
[Detailed Explanation of the Macroeconomic Situation \(only in Spanish\)](#)

Must reads

[Banco de la Republica leaves the benchmark interest rate unaltered](#)

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá D.C. on June 28, 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 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 prepared by the Bank's technical staff on inflation and the economic situation with respect to growth and prospects for the future (Section 1) and a review of the policy discussions and options considered by the Board of Directors (Section 2).

1. SITUATION WITH RESPECT TO INFLATION AND ECONOMIC GROWTH

Background Information

a. Recent Developments in Inflation

Annual consumer inflation was 2.00% in May, remaining just about stable compared to the rate in April (2.02%). Price hikes for several regulated items were offset by lower prices for processed foods and reductions in the non-tradable CPI excluding food and regulated items.

Within the non-food CPI, one of the most notable aspects in May was the increase in the annual change in regulated prices (1.25% as opposed to 0.9% in April). This surge centered on electricity rates in several cities, including Bogotá. May also saw public transportation fares rise in other cities, such as Medellín. On the other hand, the annual change in fuel prices remained in negative terrain (-3.5%).

There was a moderate increase in the annual variation in the tradable CPI excluding food and regulated items (1.06% versus 0.98% in April). Peso depreciation so far this year (approximately 9% between December 31 and June 24) has yet to pass through to this sub-basket.

As for non-tradables excluding food and regulated items, the outcome in May (3.7%) reflects a drop of 9 basis points (bp) from the previous month. Most prominent was the reduction to 3.7% in the annual variation in rental fees (as opposed to 3.8% in April). This indicator has been declining very slowly, although with a few interruptions, since October of last year.

The annual change in the food CPI by May (1.3%) was down 28 bp following consecutive hikes during the two preceding months. This decline was mainly the result of reductions in processed food prices (from 0.91% to -0.14%). In contrast, prices for perishables rose for the second month in a row (from 0.4% to 2.6%). The variation in prices for meals outside the home showed no change and remained at 3.3%.

In May, the average of the four core inflation indicators tracked by Banco de la República fell slightly, reaching 2.44%, which is 4 bp less than the April figure. The four indicators have stayed between 2% and 3% since January of this year.

The IPP maintained a negative annual variation in May (-2.1%), but did increase compared to the month before (-2.4%). The change in prices for goods consumed and produced in Colombia, as well as for imported goods stayed in negative terrain.

Inflation expectations rose slightly in May, but remained at levels consistent with meeting the target. The monthly survey conducted by Banco de la República indicates inflation is expected to be 2.6% by December of this year (7 bp higher than the expectation a month ago) and 3.1% at twelve months (an increase of 8 bp compared to April). On the other hand, the expectations derived from TES horizons of two, three and five years stayed between 2.5% and 3.0%.

b. Growth

GDP was up by 2.8% during the first three months of the year, in line with the midpoint of the forecast range presented in the previous quarterly inflation report. This result is related, in part, to the presence of fewer calendar and working days compared to the same period last year, but also to the various supply shocks witnessed in the mining sector.

Most of the components of domestic demand slowed. The categories of investment in machinery and equipment and consumer durables contributed the most in that respect. In contrast, investment in building construction and civil works increased significantly (17.5% and 14.4%, respectively) partially offsetting the weakness in the other components.

Both exports and imports declined compared to the same period in 2012. In the first case, the annual variation was -1.2%. A number of supply shocks to mining production seriously affected sales abroad, especially of coal. In the case of imports, the slowdown in annual growth to -0.2% was mainly in foreign purchases of capital goods.

On the supply side, construction and social, personal and community services were the sectors reporting

the most annual growth: 16.9% and 4.5%, respectively. Mining growth remained low: 1.4%, due to the supply shocks affecting coal production, which declined 21% annually and offset the momentum in oil, which was up by 7.8%. The only major branch to post an annual contraction was industry (-4.1%).

