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[The Banco de la Republica Keeps 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 January 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 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

In December, annual consumer inflation (1.94%) registered a surge of 18 basis points (bp) compared to what was registered in November. This rise was concentrated in the regulated and food indices. Based on this, consumer inflation in 2013 was 50 bp less than it had been in 2012.

In the basket for food, the annual variation was 0.86% at the end of the month or 24 bp higher than in November. In terms of annual changes, the surge was concentrated in staples (from -2.09% to -0.16%). Likewise, there was a moderate surge in meals away from home (from 3.08% to 3.26%) in December while in processed foods there was a slight slowdown with respect to the previous month (from -0.10% to -0.24%).

The annual change in the CPI excluding food was at 2.36% in December, 15 bp more than it had been the previous month. The 60 bp rise in the annual variation of the CPI for regulated items (1.05% annually) which is mainly attributable to public utilities (electricity fees) is noteworthy. The changes that occurred in the annual variation were lower for the other items in the sub-basket. Fuel ended the year in negative territory (-3.2%).

The other CPI sub-baskets excluding food, tradables and non-tradables did not show significant changes. In the first case, the annual variation for December stayed at the same level as the previous month (1.4%). The prices for this basket have been rising from very low levels over the course of the year in the wake of the depreciation in the exchange rate. Furthermore, the non-tradables showed an annual change of 3.76%, which is 3 bp above the prior figure. The change in the prices for this basket has remained stable over the last few months which suggests that the pressures from demand continue to be moderate.

The average of the four indicators of core inflation monitored by the Banco de la Republica was 2.51% in December, 5 bp higher than the previous month. This measurement has shown few changes since the decline at the beginning of the year and has fluctuated around 2.5%.

The annual change in the PPI went from -1.3 % in November to -0.5% in December. Both the local and imported components rose with respect to last month. (In the first case, the rise was 90 bp while in the second, it was 55 bp.)

Inflation expectations for different horizons did not show significant changes during the last month. According to the Banco de la Republica's monthly survey of financial market analysts, the inflation expected for 12 months from now is 2.85%. This is only 4 bp lower than the result last month. In the same survey, the inflation expected for December 2014 is 2.80%. The Bank's quarterly survey of businessmen, in turn, shows that their inflation expectations for 12 months from now are 2.7%, which is a little less than the result from October (2.9%). Finally, inflation expectations derived from the TES curve for 2-, 3-, and 5-year maturities have risen slightly since January to converge at 3.0%.

b. Growth

The indicators available for the last quarter of 2013 suggest that the GDP expanded at a rate that was below the rate registered for the third quarter. Nonetheless, this is expected to be above the average for the first half of the year.

Private consumption is expected to have grown at a rate similar to that for the previous quarter. This conclusion is the result of the performance of retail sales from the Monthly Retail Sample (MMCM in Spanish), which shows that they grew 5.3% annually in November (5.9% for the October-November two-month period). This figure is higher than what was registered for the third quarter (4.9%). When the segment of vehicle and car sales is discounted, the retail sales grew 8.7% (6.7% in the two-month period). This indicates a surge with respect to what was registered for the third quarter (4.0%). In line with the abovementioned, the balance of sales in the Banco de la Republica's Monthly Survey of Economic Expectations (EMEE in Spanish) shows that the merchants saw a slightly better demand in October and November than was seen in the third quarter. The consumer confidence index for December, in turn, did not show significant changes with respect to the levels in November and October. Likewise, the positive performance in the labor market as well as the stability in the growth rate of the household portfolio indicate that household consumption is maintaining the strength seen in the third quarter.

Regarding investment, according to the balance of investment expectations in the Banco de la Republica's Monthly Survey of Economic Expectations (EMEE in Spanish) gross capital formation excluding investment in public works and construction would have grown at rates that were significant and higher in the fourth quarter than those seen in the third quarter. In real terms, the figures on imports of capital goods for industry confirm this. Investment in transportation equipment would have continued falling in annual terms although at a lower rate. It can be assumed that investment in public works will remain at the high levels seen in the third quarter. The same can be expected for investment in construction.

