Monetary Policy Report

A regular meeting of the Board of Directors of Banco of the República took place in the city of Bogotá D.C. on Friday, April 24, 2015. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit, José Darío Uribe Escobar, Governor of the Central Bank, 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 the outlook of the technical staff of the Central Bank on the macroeconomic situation (section 1), followed by a review of the main discussion regarding monetary policy by the Board of Directors (section 2).

A more detailed description of the macroeconomic situation prepared by the technical staff from the Central Bank will be presented in the Inflation Report for the first quarter of 2015 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. In the present report, the estimated growth average of Colombia's trade partners for 2015 decreased. The economic recovery of the United States would be slower than estimated, while the product of the euro zone would expand at a lower rate. China would continue slowing down and the countries of the region would record weak or negative growth rates. If these forecasts take place, in 2015 external demand for Colombia would grow at a lower rate, somewhat below the one for 2014.

2. The lower international prices of oil and other commodities have pressured world inflation downward. This has contributed to the fact that in some developed countries consumer prices have not increased or register deflation.

3. The European Central Bank continued providing monetary stimuli, while the Federal Reserve suggested in its last meeting that the possible increase of its interest rate would be more gradual than it was announced by the end of 2014. In this context, the long-term interest rates in said countries have lowered and continue at low levels.

4. Appreciation of the US dollar vis-à-vis the majority of currencies has partially reversed. In the region, the risk premia lowered, having registered increases at the beginning of the year.

5. In the first quarter of 2015, the average oil price was somewhat below the levels registered by the end of 2014. In the same period, other commodities exported and imported by Colombia descended. Should all these prices continue, in 2015 the terms of trade would record low levels similar to those registered at the beginning of 2009. This fall in the terms of trade would generate a significant loss in the dynamics of national income.

6. The previous behavior of external demand and of the prices of commodities has been reflected in the results of foreign trade. In the first two months of the year, exports in US dollars descended 34%, a fall explained mainly by those of mining origin (-47%), especially due to the lower price of oil. In the same period, external sales of the main agricultural products increased 22.5%, while those of the remaining sectors descended 11%.

7. So far this year, total imports accumulate a fall of 3.8%, due to the lower external purchases of intermediate goods (-18.4%). Imports of capital goods increased by 13.9%, and those of consumption increased by 1.3%. The increase in capital goods is explained by the 63.9% increases in transportation equipment and 4.1% in building materials. Within consumer goods, a fall of 3.2% in durable goods and an increase of 6.2% in non durables were registered.

8. With this information, the technical staff increased the forecast of the deficit of the current account as a percentage of the GDP for 2015, from a range within 3.3% to 5.5%, to one within 4.2% and 6.1%. The new most probable outcome for 2015 (5.3%) would be similar to the deficit observed in 2014 (5.2%). Nearly 0.9 percentage points of the estimation for 2015 would be explained by the lower GDP in US dollars, due to the greater level of the exchange rate. In US dollars, the deficit in the current account would be reduced because this assumes that the lower level of factor revenue and the reduction of the deficit of the service balance would partially offset the expansion of the trade deficit. As for financing, forecasts consider a reduction in foreign direct investment, especially in the mining and energy sector, and lower portfolio inflows. This comes from a lower base of comparison for 2014, when significant inflows of this nature took place as a result of an increased weighing of Colombian public bonds in some reference indexes of emerging markets.

9. As for the domestic context, the new information for the first quarter of 2015 indicates that the economic activity would be less dynamic than the one registered in the last quarter of 2014. The information of retail trade, consumer confidence, and the survey of economic expectations, indicate a slowdown of consumption and private investment. On the side of offer, the fall of industrial production and cattle slaughter, smaller growth of non-regulated energy demand, and the downturn in the present and future perception of trade indicate that economic growth will continue slowing down. As for other activities such as oil, coffee and cement, other data suggest good behaviors.

10. Regarding the labor market, the figures to February 2015 show that the seasonally adjusted unemployment rate continues at historically low levels, with a dynamic occupation rate which is explained mainly by salaried employment.