With respect to the second quarter of 2013, the available indicators with information at April show a generalized rebound in growth rates. Therefore, the momentum in private consumption is expected to be better in the second quarter than in the first. This follows the performance of retail sales. According to the Monthly Retail Trade Survey (MMCM, Spanish acronym) published by DANE, retail trade accelerated in April compared to the March figures and to the average for the first three months. In fact, retail sales rose at an annual rate of 5.7% (versus 0.8% and 0.9% in March and first quarter, respectively). For March and April, the growth in retail sales was 3.1%, which is better than what was observed in January and February of this year and similar to the rate in the fourth quarter of last year. In results of Banco de la República's Monthly Survey of Economic Expectations (EMEE, Spanish acronym) lean in the same direction, with the data up to April showing sales expectations are higher, on average, than they were during the first quarter. On the other hand, according Econometrics, automobile sales in April were up by 3.3% and fell 10.4% in May. This latest drop is less pronounced than the decline witnessed in the first quarter. Finally, the consumer confidence index (CCI) published by FEDESARROLLO shows higher levels in April and May than those observed in the first three months of 2013, and is above the historical average for the series (since 2001).

As for the indicators associated with supply, the signals were mixed. The industrial production index rose 8.4% in April. However, the trend component of the series continued to decline slowly. Consequently, the months of March and April continued to see a drop of 1.6% annually and 2.7% for the year to date. Although the indicators of orders and inventories from the FEDESARROLLO industrial survey showed a slight rebound in April, they continued to exhibit a downward trend. Something similar occurred with the balance of expectations for production three months out, which suggests industry would remain weak going forward.

In relation to construction, with the data at April, building licenses were up by 36.4% (divided between 39.1% for housing and 27.7% for other types of construction), while cement production and shipment rose 4.2% and 16.4%, respectively. These last two items had not seen positive growth since November of last year.

Coal exports in April posted a rise of 27.9% in volume and 11.2% in value (USD).

The limited amount of data available at May show performance was less favorable than in April, but better than in February and March. Oil production increased 8.3% annually and remained above one million barrels per day, while coffee production registered 36% annual growth, following 67% in April. The demand for energy rose 2.6% annually.

In general, growth of the Colombian economy 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. The Bank's technical staff continues to forecast GDP growth for 2013 at 3.0% to 5.0%, with 4.3% being the most likely figure.

c. Financial Variables

In May, bank lending (D/C and F/C) maintained the annual growth rate witnessed the month before (14.0%). The build-up in the annual variation in the loan portfolio in domestic currency, which increased from 12.58% in April to 12.68% in May, was off-set by the slowdown in the foreign currency portfolio, which went from 36.26% to 34.67% growth during the same period.

As for the different types of loans, performance was mixed. The annual increase in consumer lending went from 15.65% to 14.47% between April and May, while the annual variation in the mortgage portfolio increased from 13.68% to 13.82 % during the same period. The latter is associated with use of the home purchase subsidy decreed by the government as of April. Contrary to what was observed since the fourth quarter last year, the domestic component of commercial loans experienced an increase in annual growth during this period, (from 10.97% to 11.16%); this meant a slight recovery in the total from 13.46% to 13.51%.

The nominal interest rates applied by lending institutions to all types of loans continued the downward trend that began with the policy rate cuts initiated in July 2012. The highlights in terms of the response by May include the prime lending rate (-238 bp), the mortgage rate (-203 bp) (partly due to government backing for home purchases), the ordinary commercial rate (-201 bp) and the rate for home construction (-190 bp), following by reductions in the consumer loan rate (-177 bp), microcredit (-174 bp) and the rate on credit card lending (-134 bp).

Interest rates also declined in real terms, but to a lesser extent, due to the effect of the slump in inflation. The decline, since July 2012, amounts to -185 bp on preferential loans, -150 on mortgage loans, -148 bp on ordinary commercial loans, -138 bp on loans for construction, -122 bp on consumer loans, and -112 bp on microcredit.

In May, the real interest rate was 15.3% for consumer loans, 8.5% on mortgages, 4.5% for preferential lending and 7.8% on ordinary commercial loans. These levels are below the respective historic averages calculated since 2000. In contrast, the real rate on credit card lending, at 26.1%, was above average. The treasury rate, at 5.0%, equals its average.

d. The External Context

The global economy continues to send mixed signals. Although the European contraction persists, prospects in the United States and Japan are more favorable. A good many of the emerging economies in Asia and Latin America are experiencing robust growth, but less than was forecast in previous reports.

In the United States, the momentum in the private sector offset the contractionary effects of the fiscal adjustment and allowed the economy to grow by about 2%. With the figures at May, the indicators of consumption in that country, including household confidence, continued to support a gradual recovery. Meanwhile, industry showed some weakening during that month, although the figures advanced to June suggest it would not persist. In contrast, the recovery in the housing and job markets continues.

