Detailed Explanation of the Macroeconomic Situation (only in Spanish)
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Banco de la República Holds the Benchmark Interest Rate at 3.25%

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá D.C. on August 30, 2013. In attendance were Mr. Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit, Mr. José Darío Uribe, Governor and Managing Director of Banco de la República, and the Board Members Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Enrique Meisel Roca, César Vallejo Mejía and Juan Pablo Zárate Perdomo. These minutes contain a summary of inflation, economic growth and their prospects for the future, which was prepared by the Bank's technical staff (Section 1), in addition to a review of the key deliberations and policy options considered by the Board of Directors (Section 2).

1. INFLATION AND ECONOMIC GROWTH

a. Recent Developments in Inflation

Annual consumer inflation was 2.22% in July; this is 6 basis points (bp) more than the month before. During the first seven months of the year, the accumulated change in the CPI came to 1.77%, which is less than the change accumulated during the same period in 2012 (1.98%).

The annual change in the food CPI was 1.6% in July, 30 basis points more than in June. The increase was concentrated in the perishable food basket (4.0% versus 2.4% in June); its annual growth has accelerated from a negative rate in February. For processed foods, the annual change in prices (0.06%) remained near zero for the third month in a row, after declining during the period from mid-2012 to early 2013. In this case, lower international prices for commodities such as wheat, corn and soybeans would have offset the effect of recent nominal depreciation of the peso. Moreover, the annual change in meals outside the home remained stable at 3.5%.

As for the CPI excluding food and regulated items, July saw larger annual variations in tradables and non-tradables. In the first case, the increase (to 1.3% from 1.1% in June) adds to those observed in previous months and would be related, in part, to depreciation of the peso so far this year. The annual variation in non-tradables (3.9%) represented an increase of 12 bp from the previous month. In the case of rentals, the annual adjustment was up by 7 basis points compared to June, reaching 3.8%.

July saw a sharp drop (of 61 bp) in the annual change in the basket of regulated items (to 1.4%), following three consecutive months of growth. This decline was concentrated mainly in electricity rates and, to a lesser extent, in public transportation. According to DANE, electricity was down by 5.5% during the month.

The average of the four core inflation indicators monitored by Banco de la República came to 2.54% in July, which is similar to the average the month before (2.52%). This indicator has been quite stable at around 2.5% since February of this year.

The annual change in the PPI stayed in negative terrain during July (-0.03%), but with an upward trend that began in April. The local and imported components increased with respect to the previous month (19 bp in both cases).

There were no significant changes in inflation expectations during July. According to the Bank's monthly survey of financial market analysts, the rate anticipated for December of this year is still 2.6%, while the expectation 12 months out returned to 3.1%.

Inflation expectations derived from the TES performance curve at horizons of 2, 3 and 5 years remained between 2.4% and 3.0%. These levels are similar to those observed in June.

b. Growth

The latest information suggests household consumption would have expanded at a higher rate during the second quarter than in the first. The good levels for the consumer confidence indicator, which were similar in April and June to those registered at the end of 2011 and above the average for 2012, justify this forecast, as does the added momentum in commerce. With respect to commerce, the latest information reported by DANE shows retail sales in June posted an annual increase of 4.1% compared to the same month in 2012. The retail sales index for the second quarter as a whole was up 4.9% annually, which is more than the increase in the aggregate for the first three months of 2013 (0.8%). Another indicator that suggests a build-up in consumption is the total sales balance from the Monthly Survey of Economic Expectations (EMEE, in Spanish) conducted by Banco de la República, which was at levels above the average for the first quarter.

As for investment, the drop in imports of capital goods and the downturn in the balance of short-term and mid-term investment expectations noted in the EMEE continue to suggest mediocre performance, apart from investment in building construction and civil works.

Total exports in dollars were down by 4% during the first half of the year with respect to the same period in 2012. A decline of 8% in mining exports, given a 29% drop in coal and 12.6% in gold, is the main reason for this outcome. Exports of agricultural goods also fell, although to a lesser extent (-2%), while exports of industrial goods and others posted 9% annual growth.

During the first half of 2013, the total dollar value of CIF imports declined by 1%, due to fewer purchases of raw materials (-2.7%) and capital goods (-1.7%). On the other hand, imports of consumer goods rose 4.2% during the period.

With respect to the various branches of economic activity, the decline in industry is expected to continue, although not as pronounced, while mining, construction, agriculture and commerce should perform well.

The industrial production index, excluding coffee, dropped by 5.5% year on year at June. Given this figure, the second quarter was down 0.3% (following -6.6% in the first three months of the year), while the reduction for the year to date was -3.4%.

The second-quarter figures for construction suggest continued growth. The annual rise in cement production was 0.71%, while shipments were up by 4.3%. Despite a decline in building permits during June, the cumulative figure for twelve month continued to increase by about 7.6%.

