



REPORT BY THE BOARD OF DIRECTORS TO THE
CONGRESS OF THE REPUBLIC

M A R C H 2 0 0 6

BANCO DE LA REPÚBLICA
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José Darío Uribe Escobar

Bogotá, D.C., March 30, 2006

Honorable Chairmen and Members
Third Standing Constitutional Committees of
The Senate and
The House of Representatives

Dear Sirs,

Pursuant to Law 31 of 1992, Article 5, the Board of Directors of the Banco de la República hereby submits for consideration by Congress a report on the country's macroeconomic results for 2005 and the year to date. The report also presents the Board's targets for this year and the outlook for the different macroeconomic variables. The final section describes the composition of the international reserves and discusses projections for the Banco de la República's financial situation in 2006.

Yours truly,



José Darío Uribe Escobar
Governor

INTRODUCTION

The fall in inflation has gone hand in hand with faster output expansion. Colombia's headline GDP growth has averaged 4.3% in the past three years, surpassing growth for Latin America as a whole and for individual countries such as Brazil and Mexico.

Consumer inflation stood at 4.85% in December 2005, lower than in 2004 (5.5%) and within the target range of 4.5% - 5.5% set by the Banco de la República's Board of Directors for 2005. And this declining trend has continued over the early months of 2006.

The fall in inflation has gone hand in hand with faster output expansion. Colombia's headline GDP growth has averaged 4.3% in the past three years, surpassing growth for Latin America as a whole and for individual countries such as Brazil and Mexico.

Internal and external factors alike have been the driving force behind the economy's stronger performance. The internal factors include consumer and investor confidence, aggregate spending growth and improved productivity; low real interest rates have been of key importance, too, as has the ample liquidity provided to the economy in recent years by the Banco de la República without jeopardizing inflation targets. The external factors include, notably, strong stable growth among Colombia's main trading partners, favorable terms of trade and greater capital flows, particularly as foreign direct investment (FDI).

The current favorable situation is expected to continue over the immediate future. Business and household surveys reveal high levels of confidence, so that private spending can be expected to remain buoyant all through 2006.

Private investment, in particular, should continue high, with machinery and equipment as a major component, usually associated with productivity gains. At the same time, lower unemployment, real wage growth and

The current favorable situation is expected to continue over the immediate future. Business and household surveys reveal high levels of confidence, so that private spending can be expected to remain buoyant all through 2006.

The Colombian economy's sustained growth in recent years has brought social benefits in terms of lower unemployment and poverty levels.

expanding consumer credit should boost household consumption in both durable and nondurable goods. Foreign projections, too, indicate that the terms of trade and a dynamic world economy should continue to favor export growth.

The Colombian economy's sustained growth in recent years has brought social benefits in terms of lower unemployment and poverty levels. In effect, between December 2002 and December 2005, unemployment fell from 15.6% to 10.4% and, according to the National Planning Department, the proportion of the population below the poverty line decreased from 54% to 49%.

To consolidate this progress the economic authorities face the major challenge of ensuring a high level of sustained growth. To this end, all risks liable to affect economic growth negatively have to be identified. An economy achieving substantial expansion, as Colombia's did in 2004 and 2005, strengthens its economic indicators and becomes less vulnerable. But the very buoyancy of its growth implies new risks that will need to be recognized and dealt with in a timely manner.

It is well known that over-appreciation of the peso compromises growth sustainability by making exports less competitive and by subjecting domestic production to serious international competition. The country's economy thus becomes more vulnerable to negative external shocks in the future. The monetary authority is fully aware of this risk and has consistently taken measures to forestall it. To this end it has been applying a discretionary intervention policy since September 2004, acquiring \$4,658 million in 2005 and a further \$1,110.7m between January and February 2006. During this same period it has sold reserves worth \$4,250m to the government, thereby allowing the latter to prepay costly foreign debt and also to replace it by domestic indebtedness. Discretionary intervention has been a determining factor in moderating the pace of appreciation in an international context of a weakening dollar, without jeopardizing the inflation targets.

An adequate volume of reserves makes it less likely that an external crisis will occur and, should one do so, acts as a financial cushion that minimizes the need for making a sudden adjustment to the economy. Thus, a higher level of international reserves reduces the cost of a possible crisis, in terms of loss of output and employment.

Growth may also be affected by unexpected external changes, such as terms-of-trade shocks, financial panics, contagion from crises elsewhere, and other factors capable of causing a reversion of capital flows. One way of reducing the risk to growth is to accumulate international reserves and decrease short-term foreign-debt obligations to such levels as allow the economy to overcome said unexpected changes as inexpensively as possible. At December 2005 net international reserves amounted to \$14,947.3m, a level considered adequate, as discussed in the body of this Report. An adequate volume of reserves makes it less likely that an external crisis will occur and, should one do so, acts as a financial cushion that minimizes the need for making a sudden adjustment to the economy.

Thus, a higher level of international reserves reduces the cost of a possible crisis, in terms of loss of output and employment.

Another aspect that is being carefully analyzed in the Inflation Reports is the possibility of excess aggregated demand making it difficult to meet the inflation targets. The Board of Directors remains alert to the existence of this risk. To evaluate it the Board monitors the economy's behavior rigorously by means of productive-sector surveys and the analysis of numerous economic variables. The information thus obtained about the level of capacity utilization helps to identify in good time any bottle-necks liable to bring about price pressures. The Board also relies on numerous econometric models that enable it to assess the most likely paths of future price and output movements, providing a basic tool for timely decision-making.

Financial-system stability is another determining factor of growth that needs to be sustained. The experience of 1999 clearly showed that a real-sector crisis goes together with a financial-system crisis and that the two reinforce each other. Aware of this danger, the Bank's Board of Directors attaches particular importance to assessment of this risk, using the best techniques applied internationally and presenting the results in a half-yearly Financial Stability Report. The financial sector's current healthy situation is reflected by loan-quality, loan-coverage, profitability and capital soundness-indicators, which are at historical peaks. However, the growing share of public-debt securities (TES) in the financial system's balance sheet has led to their valuation representing an increasing portion of the system's income. As a result, financial institutions are more sensitive to interest-rate changes. Progress in measuring, regulating and monitoring market risk is of vital importance to the financial system's stability.

Some analysts have suggested that a potential risk is associated with the rapid increase in the value of assets other than TES, particularly shares and property. Stock prices have risen considerably, and some shares may be overvalued. But a fall in share prices poses a low risk to the economy, for equity holdings make up barely 1% of the portfolios of households and of some financial intermediaries. In the property market there is currently no indication of a housing-price bubble; rather a price recovery has reversed the dramatic fall of the late nineties. And unlike what occurred in the past decade, households have not financed their home purchasing through high levels of borrowing, with the result that the mortgage portfolio still registers negative growth rates. Moreover, it is not obvious that monetary policy should respond to asset-price variations, for by trying to do so it might make real activity more volatile.

It is clear to the monetary authority that management of its policy instruments, particularly the interest rate, is crucial to preserving monetary

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stability. But the authority is also aware that the full weight of this task cannot be borne by a single instrument, no matter how powerful. Hence its belief that it is essential for monetary policy to be complemented by fiscal policy to bring about the strongest possible growth in a context of stability; and to this end it is of paramount importance to have a fiscal management committed to austerity and rehabilitating the public finances. In this respect, the Board regards the consolidated public-sector fiscal balance achieved in 2005 as a highly positive development, which has moreover helped to reduce appreciation pressures on the peso by moderating external financing needs. Prepayments of external public debt have also furthered this aim, by giving the Banco de la República greater scope for intervention in the exchange market.

It is important to maintain this fiscal balance in the future and therefore essential to pursue structural reforms in taxation and subnational transfers. Tax reform is required not only to make up for the disappearance of transitory income items, such as the wealth tax and the financial-transactions levy, but also because it will help to make the tax system fairer and more efficient by eliminating exemptions and broadening the tax base. The system of subnational transfers has to seek a reasonable balance between the government's income-generating capacity and the regions' needs. It should be pointed out however that maintaining a fiscal balance in future may require greater effort if conditions do not remain as favorable as they are today.

This report is organized in the same way as usual: Chapter I outlines the main results of economic activity and employment in 2005 and the outlook for both for 2006. Chapter II presents inflation results and outlook. Chapter III describes policy action taken by the Banco de la República's Board of Directors in 2005 and movements in the exchange rate, interest rates and monetary aggregates; it also analyzes the financial system's credit behavior and stability indicators. Chapter IV discusses public-finance developments and the outlook for 2006. Chapter V reviews the country's balance-of-payments movements and outlook. Chapter VI describes the situation and management of Colombia's international reserves, and also the indicators of external vulnerability. Lastly, Chapter VII presents the Banco de la República's financial statements at the end of 2005 and its profit forecast for 2006.

This report also includes a number of boxes on issues that the Board of Directors consider particularly relevant to the present economic situation: the relationship between asset-price behavior and monetary-policy management (Box 1); a discussion on nominal and real exchange rates,

The Board regards the consolidated public-sector fiscal balance achieved in 2005 as a highly positive development, which has moreover helped to reduce appreciation pressures on the peso by moderating external financing needs.

their significance and determinants (Box 2); an assessment of the Colombian financial system's current credit, market and liquidity risks (Box 3); evolution of the Pension Funds' portfolio (Box 4); workers' remittances and their economic impact (Box 5); and, lastly, a discussion on the revised program for external management of the international reserves (Box 6).

I. ECONOMIC ACTIVITY AND EMPLOYMENT

The latest estimates point to a GDP growth of around 5%, compared with a 3%-4% range expected by most analysts. This 5% growth rate is higher than the past century's historical average and, in real terms, raises per-capita GDP above the levels reached before the late -nineties' crisis.

Economic growth in 2005 was around 5.0%, a performance not seen for a decade. With growth of over 4.0% for three years running, recovery from the late-nineties' crisis has taken firm hold. Since 2003 Colombia's average economic growth has exceeded average growth for Latin America as a whole and for individual countries such as Brazil and Mexico. The pace of growth has responded to various factors, including low interest-rate policies, which could be maintained thanks to lower inflation, external conditions, consumer and investor confidence and productivity and employment gains.

The external factors contributing to economic dynamism include, notably, strong stable growth among Colombia's main trading partners, favorable terms of trade, and capital flows to emerging countries. In addition, Colombia and most other countries of the region saw their country-risk premiums fall substantially during 2005. All these factors helped the peso to appreciate against the dollar, by around 4.4% in 2005.

The pace of growth has responded to various factors, including low interest-rate policies, which could be maintained thanks to lower inflation, external conditions, consumer and investor confidence and productivity and employment gains.

The favorable external environment together with macroeconomic policy led to a considerable expansion in aggregate spending. Private investment remained buoyant, rising as a percentage of GDP by more than the historical average for the second year running. There was moreover an upturn in personal consumption of both durable and nondurable goods. Figures for 2005 show household per-capita consumption at the peak levels registered before the late-nineties' crisis.

Traditional and nontraditional exports increased substantially in dollar value in 2005. Venezuela's economic growth continued to gain ground in Colombian sales of nontraditional products, reaching levels similar to those of other economies, while nontraditional exports to the United States rose to a historical peak in dollars in 2005.

Imports accelerated in 2005, driven by real exchange-rate appreciation, investment buoyancy and greater economic activity. In effect, capital and intermediate goods accounted for most of the increase in imports, reflecting favorable investment conditions and greater vitality in the productive system. For their part, overseas purchases of consumer goods indicate an improvement in household income and a perception that it will prove sustainable.

The economy's satisfactory performance, and favorable expectations have had a positive effect on job creation. Thus, in 2005 national unemployment decreased to 10.2% and urban unemployment to 12.1%.

Figures for 2005 show household per-capita consumption at the peak levels registered before the late-nineties' crisis.

A. ECONOMIC ACTIVITY

Economic growth in 2005 surpassed government and private forecasts. The latest estimates point to a GDP growth of around 5%, compared with a 3%-4% range expected by most analysts.¹ This 5% growth rate is higher than the past century's historical average and, in real terms, raises per-capita GDP above levels registered before the late nineties' crisis (Chart 1).²

1. Domestic demand

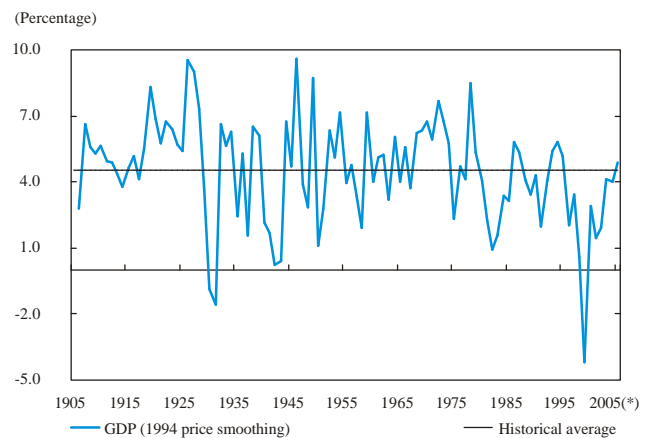
Business and household confidence remained high, helping to raise consumption and investment, while low interest rates and domestic and foreign financing facilities benefited growth in domestic demand. Recovery in employment since 2004 has also boosted this dynamic.

¹ At the time of this writing no final growth data are available for 2005.

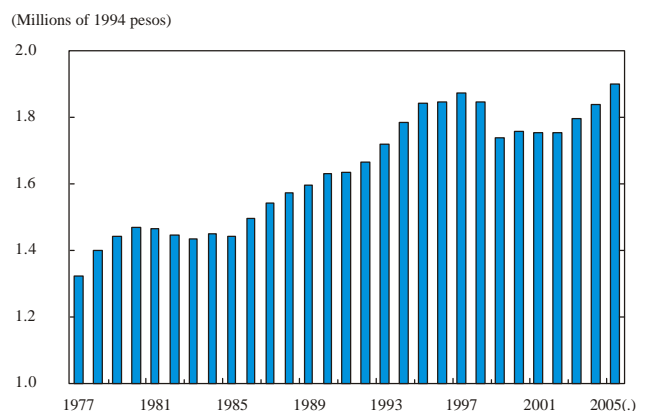
² The National Statistics Agency (DANE) is now revising industrial growth for 2004 and 2005, which will affect GDP estimates for that period. Preliminary exercises show that growth for 2004 may have been 0.4% higher than reported so far, reaching 4.4%, and 2005 growth 0.2% higher than expected for the full year.

CHART 1

THE COLOMBIAN ECONOMY'S REAL ANNUAL GROWTH

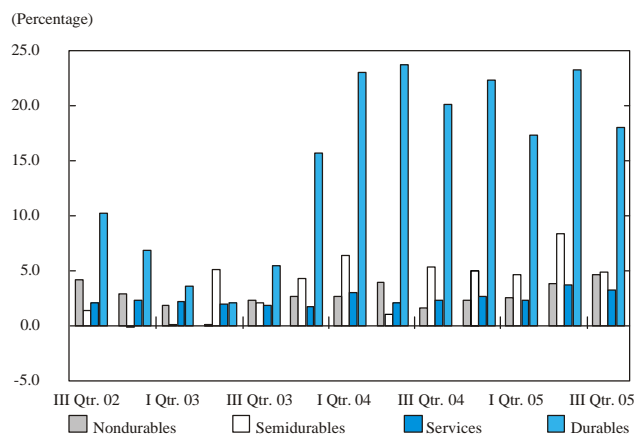


GDP PER HEAD



* Projected by the Banco de la República.
Source: National Statistics Agency (DANE), National Planning Department and Banco de la República.

HOUSEHOLD CONSUMPTION REAL ANNUAL GROWTH, BY NATURE OF GOODS



Source: DANE; calculations by Banco de la República.

The increase in public and private domestic demand in 2005 came largely from investment and from recovery in household consumption. Growth in household consumption averaged 4.5% in the past two years, a performance not seen for a decade. And for the first time since the crisis all consumer goods, not just durables, increased substantially. By contrast, private consumption of services has still not recovered the growth rates of the mid-nineties (Chart 2).

Private investment as a percentage of GDP exceeded the historical average for the second year running. Investors took advantage of the good-for-business economic and socio-political environment (as shown by Fedesarrollo’s business opinion polls), ample liquidity in the

economy, and favorable external conditions for importing capital goods. Said external conditions strongly fueled growth in imports—65% of imports consisted of intermediate and capital goods.

2. External demand

As stated above, the growth of Colombia’s main trading partners continued to contribute to the economy’s good performance and to favor nontraditional exports (Chart 3). Dollar growth was substantial in nontraditional exports to all destinations, particularly Venezuela, Mexico and Peru. Nontraditional exports to the United States stabilized in the second half of the year. It is important to point out that sales of industrial products to Venezuela and the United States in 2005 were at similar levels.

The external setting was completed by favorable development of the terms of trade, chiefly for traditional exports. The price of oil remained historically high, as did coal and coffee prices, causing traditional exports to show a substantial dollar growth, partly mitigated by a fall in the volume of oil sold.

In local currency, however, the country’s overall exports grew by some 5.0% in 2005, as against 10.4% in 2004. This slowdown in real export growth may have been associated, among other things, with the fall in the volume of oil sales, the exchange rate’s real accumulated appreciation, and slower growth in demand from the United States and other markets (including Mercosur). Some Colombian products are probably facing

Private investment as a percentage of GDP exceeded the historical average for the second year running. Investors took advantage of the good-for-business economic and socio-political environment, ample liquidity in the economy, and favorable external conditions for importing capital goods.

greater competition in these markets, partly because of the entry of countries such as China in the garment and chemicals industries (Chart 3).

Import growth accelerated in 2005 relative to 2004, as a result of real appreciation in the exchange rate, buoyancy in investment, and stronger economic growth. As stated earlier, there is a direct relationship between higher investment in machinery and equipment and capital-goods imports. Favorable investment conditions, expectations of stable growth, and household perception of sustainable future income are factors that most probably account for the growth in overseas purchasing.