In the area of foreign trade, the annual change in total exports was 2.6% in November. This growth is the result of higher exports of mining (5.5%) and agricultural (1%) products. The rise in mining exports is due to the increase in foreign sales of crude oil (15.9%) and derivatives (15.2%). For agricultural products, growth was registered only for coffee (21.1%). Exports of industrial goods and others declined 6.1% to a large degree because of the drops in the areas of the remaining industrial goods (-27.9%), the remaining agricultural products (-56%), and vehicles (-19.6%).

Total imports, in turn, registered a decline of 1.8% in November in comparison to the same month the year before. This performance is due to the decline in imports of capital goods (-6.8%) and consumer goods (-3%) and is partly offset by the rise in imports of raw materials (3.3%).

With respect to supply, the indicators available for industry show that the stagnation of the sector has not been overcome yet. The annual change in the IPI excluding coffee threshing was -0.6% for November. The trend leveled out again. Moreover, according to Fedesarrollo, industrial confidence declined in November. The purchase indicator registered a drop while the inventory indicator (counter-cyclical to production) did not report changes. However, in this case, the trend continues to show a favorable performance for the two variables. The expectations with respect to production in three months, in turn, declined significantly. In contrast, the demand for non-regulated industrial electricity, which has a high correlation with the IPI, grew at an annual rate of 6.4% in December.

In the case of commerce, businessmen pointed to some improvements in their perception of both their current and future business situation in the Fedesarrollo survey for November.

Some of the figures associated with mining, specifically with petroleum, continued to show growth in the fourth quarter of 2013 although at a lower rate in comparison to the third. According to the National Hydrocarbon Agency (ANH in Spanish) petroleum production in December was at one million fourteen thousand barrels daily. During the fourth quarter, a million four thousand barrels were pumped daily on average. Based on this, there was a drop (from 8.8% in the third quarter to 3.3%).

All of the above makes it possible to fix the forecast range for the annual growth of the GDP in the fourth quarter at 4.0% to 5.0% with 4.5% as the most probable rate. Thus, the forecast range for the growth of the economy in 2013 would be between 3.7% and 4.3%. Note that the performance of investment in public works, construction, and public consumption is a source of great uncertainty for these projections. The situation for 2014 is still uncertain but the GDP is expected to expand at rates similar to those registered for all of 2013. Among the factors that would maintain the strength of the growth in Colombia are: i) a more dynamic foreign demand and stronger trading partners, ii) a flow of FDI that continues to be favorable, iii) a monetary policy that continues to have an expansionary effect on productive activity, iv) low inflation that would favor the purchasing power of household income and, v) a labor market that continues to show significant strength. Favorable levels in the terms of trade are also expected although lower than the ones seen in 2013. With respect to investment in public works and building construction, less expansion than what occurred last year is expected but it should still be significant.

The above makes it possible to fix forecast range for the expansion of the GDP in 2014 at 3.3% to 5.3% with the most probable figure being 4.3%.

c. Financial Variables

Bank loans (N/C and F/C) registered an annual growth rate of 12.19% in December, a level which is lower than the one seen the previous month (13.30%). The loan portfolio in national currency dropped from 13.48% in November to 12.91% in December and the one in foreign currency also went from 11.10% to 1.65%.

Broken down by market, the portfolio of loans granted to households registered an annual growth of 13.16% in December, which is slightly lower than the growth in the previous month (13.51%). This was due to the performance of consumer loans which declined between November and December going from 12.45% to 11.95%. Loans for the purchase of housing, in turn, climbed slightly as they went from growing at an annual rate of 14.80% to one of 15.37% during the same period. Regarding the commercial portfolio, the annual growth rate in December (11.55%) was lower than it was the month before (13.32%) due to the moderation in the national currency component (from 13.65% in November to 12.76% in December) and the slowdown in the foreign currency component (from 10.16% to 1.30%). The interest rates for loans disbursed by credit institutions since the beginning of the cuts in the policy interest rate in July 2012 have accumulated reductions of: -226 bp for mortgages, -203 bp for consumer loans, and -215 bp for building loans.

