

INTRODUCTION

Sustained output growth has made it possible to reduce poverty, expand productive capacity and raise productivity, thereby improving the nation's welfare and laying the foundation for maintaining high future growth.

So far this year Colombia's economy has been growing as strongly as last year. At the end of the first quarter gross domestic product showed an annual growth of 5.2%, the same as in 2005. This good performance has been accompanied by vigorous expansion in household consumption and by a surge in gross fixed capital formation (about 5% and 15% respectively in the first quarter). The fastest growing production sectors were: manufacturing (7.3%), construction (5.7%), commerce (8.4%) and transport (9.7%). The strength of economic activity has kept unemployment on a declining trend, with the national rate standing at 11.9% in May 2006, down from 12.5% a year earlier. Sustained output growth has made it possible to reduce poverty, expand productive capacity and raise productivity, thereby improving the nation's welfare and laying the foundation for maintaining high future growth.

Output growth and declining unemployment have gone hand in hand with falling inflation. At the end of the first quarter inflation was running at an annual rate of 3.9%, considerably lower than last year's 4.9%. This price-level development ensures that the 4.5%-5.5% inflation target range set by the Banco de la República's Board of Directors for 2006 will be comfortably met.

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The above results reflect a positive dynamic on several fronts: i) ever rising consumer and investor confidence has reached record highs; ii) the financial sector has grown stronger in terms of capital, through the good performance of real activity, which has encouraged financial institutions to lend and compete in offering the system's users attractive interest rates; the resulting buoyancy of the system's loan portfolio is evidenced by a 24% annual growth at the end of June; iii) the public sector has benefited from the good behavior of economic activity through a substantial increase in the tax take; and iv) to the foregoing was added a favorable external context, reflected by robust world demand and high terms of trade, which

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helped to raise the dollar value of Colombian exports by 17.4% in the first quarter of 2006.

The challenge to the Board of Directors is to devise a monetary policy for attaining and keeping a low, stable rate of inflation at the same time as ensuring favorable future conditions for maximizing the output growth compatible with price stability. This being, as often stated, the monetary authority's fundamental aim, the Board decided to raise the intervention interest rate by 50 basis points (bp) in the course of the first quarter. This timely rate rise, within a range that has left monetary policy still expansionary, helps to ensure that the economy will continue to grow at the maximum possible rate without compromising price stability. The present Report treats this subject in depth, discussing in particular each of the transmission channels through which monetary policy operates on the economy. Since this is a lagged effect, the monetary authority has to anticipate events by taking decisions in advance to ensure future economic stability.

To preserve macroeconomic stability requires deep knowledge of the economy, with its strengths and weaknesses. In this respect, the high volatility recently exhibited by external and domestic financial markets raises the question: how vulnerable might the Colombian economy be today? Such a reflection is particularly relevant when we recall that in the nineties the economy went from buoyancy to crisis and needed several years to recover. The present Report discusses this issue methodically by analyzing the vulnerability indicators of the external, real, fiscal and financial sectors and comparing them with their nineties' levels. Review of the figures leads to the conclusion that the conditions for maintaining economic dynamism and assimilating unexpected shocks are better now than they were in the mid-1990s, when the economy was growing by more than 5%, much as it is today. Emphasis is laid particularly on the greater openness and dynamism of exports, low inflation, higher exchange-rate flexibility, high level of international reserves, and the strength of financial-system indicators. Yet, it is never possible to be free of risks, and it is the job of the economic authorities to be always alert to them. It is especially important to deepen fiscal adjustment and avoid excessive imbalances in the balance of payments' current account and increases in spending not compatible with expansion in production capacity.

This Report consists of ten chapters. The first three discuss the inflation situation, economic activity and employment. Chapter IV analyzes the behavior of financial markets and their recent volatility. Chapter V reviews monetary and exchange-rate policy, explaining the reasons for the Board of Directors' recent interest-rate decisions. Chapters VI and VII look at developments in the balance of payments and fiscal policy. Chapter VIII considers the Colombian economy's vulnerability today compared with what it was in the nineties. Chapter IX reports on the level of foreign reserves, the criteria for their management, and external-vulnerability indicators. Lastly,

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Chapter X reviews the Banco de la República's financial situation. The Report also contains three boxes dealing with concerns expressed to the Board during previous Congressional debates, namely: inflation, by income bracket (Box 1); recent productivity gains (Box 2); and oil-sector development and prospects (Box 3). The Banco de la República's contracting regime and Law 80/1993 are discussed in Box 4.