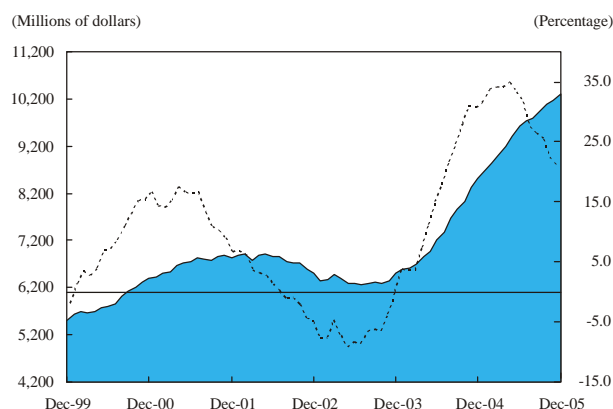
As explained in detail below, good export earnings were accompanied by capital inflows into the economy from excess liquidity in international markets, low country-risk spreads and a yield differential in favor of peso securities. The effect of all these capital inflows on the peso's appreciation was mitigated by the Banco de la República's exchange-rate intervention policy, and by the government's decision to prepay foreign debt and accumulate assets abroad. In effect, the Banco de la República bought \$4,658 m of foreign currency in the exchange market in 2005; this operation was facilitated by the sale of \$3,250 m of foreign currency to the government. The net result of consolidated public-sector operations was a decrease of some \$2,900 m in net liabilities to the rest of the world, said amount including net external-debt payments of \$1,256 m and accumulation of foreign assets worth \$1,671m. Between January and February 2006 the Banco de la República bought \$1,110.7 m in the exchange market and sold \$1,000 to the government.

Trends in 2006 point to a GDP growth of 4.0%-5.0%, with a strengthening of consumption in both the public and the private sectors. Given a fall in crude-oil production and stable coffee production, real export growth in 2006 is expected to be around 1.5% (Table 1).

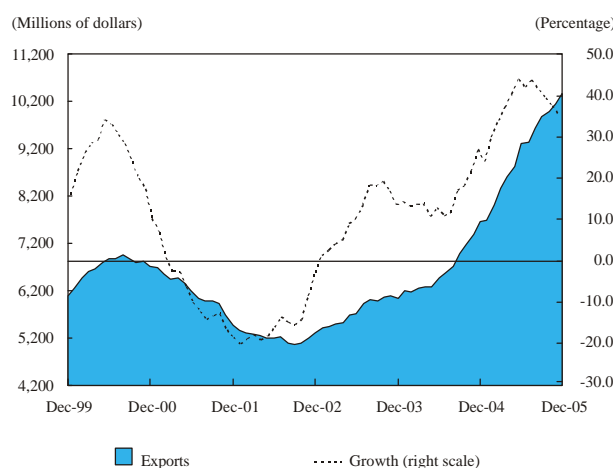
With consumption and investment rising strongly (by 5.4% and 15.4% respectively), real import growth is expected to be around 15%—or more, judging by developments early in the year. In this context, growth in 2006

COLOMBIAN EXPORTS
(12-MONTH ACCUMULATED)

NO TRADICIONALES



TRADITIONAL



Source: DANE.

will be concentrated in the economy's nontradables sectors, mainly commerce, transport and communications and public and private construction. Accordingly, GDP growth is expected to run between 4.5% and 5.0% (Table 2).

TABLE 1

GROSS DOMESTIC PRODUCT, BY TYPE OF SPENDING
(ANNUAL PERCENTAGE GROWTH)

| | 2004 | 2005 (*) | 2006 (*) |
|--------------------------------|--------|----------|----------|
| Final consumption | 3.9 | 5.0 | 5.4 |
| Households | 4.1 | 5.0 | 5.5 |
| Government | 3.3 | 5.0 | 5.0 |
| Gross capital formation | 11.7 | 25.1 | 15.4 |
| Gross fixed-capital formation | 12.8 | 18.2 | 12.3 |
| GFCF excl. civil works | 21.9 | 17.1 | 12.8 |
| Civil works | (19.1) | 24.1 | 10.0 |
| Domestic demand | 5.3 | 8.8 | 7.5 |
| Total exports | 10.4 | 5.5 | 1.5 |
| Total imports | 16.9 | 24.1 | 15.1 |
| Gross domestic product | 4.0 | 4.9 | 4.5 |

(*) Banco de la República projections.
Source: DANE; calculations by Banco de la República.

TABLE 2

GROSS DOMESTIC PRODUCT, BY SECTOR
(ANNUAL PERCENTAGE GROWTH)

| | 2004 | 2005 (*) | 2006 (*) |
|---|------------|------------|------------|
| Farming, forestry, hunting and fishing | 2.5 | 2.9 | 1.9 |
| Mining and quarrying | 2.2 | 3.5 | 0.7 |
| Electricity, gas and water | 2.8 | 3.4 | 2.6 |
| Manufacturing | 4.8 | 2.2 | 3.1 |
| Construction | 9.7 | 10.0 | 6.1 |
| Buildings | 30.3 | 3.7 | 4.0 |
| Obras civiles | (19.2) | 24.2 | 10.0 |
| Trade, repairs, restaurants and hotels | 5.8 | 8.8 | 5.7 |
| Transport, storage and communication | 5.1 | 5.4 | 6.1 |
| Financial establs., insurance, real estate and business services | 4.3 | 3.6 | 3.2 |
| Social, community and personal services | 2.7 | 4.2 | 5.0 |
| Financial intermediation services measured indirectly | 12.2 | 9.9 | 5.5 |
| Subtotal value added | 3.8 | 4.2 | 3.8 |
| Gross domestic product | 4.0 | 4.9 | 4.5 |
| Taxes less subsidies | 6.9 | 14.4 | 12.4 |
| Net FISIM financial services | 1.9 | 1.4 | 2.3 |
| Tradables | 3.6 | 3.4 | 3.3 |
| Nontradables | 4.3 | 5.8 | 5.2 |

(*) Banco de la República projections.
Source: DANE; calculations by Banco de la República.

B. EMPLOYMENT AND UNEMPLOYMENT

Both nationwide and urban unemployment³ were on a declining trend throughout 2005, dropping to their lowest levels in five years. At December 2005 national unemployment was 10.2%, down from 12.1% a year earlier,⁴ while the urban rate stood at 12.1%, down from 13.7%⁵ (Chart 4).

The drop in unemployment resulted largely from a rise in the number of people with jobs. The period 2004–2005 saw the creation of 494,000 job openings nationwide and 315,000 in the 13 largest cities, or an annual employment

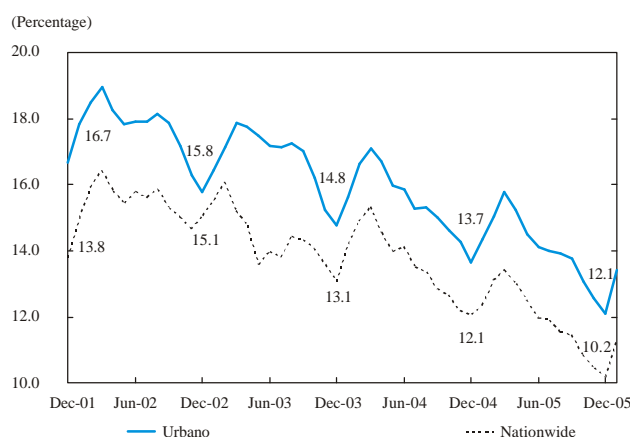
³ The urban rate refers to thirteen cities: Bogotá, Medellín, Cali, Barranquilla, Manizales, Pato, Cúcuta, Ibagué, Montería, Cartagena and Villavicencio.

⁴ This is the three-day moving average; the point information for December was 10.4%, compared with 12.1%.

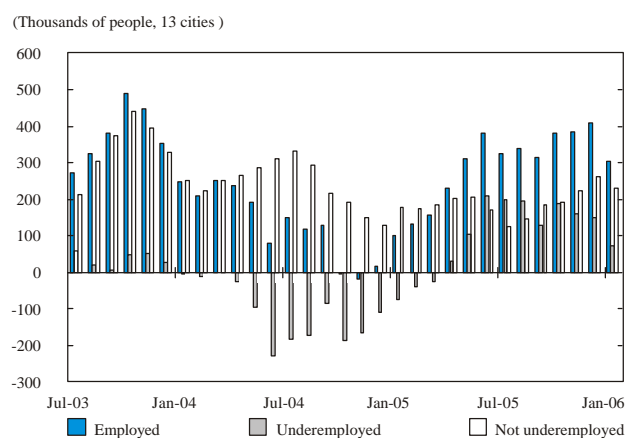
⁵ This is the three-day moving average; the point information for December was 12.2%, compared with 13.0%.

CHART 4

UNEMPLOYMENT RATE
(3-DAY MOVING AVERAGE)



JOB CREATION
(3-DAY MOVING AVERAGE)



Note: *Job creation* refers to the absolute variation in the number of people with jobs relative to the same period the year before.
Source: DANE, and DANE Continuing Household Survey; calculations by Banco de la República.

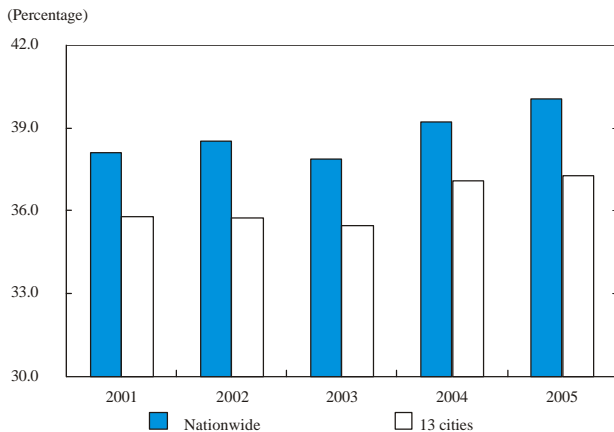
TABLE 3

LABOR-MARKET STATISTICS
(AVERAGE ANNUAL CHANGE IN NUMBER OF PEOPLE)

| Period | Nationwide | | | 13 cities | | |
|-----------|------------|------------|---------------|-----------|------------|---------------|
| | Employed | Unemployed | Underemployed | Employed | Unemployed | Underemployed |
| 2001-2002 | 114,022 | 178,421 | 647,325 | 234,669 | (11,094) | 319,977 |
| 2002-2003 | 846,653 | (206,377) | (276,147) | 317,837 | (38,690) | 30,597 |
| 2003-2004 | 111,011 | (111,337) | (74,358) | 120,777 | (120,290) | (106,114) |
| 2004-2005 | 494,074 | (360,821) | 55,385 | 315,706 | (109,389) | 115,666 |

Source: DANE; calculations by Banco de la República.

**INACTIVITY RATE
(ANNUAL AVERAGE)**



Source: DANE; calculations by the Banco de la República.

increase of 2.8% and 4.0% respectively (Table 3). This increase was more than sufficient to absorb the new labor supply (expansion in the economically active population), thereby reducing the number of jobless.

The evolution of underemployment over the year suggests that the change in the number of people holding jobs was associated with formal employment. In effect, the contribution of underemployment to the rise in employment was less than 12.0% (55,000 people) at the national level and 36.6% (115,000 people) at the urban level. Those figures indicate an improvement in employment quality in towns other than the 13 major cities and in the wider countryside. The stronger impact of urban underemployment began to wane from the second

half of the year.

In short, the decrease in unemployment in 2005 is explained by a rise in employment and, in the case of the national rate, also by a decline in labor supply. The economy's satisfactory performance and favorable expectations have also had a positive impact on job creation. Taking into account the GDP growth forecast for 2006, unemployment is expected to continue to decrease over the year (Chart 5).

II. INFLATION IN 2005 AND OUTLOOK

Lower inflation expectations undoubtedly helped to reduce inflation in both tradables and nontradables and constituted a major achievement of monetary policy, reflecting as they did greater confidence in the monetary authority's ability to move inflation toward the target.

A. CONSUMER INFLATION

Annual consumer inflation in 2005 was 4.85%, down by 64 basis points (bp) on a year earlier. It ran within the 4.5%-5.5% target range set by the Bank's Board of Directors (Chart 6), making it the second year running that the inflation target was strictly met.

The reduction of consumer inflation in 2005 resulted from a sharp fall in nonfood inflation, which dropped from 5.5% in December 2004 to 4.1% a year later (Chart 7). In contrast, food inflation rose by 116 bp to 6.6% by the end of 2005 (Chart 8).

In early 2006 consumer inflation continued to decrease, down to 4.19% in February, thanks to falls in both food inflation (5.4%) and nonfood inflation (3.9%). Lower nonfood inflation resulted largely from a decline (222 bp over the last two months) in regulated goods and services; this item includes utility rates and transport and gasoline prices. Regulated-price inflation was driven down by the behavior of water-supply and transport charges.

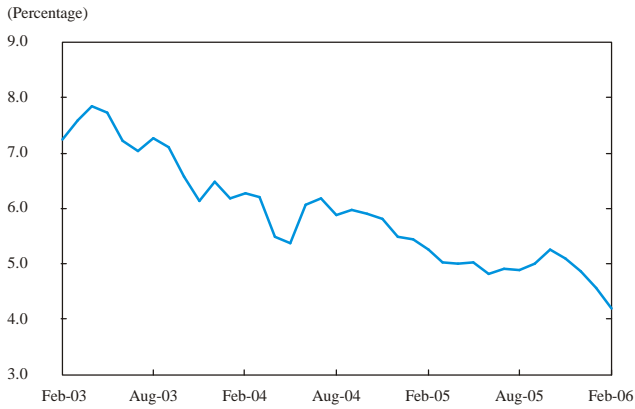
The reduction of consumer inflation in 2005 resulted from a sharp fall in nonfood inflation, which dropped from 5.5% in December 2004 to 4.1% a year later.

B. CORE INFLATION

The core inflation indicators that the Bank estimates averaged 4.0% at the end of 2005, the lowest average in their history. One of these indicators is nonfood inflation, which registered reductions in all its components but especially in tradables (determined basically by the exchange rate) and regulated services. Both groups have been on a declining trend since 2004.

CHART 6

HEADLINE CONSUMER INFLATION



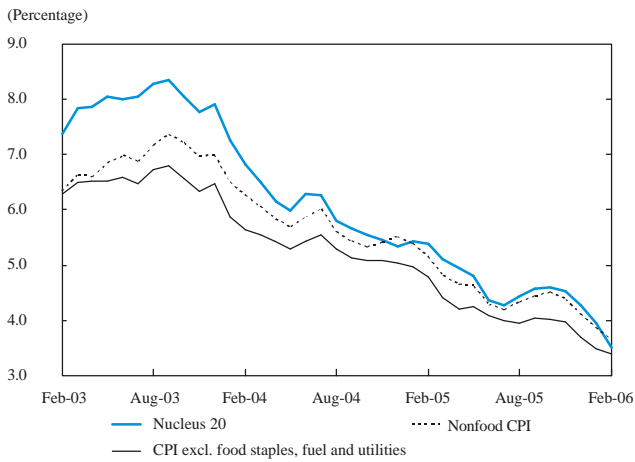
Source: DANE.

From December 2004 to December 2005 nonfood nonregulated tradables inflation fell from 3.5% to 2.2% (Chart 9).⁶ An even greater fall occurred in the inflation of regulated services, which dropped from 10.2% to 6.7% (Chart 10), thanks to reductions in its three main components: fuel, utilities and public transport. Readjustments to the price of fuel in 2005 were smaller than in 2004, causing the indicator to

⁶ This refers to the contribution to deceleration; that is, it takes into account the weight of the basket.

CHART 7

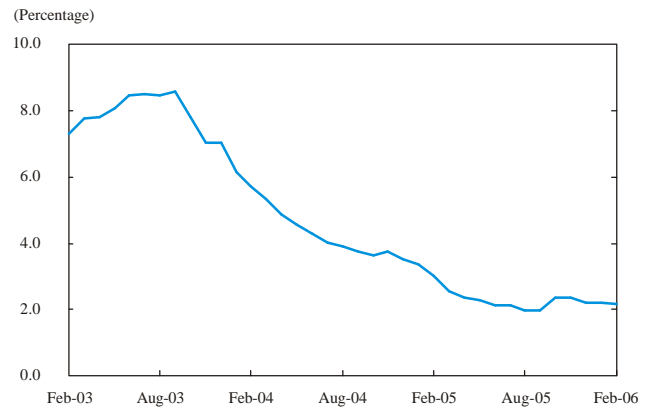
CORE INFLATION INDICATORS



Source: DANE.

CHART 9

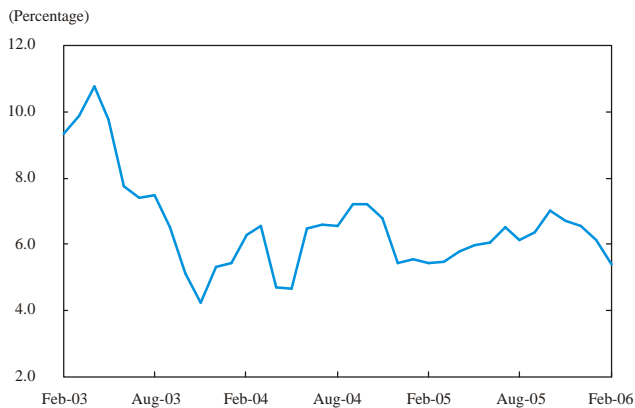
ANNUAL TRADABLES INFLATION (EXCLUDING FOOD AND REGULATED PRICES)



Source: DANE.

