options**

The following points were emphasized during the discussion:

- (i) Prices continue to rise at a pace that exceeds the targets set by the Board of Directors.
- (ii) Food weighs heavily on future inflation.
- (iii) Non-tradable inflation, without food and regulated prices, declined in October but still exceeds total inflation.
- (iv) Available indicators suggest the momentum in aggregate demand remains high compared to production, but is showing signs of moderation.
- (v) There is still uncertainty about the future of the world economy and our major export markets (Venezuela and the United States).
- (vi) What are the monetary-policy implications of the inflation targets set by the Board and how will inflation expectations respond to those targets?

Despite the October figures, the Board believes the various indicators are proof that the intervention interest rate hikes and the change in reserve requirements have helped to curb the increase in aggregate demand and credit. In the last few months, these measures have reinforced the pass-through channels for monetary policy, taking interest rates to levels that are more coherent with those objectives. For example, the term deposit rate (DTF) went from 5.97% to 8.59% between May 2006 and October 2007, while the average lending rate went from 12.89% to 17.24%.

External demand is still strong, terms of trade remain favorable and even improved recently, and credit continues to increase at high rates. Domestic demand is still growing faster than national production, but is losing some momentum.

The Board's deliberations focused on: (i) the effect of monetary-policy measures, given the lag in their impact; (ii) the elements that will influence inflation forecasts for the remainder of the year and for 2008; (iii) the increase in the current account deficit, which denotes more growth in demand than in national production; (iv) the fact that changes on the international scene could alter the exchange rate in a context marked by sharp growth in domestic demand; (v) the uncertainty sparked by extreme volatility on international markets and how it could affect the Colombian economy; and (vi) the need for the monetary authority to enhance its credibility as a way to anchor inflation expectations in view of the upward price trends other countries are increasingly faced with.

The Board was unanimous in its conviction that an additional hike in the intervention interest rate is necessary to comply with the inflation targets for 2008 (in the 3.5% to 4.5% range, with 4% as the specific target for legal effects) and for 2009 (a specific target between 3% and 3.5%). Accordingly, it decided to raise its intervention rates by 25 bp from 9.25% to 9.50%, inasmuch as the growth in aggregate demand and credit remains strong, use of installed capacity is high, and the international context reflects a moderate slowdown in the world economy.

In this respect, several Board members indicated the new interest rate is consistent with a contractionist monetary policy that acts as "insurance" to seal the market's credibility and anchor its expectations to meeting the inflation targets for 2008 and 2009. After the new 25 basis point increase, they believe no additional hikes will be necessary and, depending on how domestic prices and employment behave, and the way external conditions develop, particularly in the United States and Venezuela, monetary policy eventually could return to a more neutral stance.

Other Board members said it is extremely difficult to predict future decisions on intervention interest rates and felt that future hikes cannot be ruled out if information in the coming months suggests it is advisable to ensure that inflation targets will be met and to maximize the rate of sustainable economic growth. For that reason, the Board will await new information and its implications for the inflation forecast.

Based on the data at their disposal, the Board believes that 9.50% interest is near a level that is coherent with the bid to keep inflation on target. It also feels this rate is consistent with maximum sustainable economic growth.

### **3. Policy Decision**

The Board of Directors unanimously agreed on a 25 basis point hike from 9.25% to 9.50% in Banco de la República's intervention rates.

Bogotá, D.C., December 7, 2007