Finally, in the agricultural sector, the recovery in coffee production, which rose at an annual rate of approximately 40% during the second quarter, coupled with an increase in the slaughter of cattle (3.3%), suggest a build-up in the sector compared to the first quarter.

Given all these factors, the Bank's technical staff's did not revise its forecast range for GDP growth in the second quarter, as presented in the last edition of the Inflation Report (between 2.5% and 4.0%, with 3.4% being the most likely figure). It is important to emphasize, once again, that the unpublished figures on civil works and public consumption show a high degree of volatility. So, a broad forecast range is justified.

The information at hand for the third quarter of 2013 is limited, but does suggest the momentum in private consumption during the second quarter would continue or even improve. On the one hand, the consumer confidence indicator was lower in July than in June, but did exceed the other levels on record so far in 2013 and the average since 2001. A breakdown by components shows household perception of current economic conditions is still relatively high, while medium and long-term consumer expectations remain stable.

The leading indicators on the supply side, such as those for orders and inventory from the FEDESARROLLO survey, point to some improvement, while industrialists expect production in the next three months (EOE) to remain at levels similar to what they were in recent months. The business confidence indicator in the manufacturing sector also improved.

The annual increase in the total the demand for energy was 3.4% in July. The demand for unregulated industrial energy, which is closely correlated with industry, posted an annual increase of 1.1% (vs. -1.2% in June). This could suggest growth in the sector would have contracted less during July than in previous months.

Oil production surpassed one million barrels per day (1.002 Mbd) in July, up from 974,000 in June. So far this year, production has increased by 7.2%. If that favorable performance were to be sustained, growth in this sub-branch would accelerate compared to 2012.

In view of the foregoing, the Bank's technical staff continues to forecast 3.0% to 4.5% growth for 2013 as a whole, with 4% being the most likely figure. The country's economic growth is expected to increase throughout the year to the extent that aggregate spending reacts to the monetary policy measures adopted earlier and to the programs being carried out by the national government.

c. Financial Variables

The annual increase in bank lending (D/C and F/C) came to 13.71% in July, slightly less than the month before (14.05%). Annual growth in the loan portfolio in domestic currency slowed from 12.85% to 12.45% between June and July, while the build-up in loans in foreign currency went from 35.56% to 37.07% during the same period.

As for the different types of loans, those to households slowed, posting an annual rate of 13.27% growth by July, which is 44 bp less than the month before. This was due mainly to less of an increase in consumer lending (down from 13.66% in June to 12.90% in July), since the mortgage loan portfolio accelerated at an annual growth rate of 14.28% compared to 13.86% in June. The annual increase in loans to businesses dropped by 27 bp between June (13.95%) and July (13.70%).

With respect to interest rates on loans disbursed by lending institutions, the reductions accumulated since the start of the policy rate cuts in July 2012 come to 230 basis points for mortgage loans, 209 bp for construction loans and 200 bp for consumer loans.

By July, the real interest rates on consumer, mortgage, preferential, ordinary commercial and treasury commercial loans were below the respective historic averages calculated since 2000. In contrast, the real rate on credit card lending was above average.

The extent of the drop in real interest rates has been less, because of the impact of lower inflation, with reductions during the monetary stimulus period amounting to 194 bp on mortgage loans, 174 bp on loans for construction and 163 on consumer lending.

d. The External Environment

During the second quarter, GDP growth in the euro area was more than anticipated by the Bank's technical staff. The added momentum in Germany and France, coupled with less deterioration in real activity in the economies of the periphery explain this outcome. The trend in business and consumer confidence indicators has been favorable so far during the third quarter, as has the trend in indicators of sentiment in the manufacturing and service sectors. If this continues, the recovery in real activity should persist throughout the second half of the year. However, the job market is still weak, and lending to the private sector remains depressed.

In the United States, according to the latest methodological revision of the national accounts, GDP growth during 2011 and 2012 was higher than previously estimated. In contrast, the figures for the first quarter of 2013 show less of an expansion in real activity than was estimated originally. The second quarter witnessed better growth, which should continue unless prevented from doing so by the effect of the tax adjustments. The partial figures at hand for the third quarter indicate the economy has continued to grow at a modest pace. The trend in retail sales and consumer confidence remains favorable. Moreover, although industrial production is almost stagnant, the indicators of sentiment in the sector point to a recovery in the coming months.

In the case of emerging market economies, information at the second quarter shows growth in the Asian countries was modest, with somewhat of a slowdown in Thailand and Indonesia. The figures on economic activity in the third quarter do not show the decline in China's economy has continued.

Economic growth in Latin America would be slightly less than expected. The GDP figures for the second quarter exhibit a sharp slowdown in Mexico and some moderation in Chile. In the case of Peru and Venezuela, growth accelerated, but is still quite limited in Venezuela. Brazil's economy has continued to expand, although at a moderate pace.