CHART 8

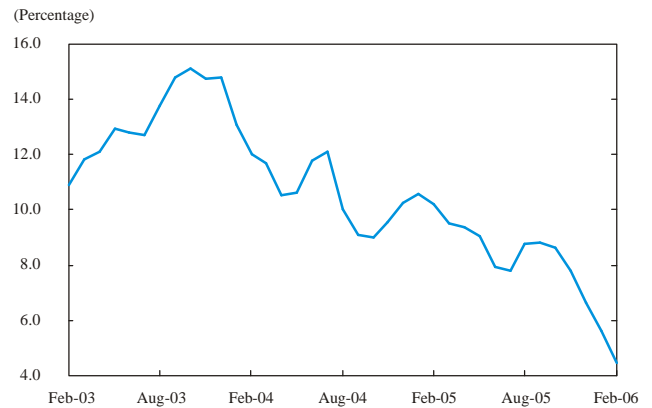
FOOD INFLATION



Source: DANE.

CHART 10

ANNUAL REGULATED-PRICE INFLATION (EXCLUDING FOOD)



Source: DANE.

drop from 16.9% in December 2004 to 10.3% a year later.

Public transport, too, exhibited a considerable decline in annual inflation (430 bp over the year), made possible by moderate or almost zero increments in Bogotá transport charges especially in the final quarter of the year (a period of increases some years back). This behavior is surprising, given the accumulated fuel-price adjustments of the past two years; so, the possibility cannot be ruled out that the good result at year-end 2005 was the effect of postponing readjustments until 2006.

Readjustments of utility rates seem to have gradually moved more into line with the Bank's targets, after several years of running higher than the targets because of the dismantling of subsidies, among other reasons. There is every indication that the new utility-rate formulas introduced at the end of 2005 will be consistent with more moderate rate adjustments for the coming two years.

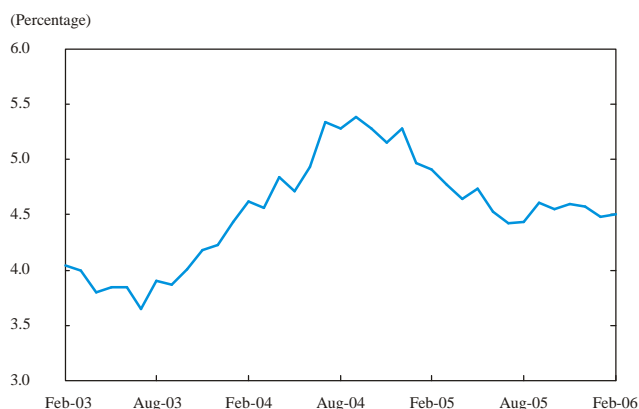
Annual inflation in nonregulated nonfood nontradables also decreased, but by less, running at 4.6% in December 2005, down from 5.3% a year earlier (Chart 11).

Housing rents, having exhibited a rising trend in annual inflation from 2001 to the end of 2004, interrupted this trend in 2005 and even gave indications of reversing it, particularly in the second half of the year. Last December housing-rent inflation stood at 4.1%, some 60 bp lower than twelve months earlier⁷ (Chart 12).

C. FOOD INFLATION

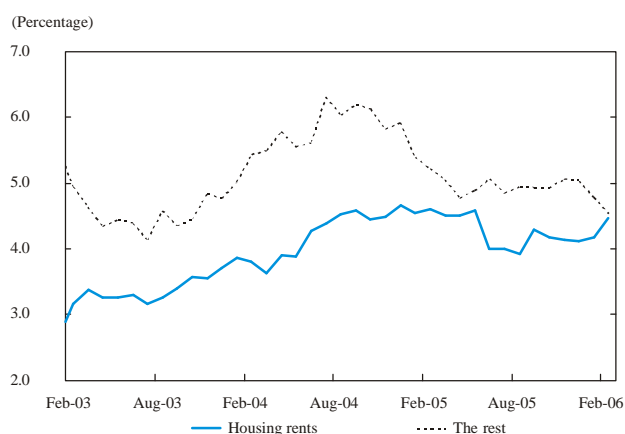
Food inflation showed a rising trend until October, when it peaked at 7% then began to fall off (Chart 8). Food-staple prices usually go up in the first half of

ANNUAL NONTRADABLES INFLATION
(EXCLUDING FOOD AND REGULATED PRICES)



Source: DANE.

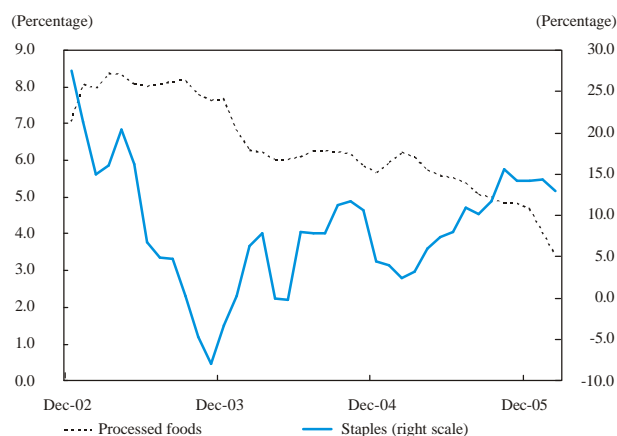
ANNUAL NONTRADABLES INFLATION
(EXCLUDING FOOD AND REGULATED PRICES)
BREAKDOWN BY HOUSING RENTS AND THE REST



Source: DANE.

⁷ Housing rents have picked up since January this year, reaching 4.5% in February. Given their high weighting (20.7%) in the consumer basket and the fact that they are already very close to the targets, their behavior will be decisive in determining the direction of core and nontradable inflation in 2006.

STAPLE AND PROCESSED-FOOD INFLATION



Source: DANE.

the year; in the second half they decline, thanks to greater supply. In 2005 the decline did not start until October; this explains the fact that in December 2005 annual inflation in food staples (14.1%) was considerably higher than in December 2004 (4.5%) (Chart 13).

In contrast, processed-food inflation decreased all through the year, notably because of lower international prices and the peso's appreciation, two factors that curbed price rises in imported foodstuffs such as cereals and oils.

D. DETERMINANTS OF INFLATION IN 2005

Generally speaking, inflation is determined by four basic factors: I) excess productive capacity, ii) costs and wages, iii) expectations, and iv) the nominal exchange rate. These variables are closely linked to the main transmission channels of monetary policy.

1. Excess capacity utilization

Use of the economy's productive capacity continued to increase in the second half of 2005. The latest information available shows most capacity-utilization indicators returning to their long-term levels or a little above them. Chart 14 presents the behavior of two of the most reliable indicators—utilization of installed industrial capacity and adequacy of productive capacity—for meeting demand increases in the coming twelve months. Both indicators are taken from Fedesarrollo's Business Opinion Surveys. A fall in the adequacy indicator means that there is less excess capacity for meeting future demand increases.

These results taken together suggest that the economy's excess productive capacity continued to decrease in 2005 despite increases in investment and productivity.

These results suggest that the economy's excess productive capacity continued to decrease in 2005 despite increases in investment and productivity.

2. Costs and wages

Costs were not a major source of inflationary pressure in 2005. And, although wage increases may have exceeded the inflation target range, they were off-

set by productivity gains. There is evidence of this in the case of manufacturing and retail wage increases: on official figures to October 2005, real manufacturing unit cost (ratio of real wage per worker to real productivity per worker) decreased by 1.0% from January to October.

3. Exchange rate

The peso's accumulated appreciation in 2005 reduced tradables inflation over the year, keeping it far below the average and target inflation rates. But greater exchange-rate stability since the second half of last year has attenuated the effect of appreciation on inflation.

4. Inflation expectations

The Banco de la República's monthly surveys clearly show a decline in expectations about inflation in twelve months' time (Chart 15). This finding is corroborated by other surveys and other expectations indicators. Inflation expectations for 2006 are in line with the target.

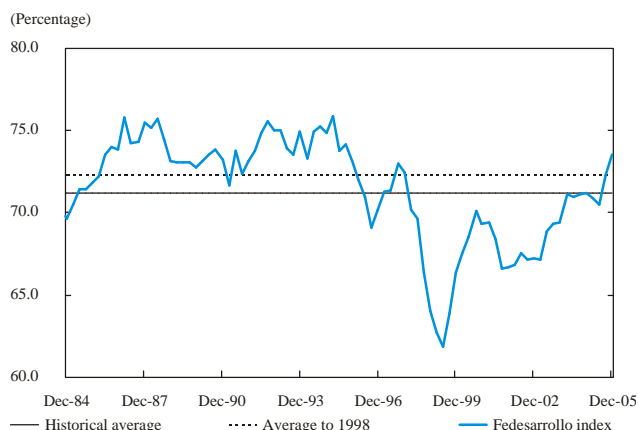
The decline in inflation expectations has undoubtedly helped to bring down both tradables and nontradables inflation. It thus constitutes a major achievement of monetary policy in that it reflects greater confidence in the monetary authority's capacity to steer inflation toward the target.

E. INFLATION OUTLOOK

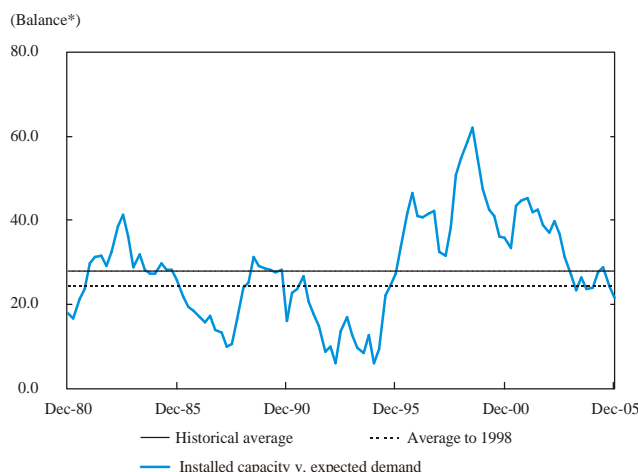
In 2006 and 2007 inflation will be determined by the following factors:

- Falling exchange-rate pressure will keep tradables inflation low but is likely to become less significant as a disinflationary factor in 2007.

CAPACITY UTILIZATION
(SEASONALLY ADJUSTED SERIES)

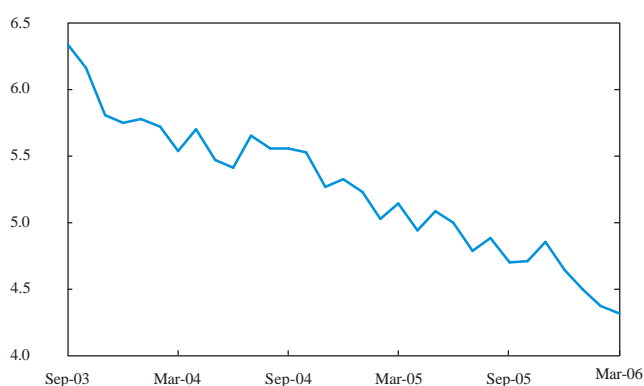


INSTALLED CAPACITY V. EXPECTED DEMAND



(*) Balance between more than sufficient and insufficient.
Source: Fedesarrollo.

BANKS' AND STOCKBROKERS' INFLATION EXPECTATIONS
ANNUAL RATE FOR EACH MONTH



Source: Banco de la República.

- Regulated-price inflation should show something of a downward trend, especially in the first half of 2006, reducing inflationary pressure this year, in contrast to what occurred other years. Low utility-rate adjustments would be the main factor contributing to this trend and would offset higher-than-target fuel-price rises. In 2007, however, regulated-price inflation is less likely to continue to lower inflation, because fuel and public-transport prices may climb higher.
- Falling food inflation should help in meeting the target. The falls would be concentrated in the first half of 2006, and the possibility cannot be excluded of something of a pick-up toward the end of the year. Falls are less likely in 2007.
- Unlike food inflation and regulated-price inflation, domestic demand is not expected to help lower inflation, for excess productive capacity might begin to generate pressure on nontradables prices in the medium term.
- Low and decreasing inflation expectations and greater credibility in monetary policy should make it easier to meet the 2006 target.

Forecasts from inflation models show there is a high probability of meeting the Board of Directors' inflation target range of 4%-5% for 2006.

In this context, forecasts from inflation models show there is a high probability of meeting the 2006 inflation target range set by the Bank's Board of Directors at 4% - 5%. Food inflation and particularly the tradables rate are expected to run below 4% by the end of the year, while nontradables inflation would be around the range's mid-point (4.5%).

ASSET PRICES AND MONETARY POLICY

The nineties were characterized by the success of several countries' monetary authorities in stabilizing inflation at low levels (between 1% and 4%). Price stability has, however, been accompanied by high variations in financial and nonfinancial asset prices: countries such as Australia, United Kingdom, Japan and United States have faced even stronger asset-price cycles than during the decades of high inflation (Boris et al., 2003). Booms and busts in asset prices, credit and investment have become a major source of economic instability in developed and developing countries alike.

High asset-price volatility is worrying, because financial imbalances expose the economy to the risk of recession and possibly deflation. For this reason asset-price cycles remain a great challenge in drawing up monetary policy.

Bubbles are more worrying in some markets than in others. Property-price bubbles have a greater impact than share-price bubbles, partly because the former tend to reflect domestic-credit conditions more strongly, whereas the latter tend to reflect global forces. In the nineties, for example, Latin American countries underwent a great expansion and subsequent contraction in both property prices and credit aggregates. In general, when housing prices boom, households have a perception of greater wealth, which leads them to borrow more and thus become more vulnerable financially to any potential reversal in house prices.

Similarly, a property boom is more likely to collapse than any other asset boom. Helbling and Terrones (2003) find that over the past thirty years only 25% of equity-price booms ended in drastic reductions, whereas 50% of property booms collapsed. House-price booms give buyers a distorted perception of the return they should expect on their investment, leading to speculative property purchases, over-investment in housing stock, increased lending and higher consumption. When house prices collapse, the process reverses: as home equity deteriorates, households' access to credit becomes limited and investment in real estate declines.

The question arises whether the monetary authority should raise interest rates to deflate the bubble; there is no consensus among economists on this. Some argue that central banks should use their monetary policy preventively by using interest rates to stop financial-market bubbles from growing (Cecchetti et al. 2000, Borio and Lowe 2003, and Filardo 2001, among others). This strategy, however, requires great precision in identifying asset-market bubbles. Other economists maintain, in contrast, that given

the capricious nature of bubbles there is great potential for a highly activist monetary authority to be imprecise about the right time to act (Bernanke 1999, Stockton 2003, Goodfriend 2003, Bordo and Jeanne 2002). Thus, the central bank may begin to raise *interest rates when the bubble has started to collapse, thereby worsening the consequences for real activity.*

Moreover, available techniques for identifying asset-price deviations from equilibrium values are not sufficiently reliable. Some studies suggest that warning signs occur when the credit-to-output ratio is four percentage points and asset prices deviate from trend by 40%. Borio and Lowe (2003) show that these warning signs could predict 55% of the financial crises three years in advance. Unfortunately, detecting bubbles (difficult to do even after they have formed) is almost impossible in real time.

The lack of consensus among economists and policymakers is reflected in central banks' reluctance to use their monetary-policy instrument to combat bubble-making. The decision to tighten policy when output is growing and inflation is under control is a difficult one to justify to the public; and it could be wrong, for it may abort a process of healthy economic expansion.

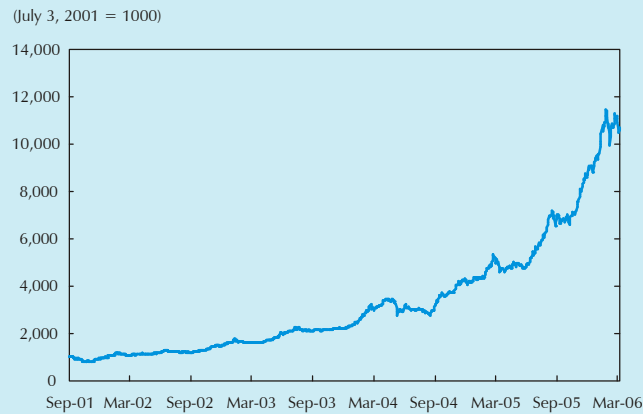
According to the foregoing, although asset prices should be closely monitored to detect potential imbalances jeopardizing financial stability, it does not seem appropriate for the monetary authority to react mechanically to asset-price movements by raising policy interest rates. These rates should be managed on the basis of an integral assessment of the prospects for consumer inflation, including asset prices as just one element. In these circumstances, financial supervision becomes highly instrumental in assessing risks that may foreshadow the triggering of potential bubbles.

The current situation in Colombia

What has happened to asset prices in Colombia and what effects can they have on the economy?

The Colombian Stockmarket General Index has risen sharply since early 2003. It went up by 86% in 2004 and by 115% in 2005 (Chart B1.1). Moreover, the ratio of share price to net worth of companies is running far above the mid-nineties' levels (Chart B1.2).

CHART B1.1
COLOMBIAN STOCKMARKET GENERAL INDEX (*)



(*) Data to March 10, 2006.
Source: Colombia Securities Exchange.

CHART B1.2
TOBIN'S Q RATIO



Source: Banco de Colombia.

However, a share-price distortion would have a limited effect on the economy, for stocks account for a very small portion of household assets in Colombia: 1%, compared with 20% in the United States (Table B1.1).

In contrast, housing represents almost 65% of household wealth in Colombia (compared with 21% in the US) (Table B1.1), making the economy more vulnerable to property bubbles. But there are currently no signs of a bubble in the housing sector: the upturn in housing prices since 1998 still presents no worrying trends (Chart B1.3); and, unlike what occurred in the mid-nineties, home purchasing has not been financed through high borrowing, so that the mortgage portfolio is still registering negative growth rates (Chart B1.4).