In the euro zone, productive activity continued to deteriorate, although at a slower pace. In this sense, the confidence indicators on the part of both businessmen and consumers have rebounded a bit in recent months, but are still at a very low level. On the less positive side, retail sales continue to deteriorate, as do the job markets, especially those in the peripheral economies. In Germany, productive activity seems to be gaining momentum; the indicators of confidence and manufacturing activity have

been rising for several months. This situation would contribute to the recovery of the region.

The pace of growth in the emerging economies will be slower than during the 2011-2012 period.

As for international prices, oil prices have been relatively stable in recent weeks. In the case of other goods exported by Colombia, such as coal, coffee and ferronickel, prices are still below the average levels witnessed in 2012. In terms of prices for imported commodities, international food prices also are at levels below those of the previous year. This suggests the level of terms of trade will be favorable this year, but below the average observed in 2012. In a context of modest pressure on global inflation and weak growth, monetary policy in most of the developed and emerging economies remains expansionary.

Recently, the Federal Reserve's announcement of a possible tapering off of asset purchases, due to improved economic performance, heightened the volatility on international financial markets. The long-term rates on bonds of the advanced and emerging economies have risen, starting from a low level. Stock prices have fallen and the dollar has gained strength. The reaction of the markets has been more pronounced in the emerging countries, which have seen a rise in the risk premium.

If there is less monetary stimulus in a context of gradual recovery in the United States, as the Fed announced, the impact on emerging economies, and especially on Latin America, could be low. Added momentum in the U.S. economy would imply more external demand, as well as favorable international prices. If this scenario were to materialize, the fundamentals of the economies in the region should not change substantially, terms of trade would remain at relatively high levels, and flows of foreign direct investment would continue. Therefore, a reduction in portfolio investments is likely, given expectations of less growth in global liquidity. This does not necessarily imply a substantial decline in domestic and external financing in the region.

2. DISCUSSION AND POLICY OPTIONS

The Board of Directors took the following relevant aspects into consideration.

- (i) The global economy continues to show mixed signals. While the European contraction is likely to persist longer than was expected previously, the outlook in the United States and Japan is more favorable. The growth of many of the emerging economies in Asia and Latin America is robust, but less than was forecast several months ago.
- (ii) The Federal Reserve's announcement of a possible tapering off of asset purchases heightened the volatility on international financial markets. The long-term rates on bonds of the advanced and emerging economies have risen, starting from a low level. Stock prices have fallen and the dollar has gained strength. The reaction of the markets has been more pronounced in the emerging economies.
- (iii) The behavior of prices for Colombia's leading export commodities suggests the level of terms of trade will be favorable this year, but below the average observed in 2012.
- (iv) In the domestic context, GDP growth during the first quarter of 2013 (2.8%) matched the technical staff's estimate. Domestic demand slowed, due to less growth in consumption, which was partly offset by stronger momentum in investment in building construction and civil works. For the second quarter,

the figures on industry and commerce, consumer confidence, as well as oil and coffee production suggest more growth than in the first three months of the year.

(v) As for loans and the cost of financing, the volatility on international markets was reflected in a rise in interest rates on government borrowing and private bonds. The increase in bank loans in domestic and foreign currency is showing signs of stabilizing at a higher rate than nominal GDP growth. Interest rates on loans continue to decline and, in real terms, are below their historic averages (except in the case of credit card lending).

(vi) In general, growth of the Colombian economy 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. The Bank's technical staff continues to forecast GDP growth for 2013 at 3.0% to 5.0%, with 4.3% being the most likely figure.

(vii) Annual inflation in May (2%) was similar to what it was in April. Average core inflation declined and was 2.4%. Analysts' average inflation expectations and those resulting from government bonds are similar to the inflation target (3%).

In short, growth of the Colombian economy in the first quarter was low and equal to the forecast. The monetary and fiscal policy measures adopted so far are expected to help place output near its potential level during the course of the year. Similarly, inflation very likely will end up within the target range.

3. POLICY DECISION

Pursuant to its assessment of the current risk balance, the Board of Directors unanimously agreed to keep the benchmark interest rate at 3.25%.

The Board will continue its careful monitoring of performance and projections with respect to 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.

Bogotá, D. C.