Detailed Explanation of the Macroeconomic Situation
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Banco de la República keeps the Benchmark Interest Rate at 4.5 %

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá D.C. on September 26, 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 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 description of the macroeconomic situation, prepared by Banco de la República's technical team, is provided 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:

1. The new figures on global economic activity suggest Colombia's trading partners could average somewhat less growth in 2014 than was estimated for the central forecast in the last quarterly report (2.5%). This would be due to the loss of momentum in the euro area and a more pronounced slowdown in China and some countries in the region. In contrast, the United States economy has performed a bit better than estimated. Consequently, the recovery in the external demand for Colombian products is likely to be slower during the second half of the year than was predicted in previous reports.
2. The Federal Reserve (Fed) is expected to end its financial asset buying program in October 2014. The first benchmark interest rate hike by the Fed continues to be forecast for mid-2015, but with somewhat faster adjustments than those anticipated in recent months. Given this scenario, long-term interest rates on United States treasuries ceased to decline in recent weeks and were situated above the average observed in 2013.
3. A number of countries in the region have seen their risk premiums increase in the last few weeks; nevertheless, they are still low and below the average for 2013. International oil prices declined, as did prices for some of the commodities exported by Colombia. Preliminary estimates indicate the deterioration in terms of trade could be more than was estimated in the last quarterly report.
4. The value of exports in dollars recovered during July and exceeded the average for the first half of the year. The recovery was more pronounced in exports of mining and agricultural products. The value of total exports in dollars accumulated a reduction of 2.6% in the first seven months of the year (it was -4.5% in the first six months).
5. Imports in dollars accelerated. In July, they posted the highest monthly value on record. The largest annual increase was in imports of capital goods, mainly due to aircraft purchases. Imports of consumer and intermediate goods also registered considerable growth. Total imports rose 8.1% in the amount accumulated between January and July; this is two percentage points more than during the first half of the year.
6. The aforementioned trends in foreign trade increased the likelihood of a negative trade balance throughout 2014 and a larger current account deficit than in 2013. The supply shock caused by temporary closure of the Cartagena refinery explains part of the increase in this deficit.
7. In the domestic context, economic growth during the second quarter of 2014 (4.3%) was in line with the forecasts. Domestic demand and its main components (consumption and investment) lost some momentum, but continued to register higher increases than those in total GDP. Exports dropped and imports slowed. On the supply side, the most dynamic economic sector was civil works, followed by financial, real estate and business services, and social, community and personal services. In addition to mining, the other sector that declined was industry, partly because of temporary closure of the Cartagena

refinery.

8. For the third quarter, the new figures on economic activity suggest growth during this period could be somewhat higher than in the second quarter. This is apparent in the performance of retail sales, industrial production, building permits and cement production up to July, and in the figures for coffee and energy demand up to August. However, oil production continued to contract in July-August.
9. The increase in bank loans in domestic currency continued to trend downward in August and during the course of September to date. This slowdown is explained by the reduced momentum in commercial loans and, to a lesser extent, in home mortgages. Consumer loans continued to grow at a stable pace. The annual increase in all types of lending was higher than nominal GDP growth estimated for the current year.
10. The pass-through of benchmark interest rate hikes to interest rates on loans deteriorated in August. Some indicators suggest this is due to a larger supply of credit. In real terms, all interest rates on loans (except credit cards) are below the average calculated since 2000.
11. Given all of the above, the technical team continues to forecast growth between 4.2% and 5.8% in 2014, with 5% being the most likely rate. This last figure implies somewhat less of an increase in GDP during the second half of the year than in the first six months.
12. Annual inflation rose in August and was 3.02%, which is consistent with the technical team's estimate. Larger adjustments in prices for food, regulated items and non-tradables excluding food and regulated items explained this behavior. The average of the various measurements of core inflation began to converge towards the target, once again, and was 2.7%
13. Analysts' expectations for inflation one year ahead and the expectations derived from government bonds at two, three and five years, remain near or slightly above the long-term target (3%).

In short, aggregate demand continues to exhibit strong growth in a context of nearly full use of productive capacity. At the same time, inflation expectations remain at around 3%. This is occurring in an environment where terms of trade are deteriorating and there is added uncertainty about the recovery in global economic activity and the cost of external financing. These factors can influence aggregate demand, as well as the exchange rate.

2. DISCUSSION AND POLICY OPTIONS

The Board of Directors decided, by a majority vote, to keep the benchmark interest rate at 4.5%.

Some members of the Board agree with the main elements of the short- and medium-term diagnosis outlined in the document prepared by the technical team. The relevant considerations in the traditional horizon for inflation targeting (one to two years) include the existence of a slightly positive output gap, domestic demand that is growing at high rates and more than expected, inflation that will be slightly above 3% in the coming months, but inflation expectations that so far show signs of being anchored to the 3% target, and a policy interest rate that implies a slightly expansionary monetary stance. However, insofar as monetary policy acts with a lag, it is important to consider the risks that could affect confidence and the future performance of the real economy, particularly those inherent in the international environment and in fiscal policy. To that extent, they considered it prudent to leave the benchmark rate at 4.5% for now and emphasized the importance of further evaluating the performance of the economy at the next meeting in order to define the future of monetary policy.

Other members of the Board argued that the latest information on second-quarter GDP growth on the domestic-demand side indicates a slowdown, despite its continued momentum, mainly due to civil works. However, given the lag between movement in the policy interest rate and its full effect on demand, the greatest impact will not be felt before the second half of 2015 and first half of 2016. On the other hand, the boost from performance in the mining-energy sector has slowed, as has the downward trend in terms of trade. Added to this is the weakness in the external sector, particularly with respect to Colombia's neighbors in the region. Lastly, total inflation and inflation expectations are anchored to the target, which is the main objective of monetary policy, while the average of the core indicators, such as non-food inflation, is still below the midpoint of the target range. According, they believe the benchmark rate should be kept at 4.5%.

Another member of the Board felt that, given a positive output gap and inflation that continues to rise in terms of its expectations, it makes sense to raise the benchmark interest rate by 25 bps to 4.75%, considering the data on growth in domestic demand during the second quarter, the relevant job market figures, and the business and consumer confidence indicators.

3. POLICY DECISION

The Board of Directors decided, by a majority vote, to keep the benchmark interest rate at 4.5%.

Bogotá, D. C.