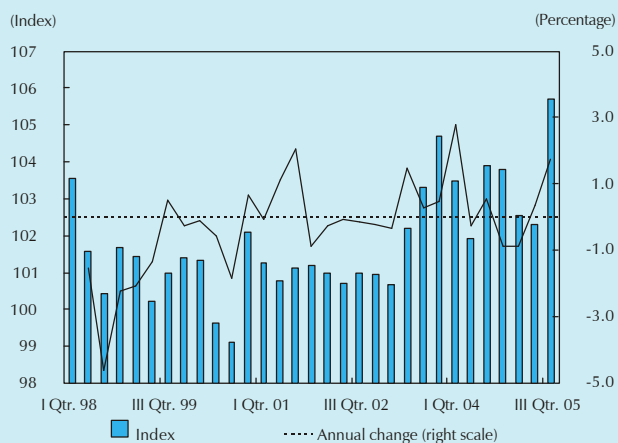
Lastly, Treasury securities (TES) are a particularly important type of asset in Colombia's financial system. TES prices have gone up sharply since February 2003, reducing the long-term interest rate (Chart B1.5). Although the valuation gains may partly reflect fundamental factors, they might also be associated with a price bubble in government bonds. This underlines the importance of constantly and properly assessing market risks associated with these assets. Box 3 analyses this type of risk to the financial system.

TABLE B1.1
COMPOSITION OF HOUSEHOLD ASSETS
(PERCENTAGES)

| | Housing | Shares | Other assets | |
|---------------|---------|--------|--------------|----------|
| | | | Financial | Tangible |
| United States | 21 | 20 | 50 | 8 |
| Colombia | 64 | 1 | 35 | n,a |

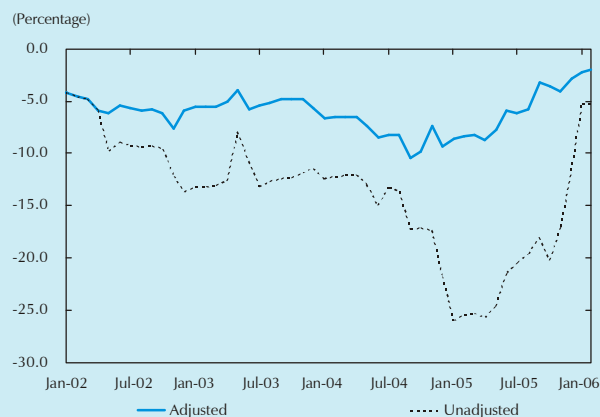
Source: Martha López, *Borradores de Economía* del Banco de la República No. 372.

CHART B1.3
MOVEMENTS IN NEW-HOUSING PRICES



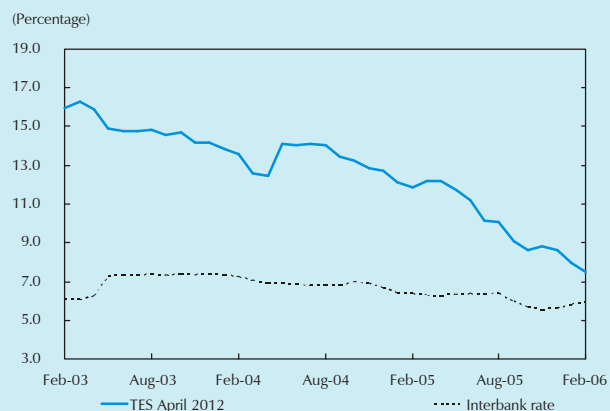
Source: DANE.

CHART B1.4
MORTGAGE-LOAN PORTFOLIO
(GROWTH RATES 2002-2006)



Source: Banco de la República.

CHART B1.5
NOMINAL INTEREST
RATES



Source: Banco de la República.

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III. MONETARY AND EXCHANGE-RATE POLICY

The year 2005 was characterized by easy monetary policy, with active intervention by the Banco de la República in the exchange market, and no changes in the intervention interest rate until September, when the Board reduced it by 50 bp.

A. INFLATION TARGETING AND POLICY ACTION BY THE BOARD IN 2005

1. Inflation targeting

Based on the experience of countries and on advances in economic theory, the policies of the Banco de la República and a great many other central banks in the world are centered on three basic propositions:

- Low, stable inflation contributes to the proper functioning of the economy and generates benefits for companies and individuals.
- Central banks are unable to influence any variables other than inflation in a sustainable way.
- When inflation and inflation expectations are near the long-term target, the search for price stability helps to bring output close to productive capacity.

Low, stable inflation is an essential part of macroeconomic stability, which is a necessary (though not sufficient) condition for achieving high, sustained growth in output and employment

As shown by numerous Bank publications, low, stable inflation brings multiple benefits, notably the following:

- i. It reduces long-term interest rates and makes them more stable, thereby promoting investment and the efficient allocation of productive resources.
- ii. Price stability precludes unjustified income redistributions, which negatively affect the economically weaker sectors of the population.

- iii. Low, stable inflation is an essential part of macroeconomic stability, which is a necessary (though not sufficient) condition for achieving high, sustained growth in output and employment.
- iv. Price stability increases real income and reduces uncertainty in the economy, thereby contributing to the population's welfare.
- v. Low, stable inflation makes for a deeper capital market and, through this channel, fosters economic growth.

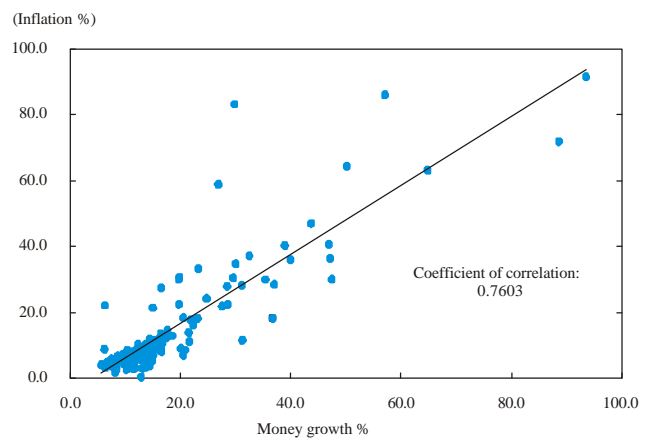
The experience of economies shows that in the long term monetary policy is the single variable that most accounts for inflation differences between countries. Chart 16 is illustrative: it shows that, considering long periods (four or more years), inflation rates are higher in countries where the quantity of money grows faster. Hence, monetary policy affects inflation levels in the long term. In contrast, over short periods (one or two years), the correlation between money growth and inflation is weak, especially when economies have low levels of inflation. In other words, in the short term there are factors other than money supply that account for inflation. Money-supply behavior may therefore be a bad guide for monetary-policy decision-making.

The enormous benefits of low inflation and the effect of monetary policy on inflation, as discussed above, explain why modern central banks have inflation targets with the characteristics described above. They also explain why modern central banks regard inflation control as the prime objective of monetary policy. But, what capacity does monetary policy have to reach or help in reaching the aims of low unemployment and high economic growth? The answer to this question leads us directly to propositions ii and iii above.

Monetary policy can affect real demand, employment and economic growth in the short term, when there are usually wage and price rigidities or non-instantaneous adjustments to people's expectations. Consequently, to the extent that there is idle capacity of the factors of production and monetary policy is expansive, recovery in production and job creation will be fostered by reducing interest rates and supplying abundant primary liquidity. Similarly, when the economy is operating above its productive capacity and monetary policy is restrictive, higher interest rates and lower provision of primary liquidity will prevent inflation from accelerating and will contribute to stable, sustainable growth in employment and output. Pursuing price stability will not, therefore, necessarily prevent the central bank from applying counter-cyclical policies that help to keep output around its (potential) productive capacity.

CHART 16

RELATIONSHIP BETWEEN MONEY GROWTH AND INFLATION
(1960-2003 AVERAGE FOR 145 COUNTRIES)



Source: IMF Database, IFS CD, November 2004.

The mandate of pursuing price stability does not prevent the central bank from implementing counter-cyclical policies that help to keep output at its (potential) productive capacity, thereby smoothing the economic cycle.

A different case arises when the economy is operating above its level of productive capacity. In this context, an expansive monetary policy will accelerate inflation and create unsustainable imbalances. The explanation for this comes in two parts. First, growth in productive capacity is determined by supply factors, mainly by labor growth, the educational standard of the workforce, increase in physical capital, general efficiency in allocating productive resources, the capacity to absorb information technology, the quality of judiciary institutions, and the degree of openness or exposure to competition; these are all real, supply factors. Secondly, the determinants of the supply capacity of economies is not directly and significantly affected by monetary policy; monetary policy has a direct, significant bearing only on the components of aggregate demand and, in the long run, on inflation.

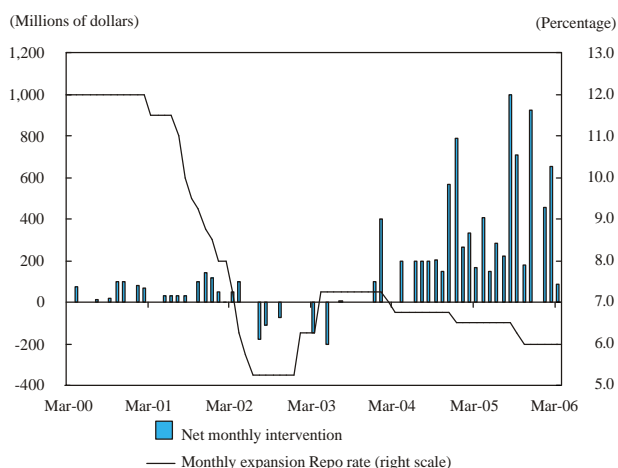
Moreover, instability in the financial system and disorder in the public finances also impose constraints on inflation-targeting policy (monetary policy in general). A central bank may well bring about and maintain a low, stable rate of inflation (with all the benefits already described), but this would be less costly if the fiscal and financial situation contributed to the endeavor. For this reason, among others, it is of key importance to ensure stable and sustainable public finances. It is therefore also essential that the central bank constantly monitor the financial system's condition and the situation of its clients.

To sum up, the prime objective of monetary policy should be price stability. For great benefits arise from low, stable inflation, and monetary policy has a systematic, sustained effect on the level of inflation. Moreover, the mandate of pursuing price stability does not prevent the central bank from

implementing counter-cyclical policies that help to bring output close to its potential productive capacity, thereby smoothing the economic cycle. As described below, these ideas have guided the country's monetary and exchange-policy decisions.

CHART 17

NET MONTHLY INTERVENTION AND EXPANSION REPO RATE (AVERAGE)



Source: Banco de la República.

2. The Board of Directors' policy actions in 2005

The year 2005 was characterized by easy monetary policy, with active intervention by the Banco de la República in the exchange market, and no changes in the intervention interest rate

until September, when the Board reduced it by 50 bp (half a percentage point) (Chart 17). From September until its monthly meeting in March 2006, the Board did not alter its stance and kept the interest rate for expansion Repos unchanged at 6%.

In 2005, under the exchange-rate intervention policy the Banco de la República made discretionary purchases of \$4,658 m, which exceeded the previous year's purchases (\$2,905 m) by more than \$1,700 m. Sales of international reserves to the government in 2005 amounted to \$3,250 m (Table 4). Between January and February 2006 central-bank intervention in the exchange market totaled \$1,110.7 m and reserves sales to the government \$1,000 m, giving a net intervention of \$110 m, which was less than the figure for 2005.

The following factors have facilitated the Board of Directors' decisions to maintain an easy monetary stance:

- i. The inflation target was met in 2005, and developments in 2006 suggest that it will be met this year.
- ii. Inflation expectations have decreased considerably and are more in line with the target in 2006 than in previous years.
- iii. The peso's sustained appreciation has reduced tradables inflation to low, stable levels below the inflation target.
- iv. Investment in machinery, plant and equipment has risen sharply, which may reflect higher productive capacity in the economy.

The foregoing does not mean that there are no inflationary medium- or long-term risks. In particular, the following potential sources of future inflationary pressure should be taken into account:

- i. Colombia's economy is growing in favorable domestic and foreign conditions that have made it possible for domestic demand to increase rapidly (by more than 6% on average). Moreover, these conditions are forecast to persist, which means that the strength of aggregate spending in the economy could begin to induce inflationary demand pressure.
- ii. In effect, despite higher investment, available economic-activity indicators suggest that overcapacity in the economy is dwindling steadily.
- iii. Real interest rates have remained low for several years relative to their historical pattern, reflecting an expansionary monetary policy.

Monetary policy should evaluate changes in the economy and its prospects in a careful, detailed and continuing manner, to forestall any unsustainable economic-growth or price dynamic.

As shown by international developments and Colombia's own experience over the past decade, the economy's departure from its sustainable path eventually results in crisis, higher unemployment and greater poverty.

- iv. Recent pay rises, including increases in the minimum wage, could begin to generate cost pressures, though that would depend on the size and permanence of productivity gains.
- v. The Bank's estimates indicate that food inflation will continue to bring down inflation in 2006 but might work in the opposite direction in 2007.

The existence of these factors suggests that monetary policy should evaluate changes in the economy and its prospects in a careful, detailed and continuing manner, to forestall any unsustainable economic-growth or price dynamic. As shown by international developments and Colombia's own experience over the past decade, the economy's departure from its sustainable path eventually results in crisis, higher unemployment and greater poverty.

B. EXCHANGE-RATE MOVEMENTS IN 2005

1. Nominal and real exchange rates

At the end of 2005 the Colombian peso's nominal exchange rate against the dollar was 2,2.84 pesos, down by 4.4% on a year earlier. This signified a 3.0% real annual appreciation (deflated by the PPI), against the basket of currencies of Colombia's trading partners (Charts 18 and 19 and Table 5). The exchange rate's behavior was less volatile in 2005 than in the two previous two years.

TABLE 4

FOREIGN-CURRENCY PURCHASES AND SALES BY BANCO DE LA REPÚBLICA (MILLIONS OF DOLLARS)

| | 2004 | 2005 | | | | | 2006 | | |
|----------------------------------|----------------|----------------|--------------|----------------|----------------|----------------|----------------|--------------|----------------|
| | | I Qtr. | II Qtr. | III Qtr. | IV Qtr. | Jan-Dec accum. | Jan. | Feb. | Jan-Dec accum. |
| Purchases | 2,904.9 | 773.8 | 841.3 | 1,935.0 | 1,108.3 | 4,658.4 | 454.7 | 655.9 | 1,110.7 |
| Put options | 1,579.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| For int'l. reserves accumulation | 1,399.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| For volatility control | 179.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Directional intervention | 1,325.3 | 773.8 | 841.3 | 1,935.0 | 1,108.3 | 4,658.4 | 454.7 | 655.9 | 1,110.7 |
| Sales | 500.0 | 1,250.0 | 0.0 | 700.0 | 1,300.0 | 3,250.0 | 600.0 | 400.0 | 1,000.0 |
| Government | 500.0 | 1,250.0 | 0.0 | 700.0 | 1,300.0 | 3,250.0 | 600.0 | 400.0 | 1,000.0 |
| Net purchases | 2,404.9 | (476.2) | 841.3 | 1,235.0 | (191.7) | 1,408.4 | (145.3) | 255.9 | 110.7 |

Source: Banco de la República.

As explained in greater detail in the following section, various factors have helped to maintain the trend toward appreciation in almost all countries of the region since 2001 (Chart 20). The external context usually makes the exchange rates of emerging economies volatile; remember that recent years' appreciation is reversing the depreciation of late 2002 and early 2003, when nominal and real exchange rates reached historical peaks.

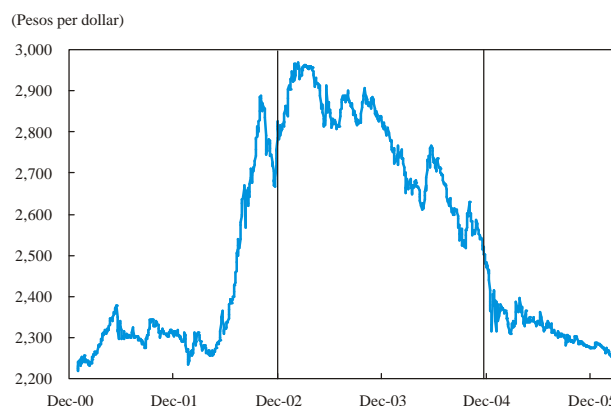
Previous Reports to Congress⁸ stated that the exchange-rate appreciation of recent years had occurred in a context of low external interest rates, fostered by the US Federal Reserve's decisions to keep real interest rates low to stimulate the US economy.⁹ This led to excess international liquidity being directed toward attractive investment markets outside the United States. The emerging economies' good pace of growth attracted investor confidence, which in turn was reflected by lower country-risk premiums, resulting in currency appreciation in these countries, particularly in Latin America. The biggest appreciations in Latin American currencies against the dollar in 2005 occurred in the Brazilian real (12.1%), Chilean peso (7.9%) and Colombian peso (4.4%).

Table 6 and Chart 21 show what happened to the Colombian peso in real terms against the currencies of the country's main trading partners, between 2002 and 2005. The Colombian peso at the close of 2005, relative to its year-end value in 2001, had

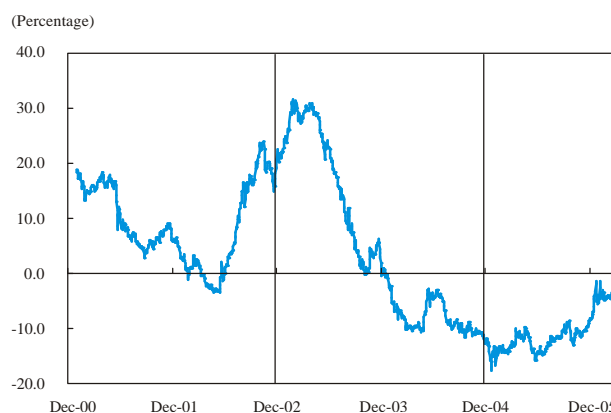
⁸ See the March and August 2005 Reports to Congress.

⁹ At the end of 2001 the Fed maintained an expansionary monetary policy, cutting its benchmark rate by 500 bp; the US economy's growth for that year was 0.8%. From 2001 to mid-2004 the Fed kept real interest rates even negative. A more detailed analysis of the US economy's situation is provided in the January 2006 *Inflation Report*.