11. In the first quarter of 2015, total corporate and household debt grew at a rate similar to the one registered in December 2014, rates that surpass the increase of the nominal GDP estimated for the present year. Corporate debt in foreign currency (direct and banking) slowed down again, a fact that has been compensated by a better pace of increase of commercial credit in pesos and in bonds. Household debt portfolio slowed down slightly, mainly due to the lower dynamics of the mortgage loan. This took

place together with increasing credit interest rates, although in real terms they continue at levels below their historic averages (excepting credit cards).

12. With all this, the technical staff considers that growth during the first quarter would register between 2.0% and 3.5%, with 2.7% as the most probable outcome. For all of 2015, the most probable growth figure was revised downward, from 3.6% to 3.2%, within a range of 2.0% and 4.0%. The amplitude of the interval reflects uncertainty over assumptions in possible extreme scenarios. In turn, the most probable value considers a lower dynamics in national income and a reduction of external financing, which could moderate expenditure, especially through a lower level of private investment.

13. Regarding prices, inflation in March increased, reaching 4.56%, a number somewhat higher than the forecast by the market average and the technical staff at the Central Bank. Acceleration of inflation was explained mainly by the greater pace of increase in the prices of food and those of tradables excepting food and regulated goods. The average of core inflation completed one semester increasing, reaching 3.65%.

14. Inflation expectations by market analysts and those derived from public debt bonds to 2, 3, and 5 years are within a range of 3.1% and 3.6%.

In all, the slowdown that started by the end of 2014 from an output level that was close to the full use of productive capacity is expected to continue in 2015. Inflation increased mainly due to transitory factors, and its expectations are above 3.0%. Given that part of the reduction of national income is structural, domestic expenditure of the economy must adjust.

2. DISCUSSION AND POLICY OPTIONS

The members of the Board agree in that 2015 will bring a slowdown in product growth, but they differ in the magnitude of the slowdown. While some Board members expect a GDP growth close to 3.0%, others believe that it could be closer to 3.5%, or even higher.

They emphasized that the lower growth of domestic expense, complemented by import substitution, and, with a longer lag, by greater exports as a result of the real depreciation of the peso, are part of a necessary adjustment of the Colombian economy to the new external conditions. In time, this adjustment will bring a lower external imbalance and, consequently, will contribute to preserve the necessary conditions for sustained economic growth.

The members of the Board agreed that total consumer inflation has exhibited upward pressures caused by temporary increases in the prices of food, and, to a lesser extent, by the pass-through of depreciation to the prices of tradable goods of the CPI basket. It is expected that the pressure begins to yield in the second semester, and for inflation to converge to the target (3.0%) within the policy horizon. The importance that medium-term inflation expectations continue to be anchored to the target, as has been the case up to now, is emphasized.

For some Board members, growth in 2015 would reach levels close to 3.0% due to a slowdown of domestic demand and to a slight recovery in exports other than oil. Previous projections included growth in these exports, which has not yet materialized; it is more likely to expect an increase in this item consistent with a total GDP growth of 3.0%. Considering the magnitude of the external shock, a 3.0% GDP growth would represent a positive result for the economy, as long as it comes with a reduction of external vulnerabilities.

Other Board members consider that GDP growth in 2015 will be closer to 3.5%, or even above. The increase of external demand that will take place mainly with the recovery of the US and Europe, the positive effects of depreciation on the agricultural and industrial sectors, the contribution of consumption and public investment (already financed by the government), and the dynamics shown by employment and credit, among others, allow to foresee that the slowdown and necessary adjustment of the economy, associated to the fall in the terms of trade, will take place in an orderly way, thus allowing the country to reach a remarkable growth rate within the Latin-American context.

One Board member reiterated a growth forecast of 3.0% of the GDP for 2015, with a downward bias. This member stated that the main source for the inflation increase, which has led the policy interest rate to a negative territory in real terms, has been that of food inflation, caused by a transitory shock in supply. Additionally, this Board member added that it may be expected that by the end of 2015 total inflation will be near the upper limit of the target range, and that along 2016 it would converge towards 3.0%. Therefore, in spite of the apparent slowdown of the economy and the return of the product gap to negative, the nominal policy interest rate should be maintained unaltered at least for the remainder of the year. This is to be the case as long as inflation expectations remain anchored to the target; otherwise, a change in the monetary policy would have to be considered.

3. POLICY DECISION

The Board of Directors unanimously decided to maintain the benchmark interest rate at 4.5%.

Bogotá, D. C.