The size of the decline in the real interest rates has been lower due to the effect of the lower rate of inflation. There have been reductions during this same period of: -181 bp for mortgages, -156 bp for consumer loans, and -170 bp for construction loans.

The levels of the real interest rates for consumer loans, mortgages, preferential loans, ordinary commercial ones and commercial lines of credit, and loans for construction in September were below their historical averages as calculated since 2000. In contrast, the credit card loans are above their average.

d. Foreign Context

In the fourth quarter of 2013, global economic activity continued its recovery due to the greater strength of the developed economies with the United States leading it. The growth of the large emerging economies in Asia and Latin America was varied with rates that were close to or lower than their potential. During the same period the indices for manufacturing and trade on the global level showed a favorable performance.

In the United States, consumer confidence has recovered after the drops produced by the fiscal uncertainty from previous months. Likewise, based on information as of December, the indicators for industry and retail sales showed favorable performance. With respect to the labor market, the unemployment rate continued to fall, but the rate of job creation has slowed down. This leads us to assume that the rate of participation has also declined. The indicators for the housing market showed evidence of better performance in the last few months since the slowdown seen in the third quarter. Regarding fiscal policy, important agreements were reached on the fiscal front in the last two months that reduced the uncertainty in the medium term as well as part of the impact of the contraction caused by the adjustment in public finances. In the next few weeks, the government's debt limit should be discussed in Congress again. However, the negotiation is expected to be carried out this time with fewer stumbling blocks than were seen in previous episodes and, therefore, it should not affect confidence significantly.

In the euro zone, in turn, the figures on productive activity for the fourth quarter show that the recovery would have been maintained in the last few weeks of the year. Thus, the retail sales and industry rallied slightly in the last few months. Likewise, the indices of business opinion in the manufacturing and service sectors remained in positive territory while business and consumer confidence showed favorable signs. In spite of the encouraging signs in the European economy, it is important to note that the region is still vulnerable to the degree that the unemployment rate stays at historical maximums (especially in the economies on the periphery), the financial markets are still fragmented, and credit continues to shrink (although at a lower rate).

With respect to emerging economies, growth in China surged in the second half of the year because of the higher investment. This economy had a growth rate of 7.7% in 2013 (the same as the rate in 2012). In the case of Latin American countries, the figures for the fourth quarter show evidence of productive activity weakening in Brazil and Chile while Peru maintained its rate of growth. In the case of Mexico, there was a little recovery.

In regards to the international prices for commodities exported by Colombia, the international prices for petroleum, coal, and nickel remained relatively stable in the fourth quarter while the prices for coffee continued to show a declining trend. The prices for food did not present significant changes in the last few months of the year and stayed at levels that were lower than those seen in 2012. In this context, the country's terms of trade remained below the levels that were reached in 2011 and 2012.

With respect to inflation, the change in the general level of prices in the main developed economies was below the long term targets fixed by their central banks. In the specific case of the euro zone, total and core inflation have been declining for several quarters and, in December, they were below 1%. In contrast, prices continued to rise in Japan. In the emerging economies, the inflationary panorama remains unequal. Thus, while in countries such as Chile, Colombia, and Peru inflation was relatively low, other economies such as Brazil, India, and Indonesia continued to undergo upward pressure.

In the fourth quarter of the year, the perception of risk in Latin American economies remained relatively stable although it was at a higher level than was seen in the first half of the year. One exception was Brazil where the economic weakness and the fall in confidence affected the growth expectations for the next few quarters. As a result, there was a larger rise in the risk premiums.