REPRESENTATIVE MARKET EXCHANGE RATE

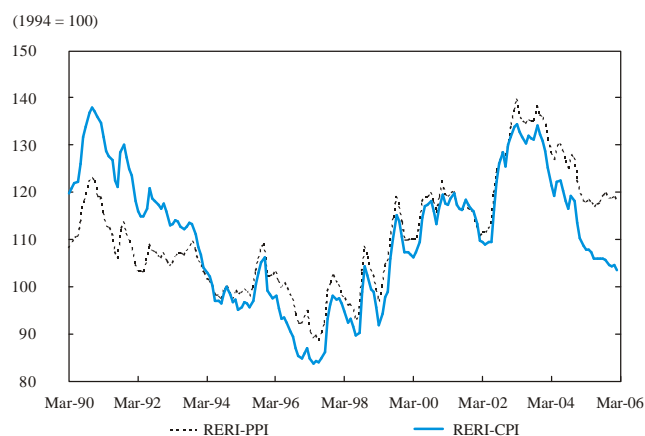


ANNUAL NOMINAL DEPRECIATION



Source: Banco de la República.

REAL EXCHANGE-RATE INDEX



Source: Banco de la República.

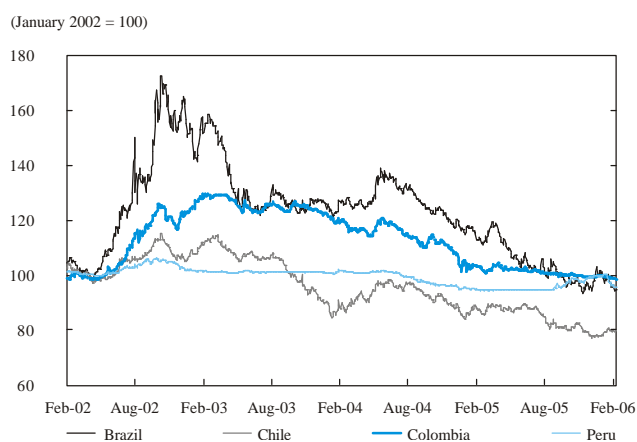
TABLE 5

NOMINAL AND REAL EXCHANGE RATES

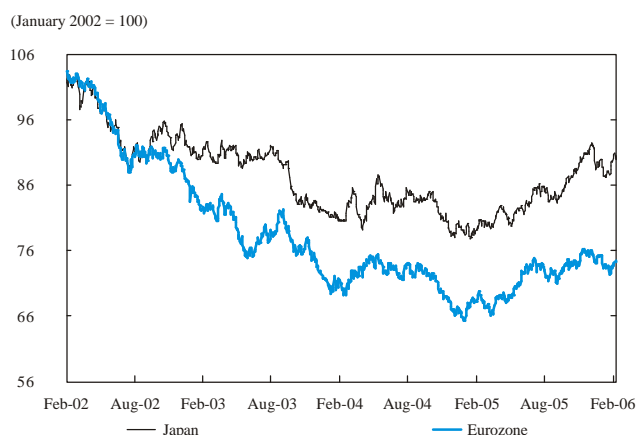
| | Year-end | | | Full-year average | | |
|--------------------------|----------|---------|---------|-------------------|---------|--------------|
| | 2004 | 2005 | Feb-06 | 2004 | 2005 | Jan-Feb 2006 |
| Nominal exchange rate | | | | | | |
| Pesos per dollar | 2,389.8 | 2,284.2 | 2,247.3 | 2,626.2 | 2,320.8 | 2,265.2 |
| Annual percentage change | (14.0) | (4.4) | (3.3) | (8.7) | (11.6) | (3.7) |
| Real exchange rate (PPI) | | | | | | |
| Index 1994 = 100 | 122.6 | 119.0 | 118.4 | 128.3 | 118.5 | 118.7 |
| Annual percentage change | (9.8) | (3.0) | 0.0 | (5.7) | (7.7) | (0.3) |
| Real exchange rate (CPI) | | | | | | |
| Index 1994 = 100 | 113.5 | 104.8 | 103.6 | 120.4 | 106.8 | 109.5 |
| Annual percentage change | (13.3) | (7.7) | (4.6) | (9.0) | (11.3) | (4.9) |

Source: Banco de la República.

CHART 20

EXCHANGE RATES OF VARIOUS LATIN AMERICAN CURRENCIES AGAINST THE DOLLAR
(NOMINAL EXCHANGE RATE INDEX)

EURO AND YEN NOMINAL EXCHANGE-RATE INDICES



Source: Bloomberg.

depreciated in real terms against the US dollar (1.9%), the euro (16.7%), pound sterling (5.8%), Brazilian real (38.0%) and Chilean peso (35.6%). It had appreciated against other currencies of the region: Mexico (10.63%), Venezuela (10.1%), Peru (10.1%), Argentina (64.9%) and Ecuador (1.2%). Note that between 2002 and 2005 the Colombian peso maintained its value in real terms against its main trading partners, even showing a real depreciation of 2.7%, despite its nominal appreciation of 16% between those two years.

2. Factors responsible for exchange-rate behavior in 2005

Different factors were responsible for the continuation in 2005 of the currency appreciation trend that many emerging countries began to exhibit from some years before. Real interest rates remained low in international markets from late 2001 on, supported by the Fed's expansive monetary policy. Low yields and lack of investor confidence in the sustainability of the US economy's macroeconomic imbalances boosted demand for overseas financial assets, causing the dollar to depreciate against most currencies in the world. Thus, the international markets' ample

**COLOMBIAN PESO'S REAL AND NOMINAL DEPRECIATION
(PERCENTAGE)**

| Country | Weightings | Nom. exch. rate index ^{1/} | | Real exch. rate index - PP1 ^{1/} | |
|--------------------------------------|--------------|-------------------------------------|---------------|---|--------------|
| | | 2005 | 2002-2005 | 2005 | 2002-2005 |
| Industrialized | | | | | |
| United States | 43.2 | (5.5) | (1.2) | 0.6 | 1.9 |
| Europe ^{2/} | 10.3 | (15.9) | 31.1 | (14.7) | 16.7 |
| Japan | 2.6 | (17.1) | 6.5 | (17.3) | (12.0) |
| United Kingdom | 1.7 | (14.0) | 19.5 | (13.1) | 5.8 |
| Switzerland | 2.9 | (17.0) | 25.1 | (17.8) | 3.9 |
| Canada | 1.3 | (1.1) | 34.1 | 0.4 | 15.8 |
| Sweden | 0.5 | (20.4) | 31.1 | (15.8) | 17.5 |
| External | 62.5 | (8.7) | 8.5 | (3.9) | 6.1 |
| Developing | | | | | |
| Mexico | 5.0 | (0.7) | (14.9) | 0.5 | (10.6) |
| Venezuela | 12.0 | (15.6) | (65.4) | (5.0) | (10.1) |
| Ecuador | 6.6 | (5.5) | (1.2) | (3.3) | (1.2) |
| Brazil | 4.0 | 11.2 | 2.1 | 10.2 | 38.0 |
| Chile | 2.4 | 5.0 | 28.1 | 10.9 | 35.6 |
| Peru | 3.3 | (9.3) | (0.9) | (8.5) | (10.1) |
| Panama | 3.3 | (5.5) | (1.2) | (3.5) | (12.6) |
| Argentina | 0.9 | (6.9) | (67.3) | (2.2) | (64.9) |
| External | 37.5 | (7.7) | (35.7) | (1.6) | (5.5) |
| Total external | 100.0 | (9.4) | (16.0) | (3.0) | 2.7 |
| Other countries ^{3/} | | | | | |
| China | | (3.2) | 1.2 | (6.5) | (14.4) |
| Korea | | (2.9) | 24.9 | (4.9) | 12.3 |

^{1/} Changes in year-end figures.

^{2/} Germany, Holland, Spain, France, Italy and Belgium.

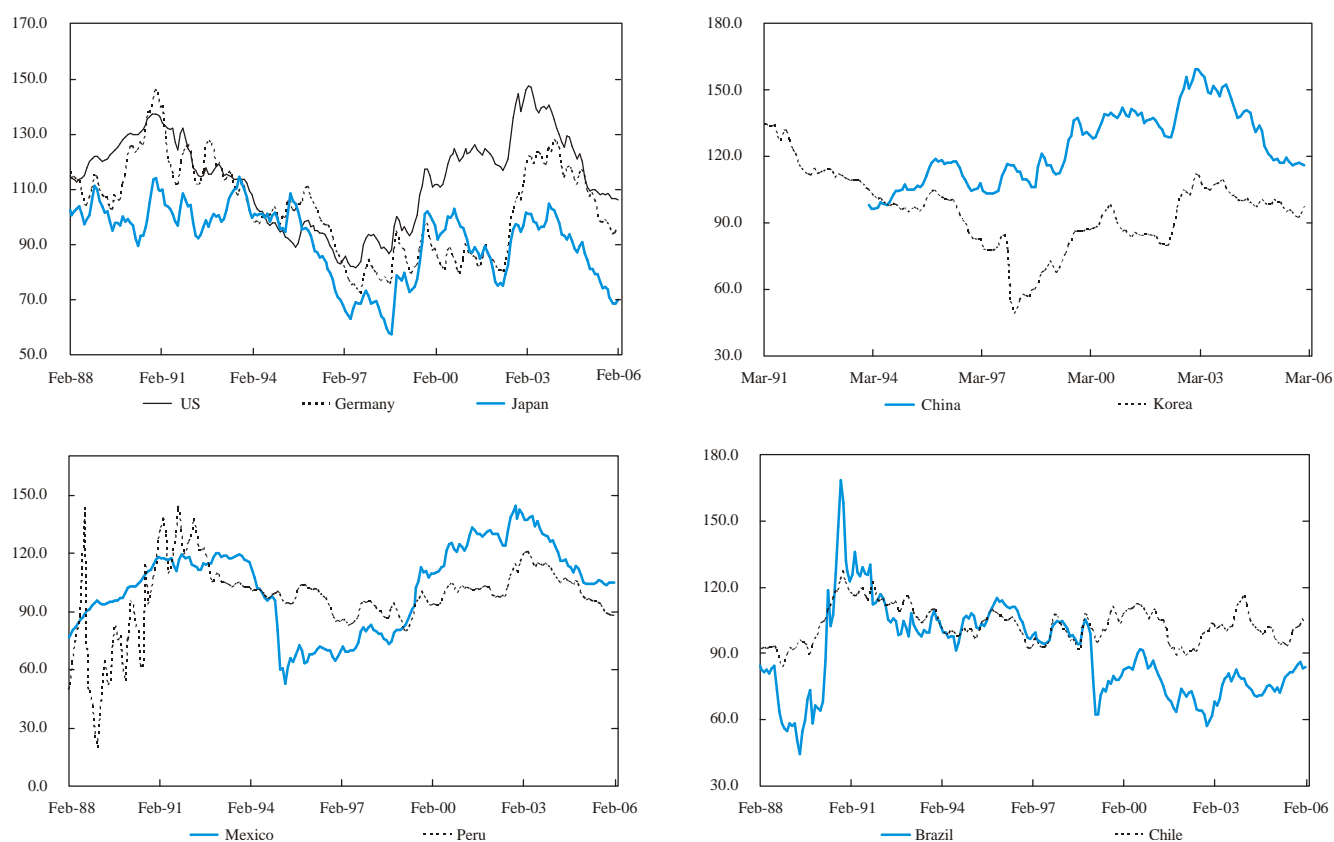
^{3/} For these countries the real exchange-rate index is deflated by the CPI.

Source: Calculations by Banco de la República.

liquidity was drawn toward emerging economies, which saw their country-risk spreads fall steeply. The satisfactory performance of these economies in 2004 and 2005 maintained investor confidence and with it the inflows of capital.

In addition, satisfactory performance by the US economy recently and especially by China and India has driven world growth and kept commodity prices at historically high levels. Colombia, like all other Latin American countries, has benefited from that external context and has, moreover, profited from the good growth of its trading partners, which have also been strengthened by high oil prices, ensuring it an expanding overseas demand.

BILATERAL REAL EXCHANGE-RATE INDICES WITH A NUMBER OF COUNTRIES
(GEOMETRIC MEAN 1994 = 100)



Source: Banco de la República.

a. International context

World economic growth in 2005 proved better than initially forecast, though weaker than in 2004. The economies of the United States and China continued to drive growth, despite high oil prices and natural disasters. Japan's economic activity improved considerably, thanks to highly buoyant domestic demand. The eurozone staged a strong recovery, produced by improvement in exports and investment and, to a lesser extent, in private consumption.

Despite high oil prices, inflation remained stable in major developed countries. Core inflation was 2.2% in the United States and 1.5% in the eurozone, and their central banks continued to raise interest rates gradually. The United States' cycle of benchmark interest-rate rises started in mid-2004. The Fed was prompted to remove the monetary-policy stimulus by figures connected with economic growth and inflation. The US economy seemed to be on a solid growth path (as reflected by labor-market recovery and faster production-growth rates), and increases were seen in

core inflation, workers' real compensation, and short-term inflation expectations.

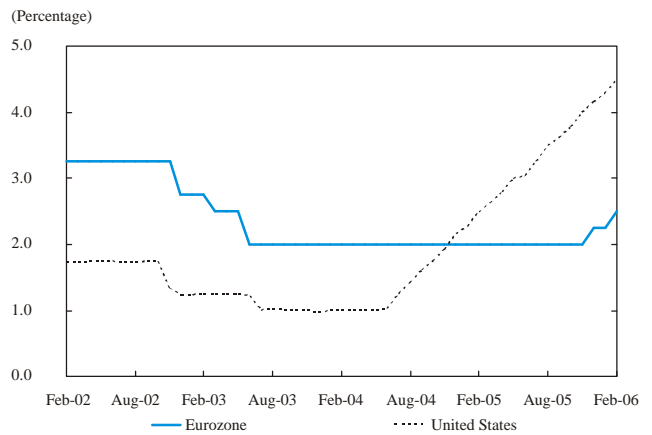
The Fed's benchmark rate was raised by 200 bp over the course of 2005 and stood at 4.25% in December. The European Central Bank lifted its rate by 25 bp, to 2.25%, in December, this being the first increase in the rate since June 2003 (Chart 22). The European monetary authorities had considered this move several months before, arguing that the monetary aggregates' accelerated growth trend posed risks of rising inflation. The above rate increases were not, however, reflected by similar rises in long-term interest rates, particularly in the United States (Chart 23). As a result, the yield curve¹⁰ continued to level off, a trend began more than a year before. As pointed out in previous reports, low long-term US interest rates are the outcome of an abundant demand for US securities that reflects a surplus of external world savings, chiefly on the part of countries exporting oil and other commodities. Purchases by central banks (particularly of Japan and China) and by pension funds have also affected yield-curve behavior.

In contrast to what happened in 2003 and 2004, the US dollar appreciated in 2005 against the yen (14%) and euro (13%), in nominal terms. The yen's and euro's depreciation against the dollar resulted from the fact that capital flows were not directed toward Europe and Japan, and from the relative weakness of their economies. Since December, however, both the yen and euro have been strengthened by better prospects for growth (Chart 20).

Like the industrialized countries, emerging economies too performed well 2005. Exports were still the main source of growth for Asian economies.

CHART 22

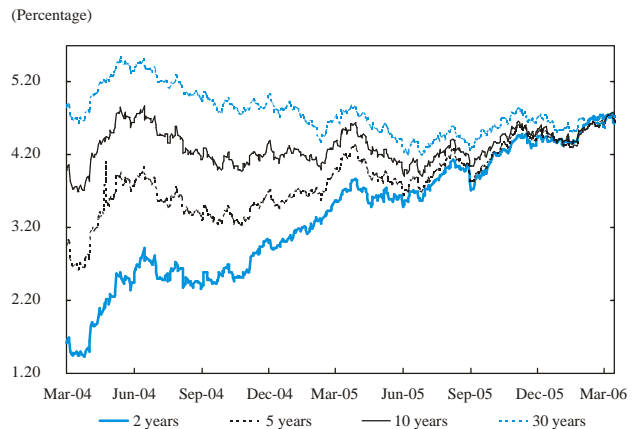
US AND EUROZONE
MONETARY-POLICY RATES



Source: European Central Bank and Datastream.

CHART 23

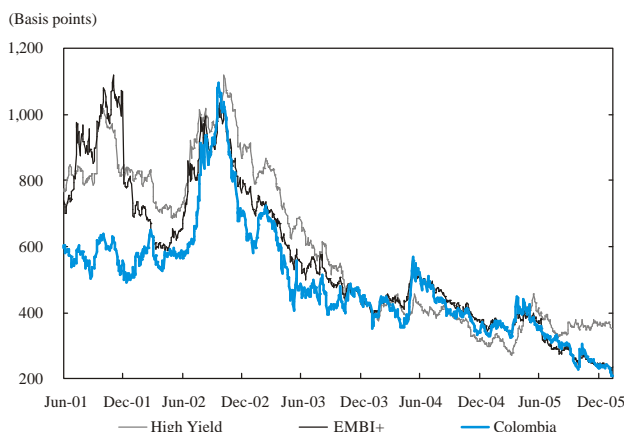
US BOND
INTEREST RATES



Source: Datastream.

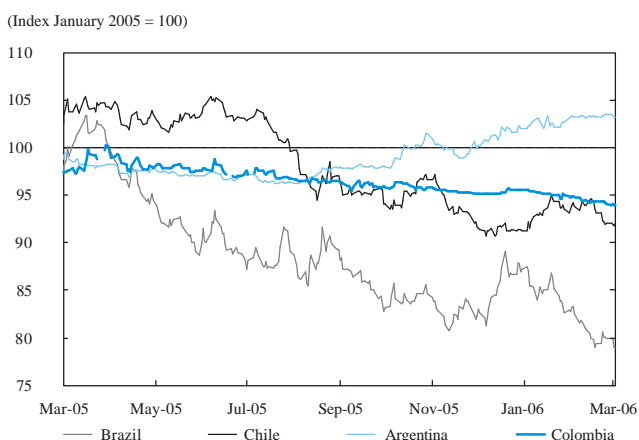
¹⁰ The yield curve reflects the weighted yield on securities with different maturities. In principle, the yield rate should be higher for longer-term securities.

