Detailed Explanation of the Macroeconomic Situation
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The Board of Directors of Banco de la República Raises the Benchmark Interest Rate by 25 Basis Points

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá D.C. on July 31, 2014. In attendance were Mr. Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit, Mr. José Darío Uribe Escobar, Governor and Managing Director of Banco de la República, and 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 how Banco de la República's technical team views the macroeconomic situation (Section 1), followed by a review of the key policy discussion points considered by the Board of Directors (Section 2).

A more detailed explanation of the macroeconomic situation prepared by Banco de la República's technical team can be found in the data section of the June 2014 edition of the Inflation Report and in the statistical appendix.

1. THE MACROECONOMIC CONTEXT

The technical team underscores the following aspects with respect to the macroeconomic context:

i. The average growth forecast for Colombia's major trading partners in all of 2014 was lowered in the June 2014 report, given the drop in output registered by the United States at the start of the year and the sharper than estimated slowdown in several countries in the region. Implicit in the new forecast is a more dynamic external demand during the second half of the year, since economic activity in the United States is expected to rebound.

ii. Long-term interest rates in the United States declined throughout the second quarter, but are still above the average observed in 2013. On average, the market expects the Federal Reserve (FED) to conclude its financial asset purchases in October 2014, and the first increase in its benchmark interest rate is anticipated for mid-2015.

iii. Certain risks associated with the momentum in the Chinese economy and other emerging countries persist in the global economy, as does the fear of deflation in the euro area. However, the latest figures on second-quarter growth in China and Spain were better than expected.

iv. Colombia's risk measurements so far this year exhibit a downward trend. At the end of July, they were at low levels and below the average witnessed in 2013. Terms of trade have been relatively stable, at levels somewhat inferior to last year's average. The second half of the year likely will see terms of trade that continue to be positive and help to keep national revenue at what can be considered historically high levels.

v. In April-May 2014, the dollar value of exports was less than it was a year earlier. The bulk of the decline was in mining exports, followed by industrial exports. Overseas sales of the country's major agricultural products are extremely dynamic, bolstered by exports of coffee and bananas. As such, during the year to April, the cumulative decline in the dollar value of total exports came to 4.6%.

vi. In contrast, the dollar value of imports rose in annual terms in April, pulled up by foreign purchases for end and intermediate consumption and, to a lesser extent, by imports of capital goods. During the course of this year through April, total imports increased at a rate of 4.5% compared to the same period the year before.

vii. Given these trends in foreign trade, the trade balance for all of 2014 probably will be negative, and the current account deficit is likely to be higher than in 2013.

viii. As for the domestic context, the recovery in consumer confidence, the rise in consumer lending, the healthy growth in retail sales and constant improvements in the job market suggest real household spending during the second quarter should continue to expand at a good rate, although less so than earlier this year. Investment also is expected to increase at a slower pace, nearer to its historic growth rate. The foregoing is judging by the behavior of expectations for business investment (EMEE) and imports of capital goods, mainly those for transport.

ix. On the supply side, the second quarter is expected to see a considerable rise in investment in civil works and in the construction of buildings and structures, although less so than in the first quarter. No growth in industry is anticipated, partly because of a temporary supply shock in the petroleum derivatives sector and fewer business days in April (due to Easter Week).

x. Bank deposits increased at less of an annual rate during the second quarter of 2014. The same period also saw lending institutions restructure the make-up of their assets in favor of the loan portfolio, mainly commercial lending. The sale of a portion of their investments (TES) to foreign agents was the main source of funding for credit growth. As a result, the bank loan portfolio in domestic currency accelerated and registers growth rates superior to the nominal increase in GDP estimated for this year.

xi. The increase in benchmark interest rates has passed through to interest rates on lending at a pace similar to that observed in the last ten years.

xii. In real terms, all interest rates on lending (except credit cards) are below the average calculated since 2000.

xiii. Given all of the above, the technical team is forecasting annual growth between 3.6% and 5.0% for the second quarter of 2014, with 4.3% being the most likely figure. This would represent a slowdown with respect to the first quarter, partly because of fewer business days. If this forecast proves to be accurate, the pace of economic growth in the first half of 2014 would be similar to the rate on record for the second half of 2013.

xiv. The technical team upwardly revised the range of its forecast for 2014 as a whole, placing it between 4.2% and 5.8%, with 5% being the most likely figure.

xv. Annual inflation in June was 2.79%, down from the rate in May and lower than the market's average forecast and that of the technical team. This pause in the build-up in inflation came after six months of continuous growth and is explained primarily by food and non-tradables excluding food and regulated items. The average of the various measurements of core inflation behaved similarly and was 2.76%.

xvi. Analysts' one-year-ahead inflation expectations remain near or slightly above the long-term target (3%), as do those resulting from government bonds at two, three and five years.

In summary, growth in aggregate demand in Colombia continues to be strong amid a context marked by nearly full use of productive capacity. The dynamic rate of growth in domestic spending is expected to persist, accompanied by a recovery in external demand. June saw a temporary pause in the build-up in inflation, but the short-term forecasts (STF) suggest it will be just over 3% by December. Inflation expectations are near or slightly above 3%. All of this is taking place in an environment where growth in lending has increased and real interest rates on loans are at levels conducive to spending.

2. DISCUSSION AND POLICY OPTIONS

As for inflation, the Board members underscored the fact that expectations are near the target and are expected to continue with the same momentum. Some additional supply shocks are anticipated with respect to inflation, particularly in food and regulated items. These might influence specific data in the overall figure for inflation, but are not expected to contaminate general expectations, given their nature and transience.

Most members of the Board believe the output gap has closed, due to the strong momentum in domestic demand and the growth in GDP. Moreover, not changing the interest rate could end up generating excess demand that would jeopardize the stability of growth and inflation. They also agreed there are risks of exogenous shocks to monetary policy associated with the behavior of external demand and the impact of fiscal policy on domestic demand, and emphasized that new information is particularly relevant to defining the need for subsequent movements in the rate.

Another Board member stated that, although he believes the output gap has yet to close, the convergence of total inflation and inflation expectations towards the target and GDP growth towards its potential rate are clear and precisely what has been sought since the onset of the policy normalization cycle in April. Therefore, he does not consider it advisable to halt adjustment in the interest rate until it reaches its normalization range, when this cycle of adjustments should culminate, with the current level being very close to that point.

One member of the Board believes that the economy is close to equilibrium and, given the risks of reduction in aggregate demand, raising the interest rate is not advisable. In fact, exogenous factors such as a decline in external confidence or a drop in commodity prices could slow the momentum exhibited by the economy during the first half of the year. Accordingly, a benchmark interest rate of 4% would be consistent with an economy growing at its potential rate, but with risks of a slowdown in the short term.

3. DECISION ON POLICY

The majority of the Board considered it appropriate to raise the benchmark interest rate by 25 bp, placing it at 4.25%.