Nevertheless, last week there was a marked depreciation of the currencies in the emerging economies with respect to the dollar and devaluations in their stock markets and public debt. The continuation of the tapering off of the monetary stimulus on the part of the FED at a time when the outlook for growth is evidently lower in some economies seems to be the cause for the rise in the risk perception. The pressures have been greater in those countries with weaker growth fundamentals: high inflation, large deficits in the current account, decreasing international reserves, and a high dependence on short term capital flows. In this context, some central banks such as those in Brazil, Turkey, India, and South Africa raised their interest rates in order to alleviate exchange rate pressures.

2. DISCUSSION AND POLICY OPTIONS

The board of directors took the following relevant aspects into consideration:

(i) In the fourth quarter of 2013, worldwide economic activity continued to recover due to the greater strength of the developed economies, especially the United States. In the euro zone, the economic indicators suggest a low but positive quarterly growth. The growth of the large emerging economies in Asia and Latin America was diverse with rates that were close to or lower than their potential. For 2014, the estimates suggest that the global recovery will continue and that the country's trading partners will have an average growth that is above what was registered in 2013.

(ii) The US Federal Reserve announced that they will again reduce the amount of financial assets purchased in February and ratified their commitment to maintain the current interest rate level for a prolonged period. Thus, to the degree that the levels of liquidity remain less expansionary, the cost of international financing could rise.

(iii) The improvement in the outlook for the US economy and its implications for the monetary policy in that country are affecting the bond, stock, and monetary markets. The Colombian peso has devalued with respect to the dollar. The international price for petroleum remains at high levels, in turn, and the prices for coal, nickel, and coffee stopped falling. Based on this, it is probable that the terms of trade will stay at favorable levels.

(iv) The technical team has projected an economic growth of 4% to 5% for the fourth quarter of 2013 with 4.5% being the most probable figure. Household consumption will have grown at rates that are similar to its historical average. Investment will have shown the greatest rise. Exports will have surged but less than imports. Respecting supply, most of the growth will have been in construction (buildings and public works) and agriculture. The mining sector will have slowed down and industrial growth (including coffee threshing) will have been almost zero. Based on this information, the Colombian economy is calculated to have grown between 3.7% and 4.3% in 2013.

(v) An economic growth that is between 3.3% and 5.3% is predicted for 2014 with 4.3% as the most probable figure.

(vi) In December, overall growth of loans slowed down although it remains higher than the rise in the nominal GDP. The nominal interest rates for loans declined and the ones for consumer loans and mortgages remained relatively stable. In real terms, they are staying below their historical averages (except for credit card rates) and are driving economic growth.

(vii) Annual inflation in December was 1.94%, a figure that is similar to what was projected and below the lower limit of the target range established for 2013 (3% +/- 1 pp.). The average for core inflation measurements was at 2.5% and the inflation expectations of economic analysts for a year from now as well as those derived from public debt paper with maturities of less than five years are close to 3%.

The members of the Board of Directors thought that there were clear indications that the output gap and the current variance of inflation with respect to the target (inflation gap) will close over the course of 2014. Regarding the magnitude, the velocity at which these gaps will close, and their relationship with the current inflation gap, differences between the members of the Board persist.

Likewise, the existing uncertainty about the effect that the normalization of monetary policy in the United States could have on the Colombian economy directly or through its impact on other emerging economies was emphasized.

Finally, the Board stressed that the monetary policy framework which consists of inflation targeting and a floating exchange rate to confront external shocks has functioned well. Thus, the gap between observed inflation and the Bank's target, the weak pass through of nominal depreciation to the level of consumer prices, and a low level of unhedged foreign exchange positions in the economy make it possible for the exchange rate to absorb the effects of the international situation without generating trauma in the Colombian economy and without putting compliance with the inflation target at risk.

3. POLICY DECISION

The Board of Directors agreed unanimously that it would be appropriate to keep the benchmark interest rate at 3.25%.

The Board will continue to monitor the performance and projections for economic activity and inflation in the country, the asset markets, and international situation carefully. Finally, they reiterate that the monetary policy will depend on the information available.