EMBI+ AND HIGH-YIELD JUNK BOND SPREADS



Source: Bloomberg.

EXCHANGE RATES OF VARIOUS LATIN AMERICAN CURRENCIES AGAINST THE DOLLAR



Source: Datastream.

The Chinese economy continued to expand vigorously, at an estimated annual rate of 9.9%. And though exports were still the engine of growth they slowed in 2005, in part because of the yuan’s real appreciation (10.0%) against China’s main trading partners.¹¹ The slowdown in exports was offset by a considerable strengthening of domestic demand, including in particular higher investment.

In Latin American economies, among them Colombia’s, exports continued to be driven in 2005 by strong external demand, plentiful international liquidity and relatively high commodity prices. In this context, the country-risk premium for emerging economies continued to fall, and by December 2005 it was 150 bp below the upturn it had shown in April (Chart 24). Colombia’s risk spread dropped by more than 200 bp. All the above helped to extend the major Latin American currencies’ trend toward appreciation against the dollar in 2005.

b. Appreciation in Colombia

In 2005 Colombia’s economy continued to benefit from the external context. The terms of trade remained at historically high levels, and the growth of the country’s trading partners ensured it an expanding external demand. At the same time, the economy’s satisfactory performance drove the country-risk spread ever lower, which, together with plentiful international liquidity and still-low external interest rates compared with domestic ones, helped to extend the Colombian peso’s trend toward appreciation against the dollar.

¹¹ The yuan appreciated by 2.6% against the US dollar. Source: J.P. Morgan, January 2006.

The year 2005 brought further increases, at annual rates, in world prices for Colombia's main exports: (coffee 31%), oil (30%) and coal (31.5%) (Charts 25 and 26). In addition, gold and nickel prices rose by 9.0% and 7.0%, respectively. The country's terms of trade were also improved by lower prices for some imports relative to their 2004 averages: corn (12%), sorghum (12.4%) and wheat (1%).

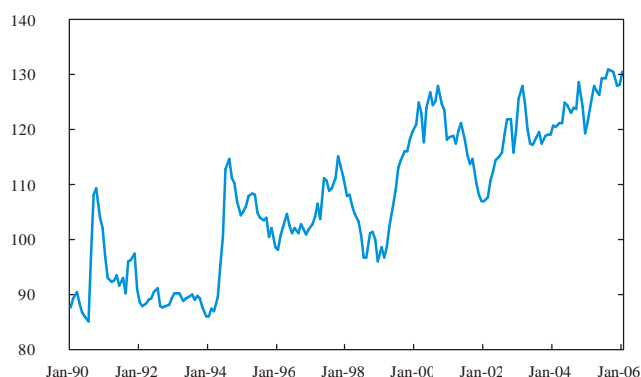
Good external demand, driven by growth in Venezuela and the United States, together with high terms of trade, worked in favor of the export sector, which saw overall sales rise by 26.6% in current dollars. The expansion was strong in both traditional exports (35.3%) and nontraditional ones (19.3%), with Venezuela and the United States becoming consolidated as the main markets for Colombia's industrial exports (Chart 27).

Net transfer income, which includes remittances and donations from abroad, amounted to some \$3,900 m, up by 7% on 2004. According to preliminary figures, income from remittances may have been slightly higher than the level of around \$3,200 m maintained in the previous two years.

Capital inflows in 2005 came mostly from foreign direct investment (\$5,220 m), and to a lesser extent from foreign debt and portfolio movements (\$857 m). The year 2005 was a particularly good one for FDI flows, which were largely boosted by sell-off decisions of a number of manufacturing- and financial-sector companies (Coltabaco, Bavaria, Granahorrar, among others), and also by the signing of oil-prospecting contracts. FDI capital inflows were partly offset by the public sector's policy to prepay its foreign debt and increase its holdings of local-currency assets, which signified a net outflow of \$2,927 m.

The appreciation pressures exerted on the peso by all the above factors were mitigated by the Bank's currency purchases, much of which was

TERMS OF TRADE
(GEOMETRIC MEAN OF 1994 = 100)

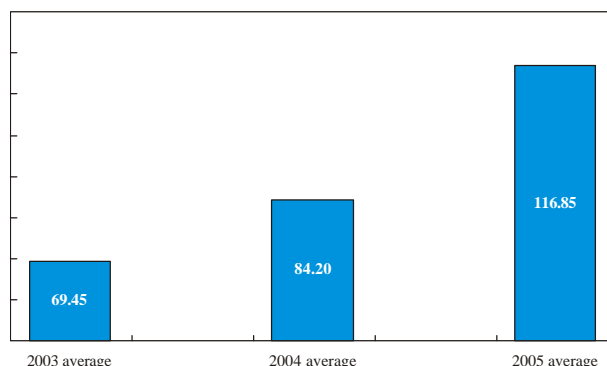


Source: Banco de la República.

INTERNATIONAL COFFEE AND OIL PRICES (*)

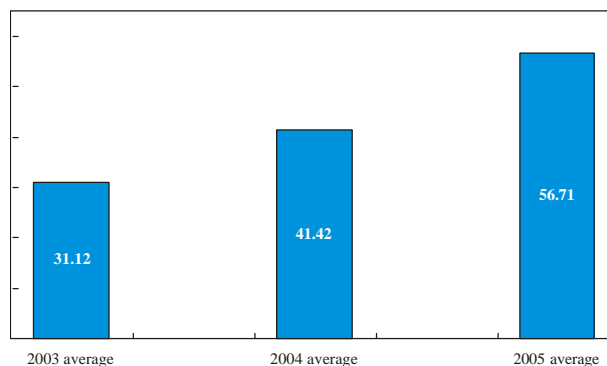
COFFEE

(Cents/lb.)



WTI OIL

(Dollars/barrel)



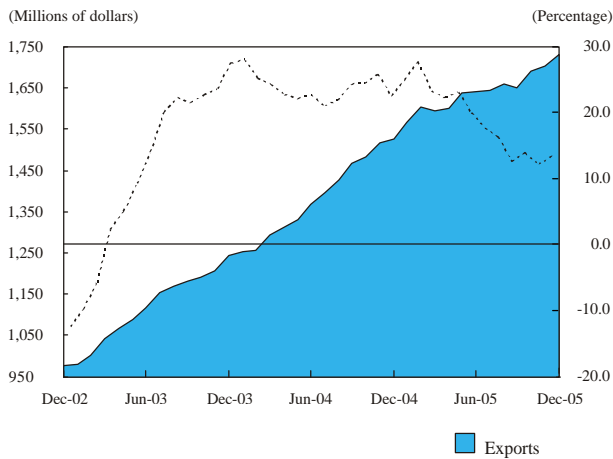
(*) International prices rises differ from those of domestic products by reason of quality. Source: Datastream.

sold in turn to the government. The public sector thus helped to counteract in part the excess foreign exchange on the market. Chapter V provides greater detail on capital flows and current-account operations in 2005.

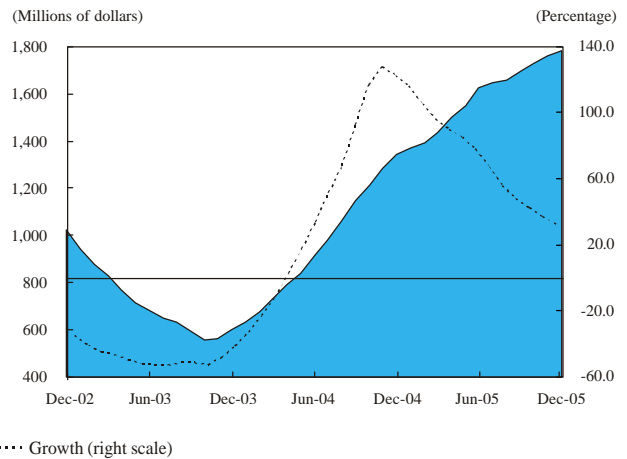
CHART 27

NONTRADITIONAL INDUSTRIAL EXPORTS TO:

UNITED STATES



VENEZUELA



Source: DANE.

Box 2

NOMINAL AND REAL EXCHANGE RATES:
THEIR SIGNIFICANCE AND DETERMINANTS

Nominal exchange rate (NER)

The nominal exchange rate is defined as the price of one unit of foreign currency in terms of the local currency. Its variations are known as nominal devaluation (depreciation) when the NER increases, and as nominal revaluation (appreciation) when it decreases.

Variations in the price of the US dollar expressed in pesos are commonly used as an estimation of the NER. But that is not the best approach, for the peso's variation against the currencies of countries Colombia trades with need also to be considered.

It is natural for the nominal exchange rate to be volatile and its future behavior uncertain. As the NER is an asset price, it can be affected by market expectations and the information available to agents. So, for instance, its variations may reflect present or expected changes in economic variables that alter national income permanently or transitorily. It may also happen that agents anticipate higher (lower) income from foreign capital, because, for example, they perceive that external rates will remain low (high) or that the country-risk perception will improve (deteriorate).

Real exchange rate (RER)

The real exchange rate is a relative price that compares the value, in the same currency, of a basket of goods in two different countries. A relative price reflects how many units of one good should be received in exchange for one unit of another, and it is obtained by dividing the price of one good by the price of the other article, both expressed in the same currency. The real exchange rate is expressed as:

$$RER = E \times P^* / P$$

E: the nominal exchange rate

*P**: external price level

P: domestic price level

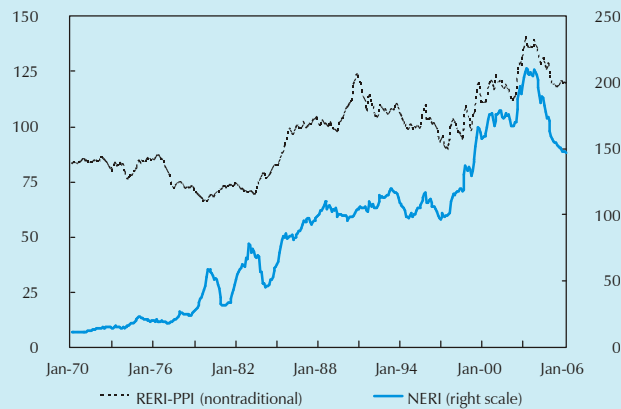
Note that the real exchange rate can also be interpreted as a comparative measure of the purchasing power of one currency vis-à-vis another. A rise in the real exchange rate, resulting for example from a nominal devaluation or a fall in domestic prices, reflects greater purchasing power for the foreign currency in a given country, thus encouraging the sale of domestic goods abroad and discouraging imports.

But the foregoing does not necessarily mean that a nominal devaluation will generate a real depreciation in the long run. That will depend on the behavior of external and domestic prices. If the nominal depreciation is accompanied by a rise in domestic prices higher than the rise in external prices, the real exchange rate could even decrease.

Chart B2.1 shows movements in the nominal and real exchange rates since 1970. Between 1970 and 1980 the exchange rate depreciated by 17.7% a year in nominal terms but appreciated by 1.9% a year in real terms, on average. By contrast, in the nineties up to 1997 it depreciated by 0.4% a year in nominal terms and appreciated by

0.75% a year in real terms. In more recent years, particularly between 1997 and 2002, both rates have exhibited a depreciation trend (9.5% the nominal rate and 3.2% the real rate).

CHART B2.1
REAL AND NOMINAL EXCHANGE-RATE INDICES



Source: Banco de la República.

Measuring the real exchange rate

The real exchange rate is used to estimate our currency's purchasing-power gain or loss with respect to other currencies. It is also a means of monitoring the competitiveness of our products. Increases in the real exchange rate (devaluation) are interpreted as an improvement in competitiveness, because domestic products become less costly than those of other countries in the international market. For their part, reductions in the real exchange rate (appreciation) reflect a rise in the price of domestic products relative to other countries' products and hence lower competitiveness.

There are different real exchange rate indices. The first step in building an overall RERI is to calculate a bilateral index for each country. The Banco de la República calculates individual indices for all our trading partners and for countries we compete with in international markets.

The bilateral indices are then aggregated by means of a weighting system to obtain overall RERIs. The weighting used for trading partners is based on bilateral trade (total and nontraditional). In the case of competitors, each country is weighted by its significance in the foreign markets in which Colombian products are present.

The difference between these criteria can be explained by considering Venezuela and China. Venezuela is a very important trading partner but not a big competitor

for Colombian exports. By contrast, we have no significant bilateral trade with China, but China is a major competitor for Colombian goods (particularly textiles and garments).

Table B2.1 shows movements in bilateral real exchange rates with our major trading partners and China, a competitor. It will be observed that these rates have depreciated more in the present decade relative to their nineties' levels.

TABLE B2.1
AVERAGE BILATERAL REAL EXCHANGE-RATE INDICES
BETWEEN COLOMBIA AND ITS MAIN TRADING PARTNERS

| | Index | | |
|---------------|-----------|-----------|-----------|
| | 1980-1989 | 1990-1999 | 2000-2006 |
| United States | 90.8 | 104.2 | 125.3 |
| Venezuela | 111.2 | 113.1 | 170.3 |
| Ecuador | 90.7 | 91.9 | 114.4 |
| Mexico | 70.8 | 92.5 | 128.6 |
| Brazil | 52.4 | 93.6 | 108.6 |
| China 1/ | 173.0 | 125.2 | 135.7 |

1/ Information available since January 1976.
Source: Banco de la República.

Colombia, like most countries, uses a geometric method for aggregating the bilateral indices of the difference countries. There are two types of base period in an index: the weighting base year, and the comparison or reference base year.

In Colombia, starting from 2002 the index is calculated using moving weightings, updated monthly. The idea with this procedure is to bring into play changes to the trade structure and, hence, each country's part in the RERI. In this way, the weightings structure is updated periodically. The preceding 12 months' available information is used, thereby avoiding fluctuations in the index from the seasonal nature of trade.¹

For example, Table B2.2 shows that in 2005 the United States accounted on average for 43.2 % of Colombia's trade, compared with 42.0% in 2002. Accordingly, this change

¹ En Colombia se utilizó un índice de ponderaciones fijas hasta el año 2002 (estructura de comercio de 1994); esa metodología establecía la estructura de ponderaciones constante durante un período de tiempo y estaba sujeta a la pérdida de representatividad cuando se producían cambios significativos en la estructura económica,

in the weighting of countries is captured in calculating the bilateral and overall real exchange-rate indices.

TABLE B2.2
MAIN TRADING PARTNERS' SHARE
OF NONTRADITIONAL TRADE
(IMPORTS + NONTRADITIONAL EXPORTS)

| Country | 2002 | 2005 |
|---------------|------|------|
| United States | 42.0 | 43.2 |
| Venezuela | 10.6 | 12.0 |
| Ecuador | 5.0 | 6.6 |
| Mexico | 3.7 | 5.0 |
| Brazil | 3.8 | 4.0 |
| Germany | 4.2 | 3.5 |
| Peru | 2.9 | 3.3 |
| Panama | 3.7 | 3.3 |
| Switzerland | 2.0 | 2.9 |
| Japan | 4.3 | 2.6 |
| Chile | 2.7 | 2.4 |
| Spain | 2.1 | 1.7 |
| England | 1.4 | 1.6 |
| Italy | 2.2 | 1.6 |
| France | 2.9 | 1.5 |
| Belgium | 2.0 | 1.3 |
| Canada | 1.5 | 1.3 |
| Argentina | 1.1 | 0.9 |
| Holland | 1.2 | 0.8 |
| Sweden | 0.7 | 0.5 |

Source: Banco de la República.

The base year used for comparison in the index is chosen arbitrarily and does not signify that the real exchange rate was in a state of equilibrium in that year. The index numbers are measures of variations, and their levels, in themselves, have no significance. That is to say, choosing a base year is a necessary condition for building the index and is not tied to any economic criteria.

Moreover, the equilibrium real exchange rate is not constant over time, for the factors it depends on may change. Hence, whatever the RER equilibrium level may have been in 1994, it should not be expected to have remained constant. For these reasons, in no circumstances can it be stated that the optimal RER level is the base-year level (that is to say, an index value equal to 100), or that it is desirable to reach that level.

Determinants of the real exchange rate

Given that the real exchange rate is a relative price, its evolution is affected by aggregate supply and demand factors in the economy. In particular, the fundamental determinants of the real exchange rate are the factors that affect the supply and demand of

(internationally) tradable and nontradable goods. The literature mainly stresses the following determining factors or “fundamentals”:

- The relative productivity of the tradables v. the nontradables sectors; an increase in the productivity of Colombia’s tradables sectors (relative to that of the nontradables sectors) generates a real appreciation of the peso.
- The economy’s recurrent revenues: for example, the discovery of an (exportable) natural resource or a permanent increase in workers’ remittances, induce real appreciation of the peso.
- The level of spending, both public and private: a higher level of spending produces real appreciation, because it generates greater demand for nontradable goods and services and thereby an increase in their relative price.
- Agents’ behavior regarding their external assets and liabilities: by involving changes in the supply of and demand for foreign exchange in the domestic market.

C. INTEREST RATES, MONETARY AGGREGATES AND LOAN PORTFOLIO

The Board of Directors decisions to reduce its intervention interest rates by 75 bp in 2004 and by 50 bp in 2005 helped directly to lower the interbank rate and indirectly to bring down lending and borrowing rates in the economy. In 2005 the rate for fixed-term certificates of deposit (DTF rate) fell sharply in nominal terms and stayed relatively stable in real terms. Interest rates for the different types of loan, particularly consumer loans, decreased by more than the central bank’s rates. Regarding liquidity, all monetary aggregates continued on a rising trend, growing at their fastest in five years, by real annual average rates that exceeded nominal GDP growth. In 2005 the increase in broad money, M3, came from growth in both cash holdings and liabilities subject to reserve requirements, with the result that demand for bank reserves expanded, bringing with it a sharp rise in the monetary base.