As for basic commodity prices on the international market, geopolitical tensions in the Middle East and North Africa boosted oil prices, which are higher than those forecast by the Bank's technical staff. Other commodities exported by Colombia, such as coal and coffee, have demonstrated relative stability in recent weeks. However, the outlook is less favorable for other commodities and minerals such as copper, silver and gold, and for some foods as well, which have seen recent price declines. Accordingly, thanks to oil price performance and lower prices for the food Colombia imports, no further reductions in the country's terms of trade are anticipated, contrary to what might be happening in other parts of the region.

With respect to the financial markets, the emerging economies continue to be affected by expectations of a gradual tapering off of the Fed's stimulus program. The prices for the financial assets of this group of countries continued on a downward trend in recent weeks, amidst an environment of capital outflows and depreciation in their exchange rates. Exchange rate depreciation has been greater in the emerging economies that have large current account deficits financed with short-term foreign borrowing and high inflation rates. As a result, several emerging countries have sold off international reserves in significant amounts.

2. DISCUSSION AND POLICY OPTIONS

The Board of Directors considered the following relative aspects.

(i) Second-quarter economic growth in the advanced economies was slightly better than anticipated. In contrast, growth in a good portion of the emerging market economies in Asia and Latin America has not lived up to expectations. Aggregate growth of Colombia's trading partners probably will be less than it was 2012. Something similar is expected for terms of trade, unless the recent upward trend in oil prices continues for an extended period of time.

(ii) Volatility in the global financial markets has increased and has affected some emerging economies in particular. The anticipation of less extensive monetary expansion in the United States sparked a considerable hike in interest rates on sovereign bonds, starting from very low levels. The currencies of emerging economies, including the Colombian peso, have devalued against the dollar. It is possible this trend will continue and contribute to a better performance by the tradable sectors of the economy and, therefore, to more balanced economic growth.

(iii) In Colombia, the new figures on foreign trade and internal demand point to added GDP growth during the second quarter of 2013 compared to the first. Household consumption and investment in civil works and buildings likely grew at a slightly higher rate. On the supply side, the increase in mining, agriculture and commerce would have accelerated, while industry would have contracted once again, although less so.

(iv) Accordingly, the Bank's technical staff kept its forecast for second-quarter growth within a range of 2.5% to 4.0%, with 3.4% being the most likely figure. For all of 2013, the range is still between 3.0% and 4.5%, with 4.0% being the most likely figure. Colombia's economic growth is expected to increase over the course of the year to the extent that aggregate expenditure reacts to the monetary policy measures adopted earlier and to the programs the national government has been implementing. However, the downside risks to these projections have increased as of late.

(v) The growth rates for bank lending have stabilized at levels above nominal GDP growth. In real terms, interest rates on the different types of loans are below their historical averages (except in the case of credit cards). However, the general financial conditions may have adjusted in response to the rise in the cost of external financing.

(vi) In July, the annual inflation rate (2.2%) was somewhat lower than the Bank's technical staff had estimated, and average core inflation remained relatively stable at 2.5%. The average of inflation expectations held by analysts and those calculated on the basis of government bonds is similar to the inflation target of 3%.

The majority of the Board members felt it was appropriate to keep the policy rate at 3.25%, especially in light of the following factors. (i) There is information suggesting a recovery in aggregate demand during the remainder of the year, largely because of the current expansionary stance of monetary policy and the programs being implemented by the national government. This is indicated by the performance of production variables, such as retail sales and cement shipments, the results of surveys of consumer and business expectations, and the key job market indicators. (ii) In the global economy, the signals are mixed. While the developed economies are showing signs of recovery, growth in some of the emerging market economies has been less than expected. (iii) Colombia's terms of trade remain high. (iv)The risk balance should consider the effect any additional monetary expansion would have on the economy's vulnerability to negative shocks, especially given the current context of a future return to normal for external financial conditions. (v) In the coming month, relevant information will be available on the growth of the Colombian economy during the second quarter and on monetary policy decisions in the United States.

Other members of the Board felt the policy interest rate should be reduced considering the following factors: (i) The downside risks to the forecasts for economic growth have increased. Aggregate growth for Colombia's trading partners probably will be less than in 2012 and something similar is expected for terms of trade. Moreover, the way domestic demand has performed recently does not point to closure of the output gap within the policy horizon. (ii) Inflation forecasts and expectations show no significant risks that inflation will exceed the target of 3%. Under these conditions, it is possible and desirable to pursue a more expansionary monetary policy, so as to reduce the expected output gap in a context where there are no inflationary risks.

3. POLICY DECISION

Having assessed the risk balance, the Board of Directors, by a majority vote, considered it appropriate to leave the benchmark rate at 3.25%.

The Board will continue its careful monitoring of performance and projections on economic activity and inflation in Colombia, asset markets and the international situation. Finally, it reiterated that monetary policy will depend on new information as it becomes available.