1. Interest rates

a. *The Banco de la República’s intervention rates*

The Board of Directors reduced its intervention interest rates by 50 bp in September 2005, having kept them unchanged since December 2004, and

The Board of Directors’ decisions to reduce its intervention interest rates by 75 bp in 2004 and by 50 bp in 2005 helped directly to lower the interbank rate and indirectly to reduce lending and borrowing rates.

has again left them unchanged since last September. The effective annual rates for liquidity-easing auctions and window operations now stand at 6.0% and 9.75%, respectively. Tightening operations have been suspended since December 2004 (Table 7).

b. Market interest rates

At the end of 2005 the interbank rate was 5.71%, down by 53 bp on the last working day of 2004 (Chart 28). In real terms, the interbank rate

TABLE 7

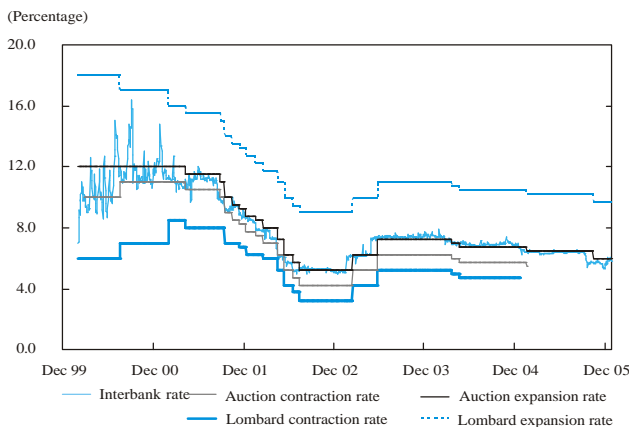
BANCO DE LA REPUBLICA'S INTERVENTION RATES
(PERCENTAGE)

| Effectivity dates: | | Min. contraction rate (Lombard) | Max. auction contraction rate | Min. auction expansion rate | Max. expansion rate (Lombard) | Interbank rate | | |
|--------------------|-----------|---------------------------------|-------------------------------|-----------------------------|-------------------------------|----------------|----------------|-----------|
| From | To | | | | | Period average | End of average | Real rate |
| Dec-17-01 | Jan-18-02 | 6.25 | 7.50 | 8.50 | 12.25 | 8.43 | 7.86 | 0.46 |
| Jan-21-02 | Mar-15-02 | 6.00 | 7.00 | 8.00 | 11.75 | 7.82 | 7.83 | 1.83 |
| Mar-18-02 | Apr-12-02 | 5.25 | 6.25 | 7.25 | 11.00 | 7.29 | 7.21 | 1.48 |
| Apr-15-02 | May-17-02 | 4.25 | 5.25 | 6.25 | 10.00 | 6.15 | 6.04 | 0.19 |
| May-20-02 | Jun-14-02 | 3.75 | 4.75 | 5.75 | 9.50 | 5.69 | 5.63 | (0.58) |
| Jun-17-02 | Jan-17-03 | 3.25 | 4.25 | 5.25 | 9.00 | 5.22 | 5.06 | (2.17) |
| Jan-20-03 | Apr-28-03 | 4.25 | 5.25 | 6.25 | 10.00 | 6.15 | 6.23 | (1.50) |
| Apr-29-03 | Feb-20-04 | 5.25 | 6.25 | 7.25 | 11.00 | 7.41 | 7.38 | 1.03 |
| Feb-23-04 | Mar-19-04 | 5.00 | 6.00 | 7.00 | 10.75 | 7.16 | 7.08 | 0.82 |
| Mar-23-04 | Dec-17-04 | 4.75 | 5.75 | 6.75 | 10.50 | 6.93 | 6.87 | 1.30 |
| Dec-20-04 | Dec-21-04 | 4.50 | 5.50 | 6.50 | 10.25 | 6.62 | 6.63 | 1.07 |
| Dec-22-04 (*) | Sep-16-05 | — | — | 6.50 | 10.25 | 6.39 | 6.00 | 0.93 |
| 19-Sep-05 | 29-Dec-05 | — | — | 6.00 | 9.75 | 5.69 | 5.71 | 0.82 |

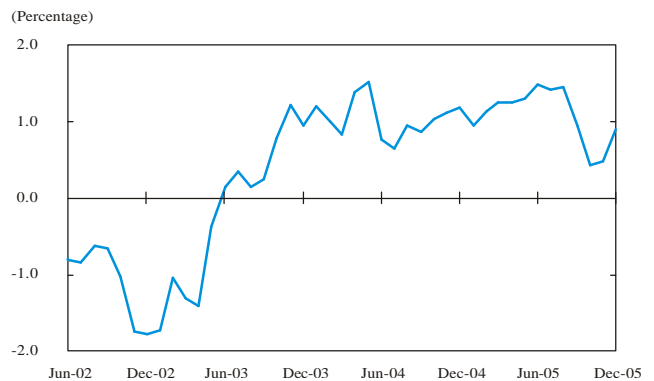
(*) The (auction and Lombard) contraction window has been closed by the Banco de la República since December 22, 2004.
Source: Banco de la República, and Banking Superintendency (interbank rate).

CHART 28

NOMINAL INTERBANK RATE AND BANCO DE LA REPUBLICA'S INTERVENTION RATES (*)



REAL INTERBANK RATE



(*) The (auction and Lombard) contraction window has been closed by the Banco de la República since December 22, 2004.
Source: Banco de la República.

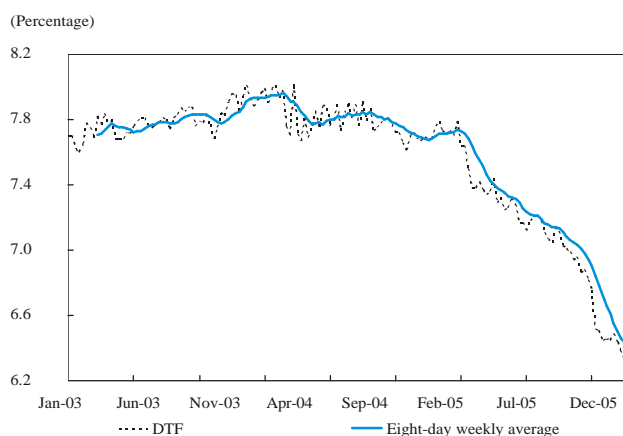
stayed low over the year (averaging 1.08%, compared with 1.04% in 2004), running even below the Bank's interest rate for liquidity-expanding operations. This behavior is largely explained by the abundance of liquidity in the interbank market and the reduction of the Bank's intervention rates by 50 bp on September 16, 2005.

As was to be expected, the Bank's rate cut was transmitted to both deposit and lending rates, in nominal terms. The DTF rate averaged 7.01% in 2005, down by 78 bp on 2004; but lower inflation signified a slight rate increase (8bp) in real terms (Chart 29).

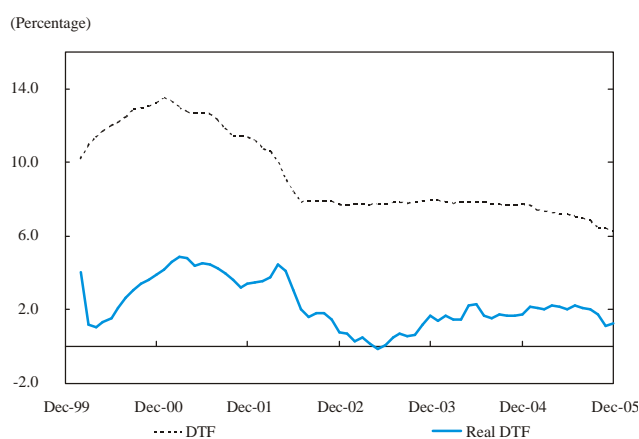
Lending rates, too, fell sharply, ending the year at the following levels, by economic destination: consumer loans 22.7% (real rate 17.0%), ordinary loans 15.6% (real rate 10.2%), preferential loans 9.7% (real rate 4.6%) and treasury loans 8.4% (real rate 3.4%). In every case the fall was bigger than the decrease in inflation, signifying lower real interest rates (Table 8, Chart 30).

INTEREST RATES

NOMINAL DTF



NOMINAL AND REAL DTF (*)



(*) CPI deflated.
Source: Banco de la República.

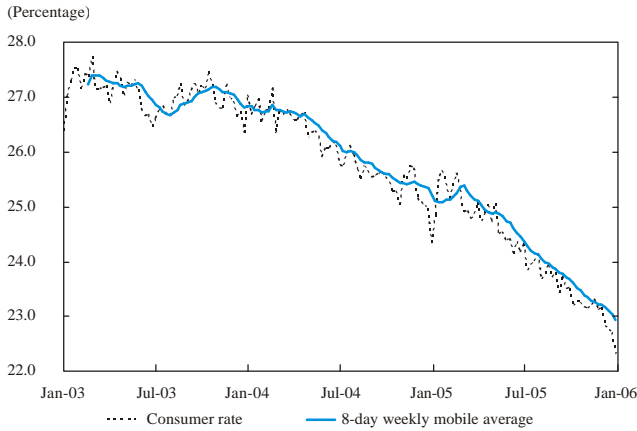
LENDING RATES (*)

| Year | Consumer | | Ordinary | | Preferential | | Treasury | |
|-----------------------|----------|-------|----------|------|--------------|------|----------|------|
| | Nominal | Real | Nominal | Real | Nominal | Real | Nominal | Real |
| 2000 | 33.5 | 22.7 | 20.4 | 10.7 | 18.6 | 9.1 | 16.0 | 6.6 |
| 2001 | 31.3 | 22.0 | 19.4 | 10.9 | 14.1 | 6.0 | 13.9 | 5.8 |
| 2002 | 27.0 | 18.7 | 17.1 | 9.5 | 10.9 | 3.7 | 9.0 | 1.9 |
| 2003 | 26.7 | 19.0 | 16.8 | 9.7 | 11.4 | 4.6 | 10.2 | 3.5 |
| 2004 | 24.9 | 18.4 | 16.7 | 10.6 | 11.3 | 5.5 | 9.5 | 3.8 |
| 2005 | 22.7 | 17.0 | 15.6 | 10.2 | 9.7 | 4.6 | 8.4 | 3.4 |
| 2004-2005 change (bp) | (228) | (144) | (111) | (37) | (158) | (85) | (116) | (46) |

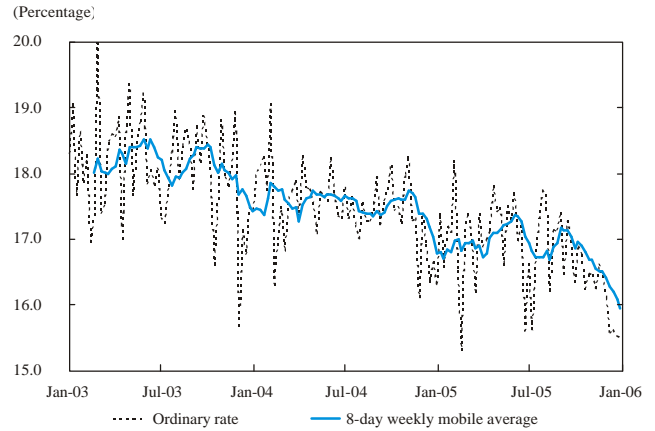
(*) Year-end data.
Source: Banco de la República.

LENDING RATES BY ECONOMIC USE

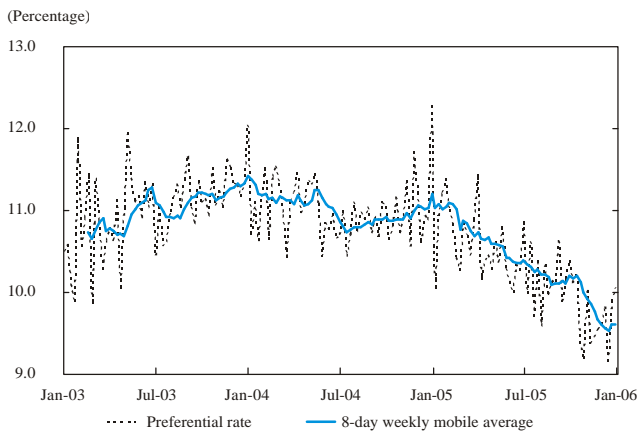
CONSUMER LOANS



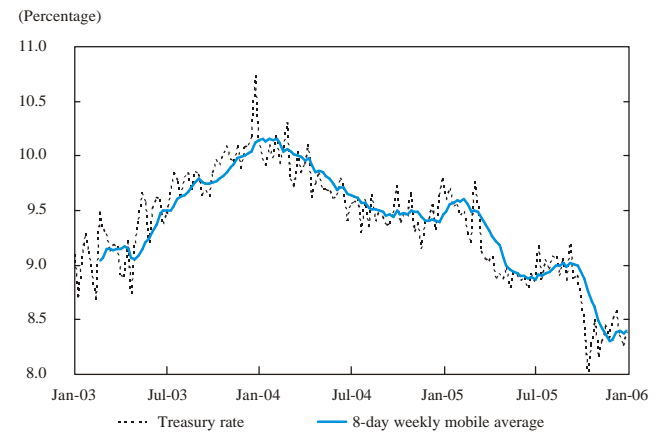
ORDINARY LOANS



PREFERENTIAL LOANS



TREASURY LOANS



Source: Financial Superintendency; calculations by Banco de la República.

c. Interest rates on public-debt securities

In 2005 the domestic market for public debt was characterized by a falling trend in interest rates on the securities, caused largely of the following factors: good levels of liquidity in pesos in the system; international investor demand for emerging-economy securities; lower inflation expectations; good economic results; and appreciation of the peso and other Latin American currencies. The fall in rates was interrupted at some particular junctures associated with uncertainty about movements in external interest rates. As a result of this, during some periods trading rates in the secondary market for TES exhibited strong correlation with US Treasuries.

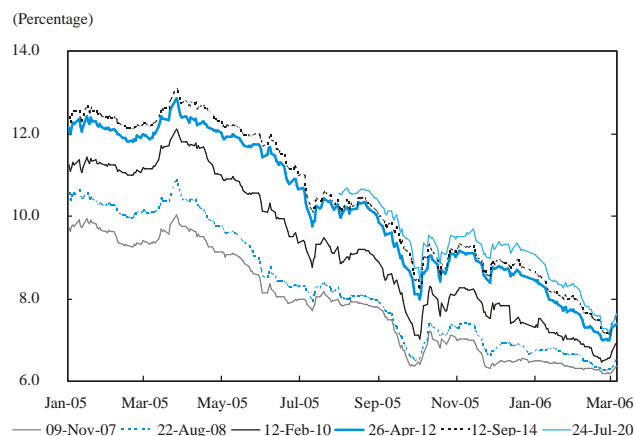
At the end of March 2005 TES rates registered an increase, associated with the Fed's March 22 meeting. At that meeting the Fed not only raised the federal-funds rate but also expressed concern about inflationary pressures in the US economy, giving rise to a perception of faster rate increases. This led to an increase in the US Treasury rate, followed by higher interest rates for foreign-debt securities of emerging economies and, ultimately, by displacement of the yield curve for domestic-debt securities.

In the following months the Fed continued to lift the rate gradually, by 25 bp at each meeting, in line with market expectations. As a result, trading rates for TES securities showed a marked downward trend up until the early part of the fourth quarter (Chart 31). On October 4, 2005 TES rates reached historical lows. From that date until October 14, trading rates in the secondary market for TES were on the rise, boosted again by a change of expectations about movements in international markets.

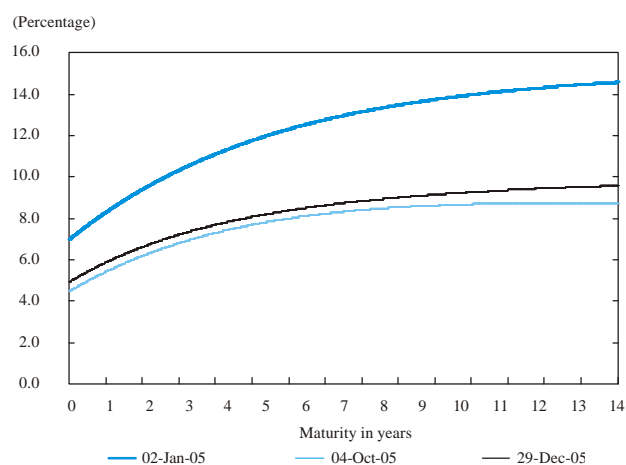
This behavior was associated with the possibility of the start of an ECB rate-increase cycle, hinted at by ECB president J.C. Trichet in statements affirming that he was prepared to raise interest rates at any moment, whereupon Latin American currencies weakened and the prices of emerging-country foreign debt declined. Colombia's country-risk indicator, EMBI Colombia, went up by 27% in that period. The zero-coupon curve for fixed-rate peso TES securities registered an average rise of 96 bp but dropped back partly between late October and November.

Lastly, the economy's third-quarter growth figure (5.75%) and November inflation (5.1%)—a clear indication that the target would be met—allowed the zero-coupon curve for fixed-rate peso TES securities to end the year at levels close to October's lowest (Chart 32).

TES FIXED TRADING RATES IN 'SEN' SECONDARY MARKET (2005)



FIXED-RATE, ZERO-COUPON TES CURVE



The monetary base expanded by an annual average rate of 19.9% in 2005, the sixth year running in which the base grew by more than nominal GDP.

2. Monetary aggregates

The monetary base expanded by an annual average rate of 19.9% in 2005, the sixth year running in which the base grew by more than nominal GDP (Chart 33).

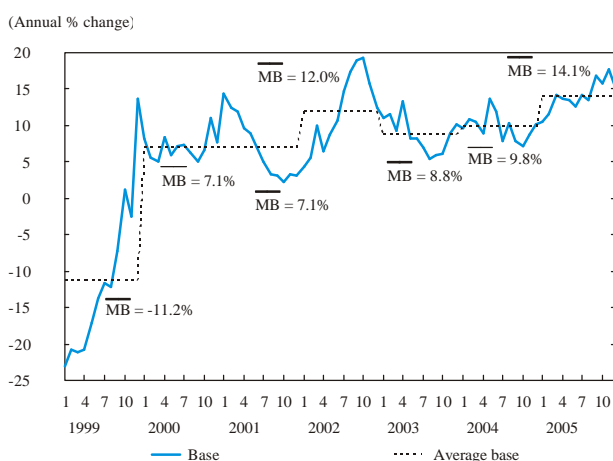
The uses of the monetary base show that its strong growth came from increases in both bank reserves and cash. In nominal and real terms, respectively, the average annual increases in bank reserves were 23.4% and 17.5%, and in cash 18.5% and 12.8% (Chart 34).

The sources of the monetary base's expansion in 2005 were: i) liquidity generated by the Banco de la República's net foreign-exchange purchases of 3,239 bn pesos (resulting from discretionary interventions in the amount of 10,757 bn pesos, less the contraction effected through foreign-exchange sales to the government in the amount of 7,519 bn pesos); ii) higher amounts of expansion Repos (1,539 bn pesos); iii) net expansion of 897 bn pesos from sales and purchases of TES securities and the contractionary effect of yields on securities matured during the year (334 bn pesos); iv) a contraction of 2,636 bn pesos through higher government deposits at the Banco de la República;¹² and v) a net expansion of 505 bn pesos resulting from other factors associated with the Bank's profit and loss statement (Table 9).

¹² Since profit transfer to the government in 2005 was in dollars (\$196 m), it had no monetary effect.

CHART 33

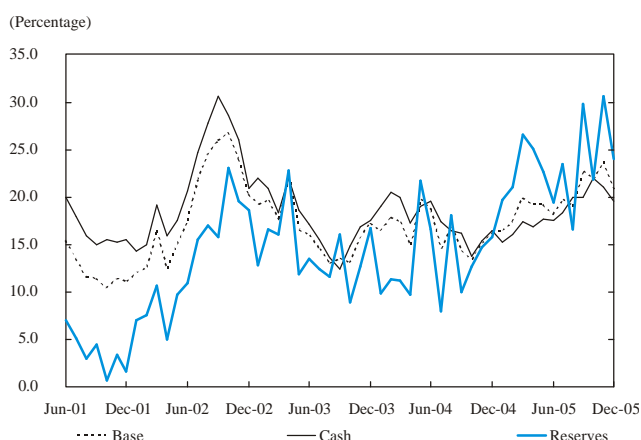
REAL MONETARY BASE



Source: Banco de la República.

CHART 34

MONETARY BASE AND ITS USES (ANNUAL GROWTH RATE OF MONTHLY AVERAGE)



Source: Banco de la República.

MONETARY-BASE SOURCES
(BILLIONS OF PESOS)

| | Annual change | | |
|---|---------------|---------------|---------------|
| | Dec-03 | Dec-04 | Dec-05 |
| I. Government | 914 | (236) | (2,636) |
| Transfer of profits 1/ | 830 | 803 | 0 |
| Pesos | 830 | 803 | 0 |
| Dollars | | 0 | 0 |
| Banco de la República's deposits | 83 | (1,039) | (2,636) |
| II. Regulation TES | 568 | (2,524) | 897 |
| Definite purchases | 893 | 1,023 | 5,230 |
| Definite sales | | (2,972) | (4,000) |
| Matured | (325) | (575) | (334) |
| III. Repos | 1,492 | (1,058) | 1,539 |
| Expansion 2/ | 1,386 | (1,086) | 1,539 |
| Contraction | 106 | 28 | 0 |
| IV. Foreign exchange | (703) | 6,194 | 3,239 |
| Accumulation put options | (703) | 4,183 | 0 |
| Discretionary intervention | 0 | 3,264 | 10,757 |
| Sales of foreign exchange to the government | 0 | (1,252) | (7,519) |
| V. Others 3/ | 239 | 272 | 505 |
| Total change in the base | 2,510 | 2,647 | 3,543 |
| Balance of the base | 16,615 | 19,262 | 22,805 |

1/ Of the 1,483 bn pesos of profits transferred in 2003 to the government, a sum of 651 bn pesos (\$220 m) was in foreign exchange and did not therefore have any expansionary effect. In 2005, the total profit transfer to the government was made in dollars: 454 bn pesos (\$195.9 m).

2/ Includes one-day, overnight and medium-term Repos.

3/ This item includes the monetary effect of the Banco de la República's income statement, TES-A maturities, loan recovery, and the Bank's investments.

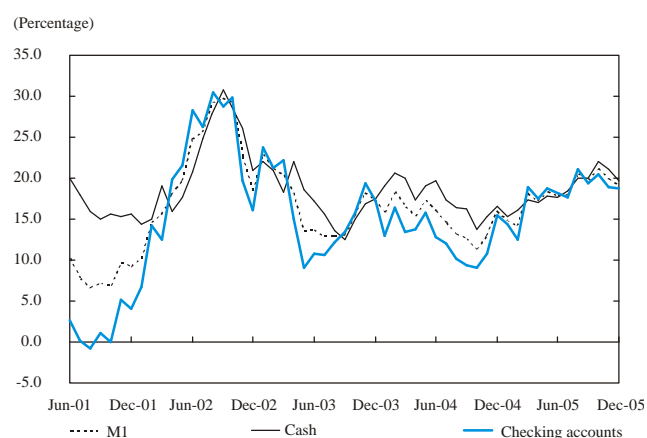
Source: Banco de la República.

In 2005 the average level of the means of payment (M1) rose by an annual rate of 18.2%, up by 3.2 percentage points on 2004. This increase stemmed from growth in both cash (18.5%) and checking-account deposits (18.0%) (Chart 35).

Expansion in broad money (M3), which began in early 2001, speeded up in 2005, reaching rates (17.9% nominal and 12.3% real) far above the pace of economic activity (Table 10 and Chart 36).

Breakdown of M3 by component shows its buoyancy to have come from an annual growth of 18.5% in cash and 18.2% in liabilities subject

CHART 35

M1 AND ITS COMPONENTS
(ANNUAL GROWTH OF MONTHLY AVERAGE)


Source: Banco de la República.

TABLE 10

MONETARY AGGREGATES

| Nominal annual % change in monthly average of weekly data | | | | | | | | |
|---|------|------|----------|------|-------------|------|---------|------|
| | Base | Cash | Reserves | M1 | Quasi-money | M2 | LSR (*) | M3 |
| Jan-04 | 16.5 | 19.0 | 9.9 | 15.8 | 9.9 | 11.6 | 11.0 | 12.0 |
| Feb-04 | 17.9 | 20.5 | 11.4 | 18.4 | 9.5 | 12.1 | 10.9 | 12.0 |
| Mar-04 | 16.6 | 19.5 | 9.6 | 15.6 | 9.7 | 11.4 | 11.6 | 12.5 |
| Apr-04 | 15.7 | 18.0 | 10.4 | 16.3 | 9.4 | 11.4 | 12.0 | 12.7 |
| May-04 | 19.8 | 19.0 | 21.7 | 17.3 | 11.6 | 13.2 | 11.1 | 12.0 |
| Jun-04 | 18.7 | 19.6 | 16.5 | 16.0 | 13.5 | 14.2 | 11.3 | 12.3 |
| Jul-04 | 14.6 | 17.3 | 8.0 | 14.6 | 13.9 | 14.1 | 12.7 | 13.2 |
| Aug-04 | 16.9 | 16.4 | 18.1 | 13.1 | 14.9 | 14.4 | 13.4 | 13.7 |
| Sep-04 | 14.4 | 16.2 | 10.0 | 12.6 | 16.2 | 15.2 | 13.9 | 14.1 |
| Oct-04 | 13.5 | 13.8 | 12.7 | 11.3 | 15.5 | 14.3 | 15.8 | 15.5 |
| Nov-04 | 15.1 | 15.3 | 14.7 | 12.9 | 16.1 | 15.2 | 15.2 | 15.1 |
| Dec-04 | 16.3 | 16.5 | 15.7 | 15.9 | 19.0 | 18.0 | 17.0 | 16.8 |
| Jan-05 | 16.5 | 15.3 | 19.6 | 14.8 | 20.3 | 18.6 | 18.5 | 17.8 |
| Feb-05 | 17.4 | 16.0 | 21.0 | 14.1 | 19.5 | 17.9 | 17.5 | 17.0 |
| Mar-05 | 20.7 | 17.8 | 28.3 | 19.0 | 20.8 | 20.3 | 17.6 | 17.4 |
| Apr-05 | 18.5 | 16.2 | 24.3 | 16.2 | 22.6 | 20.7 | 18.9 | 18.2 |
| May-05 | 19.2 | 17.7 | 22.7 | 18.3 | 19.7 | 19.3 | 18.7 | 18.3 |
| Jun-05 | 18.1 | 17.6 | 19.5 | 17.8 | 20.7 | 19.9 | 19.1 | 18.6 |
| Jul-05 | 19.8 | 18.4 | 23.5 | 18.0 | 20.1 | 19.5 | 17.4 | 17.3 |
| Aug-05 | 19.0 | 20.0 | 16.6 | 20.6 | 19.5 | 19.8 | 17.0 | 17.1 |
| Sep-05 | 22.8 | 20.0 | 29.7 | 19.7 | 21.1 | 20.7 | 17.9 | 17.9 |
| Oct-05 | 21.9 | 21.9 | 21.8 | 21.1 | 22.8 | 22.3 | 19.0 | 19.1 |
| Nov-05 | 23.7 | 21.0 | 30.6 | 19.9 | 23.3 | 22.3 | 20.0 | 19.8 |
| Dec-05 | 20.8 | 19.6 | 24.1 | 19.1 | 19.0 | 19.1 | 16.9 | 17.1 |
| Jan-06 | 21.0 | 19.5 | 25.2 | 18.4 | 17.3 | 17.6 | 15.9 | 16.3 |
| Annual nominal average | | | | | | | | |
| 2004 | 16.3 | 17.6 | 13.2 | 15.0 | 13.3 | 13.7 | 13.0 | 13.5 |
| 2005 | 20.0 | 18.5 | 23.6 | 18.2 | 20.5 | 19.8 | 18.0 | 17.8 |
| Real annual % change in monthly average of weekly data | | | | | | | | |
| | Base | Cash | Reserves | M1 | Quasi-money | M2 | LSR (*) | M3 |
| Jan-04 | 9.7 | 12.1 | 3.5 | 9.1 | 3.5 | 5.1 | 4.5 | 5.4 |
| Feb-04 | 10.9 | 13.4 | 4.8 | 11.4 | 3.0 | 5.4 | 4.3 | 5.4 |
| Mar-04 | 9.8 | 12.5 | 3.2 | 8.8 | 3.3 | 4.9 | 5.1 | 5.9 |
| Apr-04 | 9.7 | 11.8 | 4.7 | 10.2 | 3.7 | 5.6 | 6.2 | 6.8 |
| May-04 | 13.7 | 13.0 | 15.5 | 11.3 | 5.9 | 7.4 | 5.5 | 6.3 |
| Jun-04 | 11.9 | 12.8 | 9.9 | 9.4 | 7.0 | 7.7 | 5.0 | 5.9 |
| Jul-04 | 7.9 | 10.5 | 1.7 | 7.9 | 7.3 | 7.5 | 6.1 | 6.6 |
| Aug-04 | 10.4 | 9.9 | 11.5 | 6.8 | 8.5 | 8.0 | 7.1 | 7.4 |
| Sep-04 | 7.9 | 9.7 | 3.8 | 6.3 | 9.6 | 8.7 | 7.4 | 7.7 |
| Oct-04 | 7.1 | 7.4 | 6.4 | 5.1 | 9.1 | 7.9 | 9.3 | 9.0 |
| Nov-04 | 8.8 | 9.0 | 8.4 | 6.7 | 9.7 | 8.8 | 8.8 | 8.8 |
| Dec-04 | 10.2 | 10.4 | 9.7 | 9.9 | 12.8 | 11.9 | 10.9 | 10.7 |
| Jan-05 | 10.4 | 9.3 | 13.5 | 8.9 | 14.1 | 12.5 | 12.3 | 11.7 |
| Feb-05 | 11.6 | 10.2 | 15.0 | 8.4 | 13.6 | 12.0 | 11.6 | 11.1 |
| Mar-05 | 15.0 | 12.2 | 22.2 | 13.3 | 15.0 | 14.5 | 12.0 | 11.7 |
| Apr-05 | 12.9 | 10.7 | 18.4 | 10.7 | 16.7 | 14.9 | 13.2 | 12.6 |
| May-05 | 13.5 | 12.1 | 16.8 | 12.6 | 14.0 | 13.6 | 13.0 | 12.6 |
| Jun-05 | 12.7 | 12.2 | 14.0 | 12.4 | 15.2 | 14.4 | 13.6 | 13.2 |
| Jul-05 | 14.2 | 12.9 | 17.7 | 12.4 | 14.5 | 13.9 | 12.0 | 11.8 |
| Aug-05 | 13.5 | 14.4 | 11.2 | 14.9 | 13.9 | 14.2 | 11.6 | 11.6 |
| Sep-05 | 16.9 | 14.3 | 23.5 | 14.0 | 15.3 | 14.9 | 12.3 | 12.2 |
| Oct-05 | 15.8 | 15.8 | 15.7 | 15.0 | 16.6 | 16.2 | 13.1 | 13.1 |
| Nov-05 | 17.7 | 15.1 | 24.2 | 14.1 | 17.3 | 16.4 | 14.2 | 14.0 |
| Dec-05 | 15.2 | 14.0 | 18.3 | 13.6 | 13.5 | 13.6 | 11.5 | 11.7 |
| Jan-06 | 15.8 | 14.2 | 19.8 | 13.2 | 12.1 | 12.5 | 10.8 | 11.2 |
| Annual real average | | | | | | | | |
| 2004 | 9.8 | 11.0 | 6.9 | 8.6 | 7.0 | 7.4 | 6.7 | 7.2 |
| 2005 | 14.2 | 12.9 | 17.7 | 12.6 | 14.8 | 14.1 | 12.4 | 12.2 |

(*) Liabilities subject to reserves.
Source: Banco de la República.

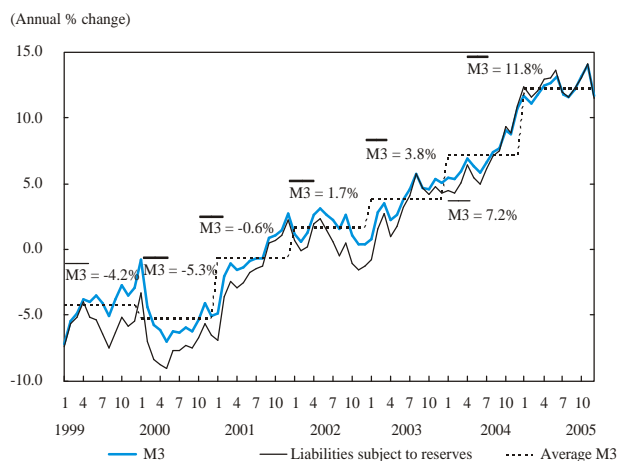
to reserve requirements, the latter up by 5.2 pp on 2004. Savings- and checking-account deposits, which make up over 55% of total liabilities subject to reserve requirements, were the components presenting the more representative increases: 29.6% and 18.0%, respectively. Similarly, CDs put their recovery on a firm footing, growing by 10.6%, and bonds issued by credit institutions continued on a rising trend, expanding by 26.3%, annual average rates.

Table 11 shows that private deposits in credit institutions increased by an annual rate of 18.2%, following their strong performance in 2004, because the peso's persistent revaluation led to a private-portfolio shift toward local currency. Thus, private CDs expanded by 10% between December 2004 and December 2005, and private-savings deposits by 26.8%.

Public deposits in the financial system registered a considerably weaker growth (6.4%) with respect to December 2004. This resulted from the introduction of a new liquidity scheme under which the National Treasury's cash surplus is deposited in the Banco de la República and not traded with the financial sector.

CHART 36

REAL BROAD MONEY M3



Source: Banco de la República.

TABLE 11

COMPOSITION OF M3
ANNUAL CHANGE
(BILLIONS OF PESOS)

| | March | | | June | | | September | | | December | | |
|-------------------|--------|--------|--------|--------|---------|---------|-----------|---------|---------|----------|---------|---------|
| | 2004 | 2005 | (%) | 2004 | 2005 | (%) | 2004 | 2005 | (%) | 2004 | 2005 | (%) |
| Private M3 | 66,554 | 77,752 | 16.8 | 69,495 | 80,779 | 16.2 | 69,475 | 84,347 | 21.4 | 77,967 | 92,213 | 18.3 |
| Cash | 10,383 | 12,121 | 16.7 | 10,750 | 12,785 | 18.9 | 10,547 | 12,925 | 22.5 | 13,832 | 16,397 | 18.5 |
| LSR | 56,170 | 65,631 | 16.8 | 58,745 | 67,994 | 15.7 | 58,928 | 71,422 | 21.2 | 64,134 | 75,815 | 18.2 |
| Checking accounts | 7,796 | 8,932 | 14.6 | 8,086 | 9,624 | 19.0 | 7,582 | 9,403 | 24.0 | 10,250 | 12,474 | 21.7 |
| CDs | 23,159 | 25,228 | 8.9 | 23,803 | 25,786 | 8.3 | 24,471 | 26,935 | 10.1 | 24,418 | 26,855 | 10.0 |
| Savings | 20,530 | 26,279 | 28.0 | 21,672 | 27,054 | 24.8 | 21,613 | 29,320 | 35.7 | 24,330 | 30,861 | 26.8 |
| Other | 4,685 | 5,193 | 10.8 | 5,184 | 5,531 | 6.7 | 5,262 | 5,764 | 9.5 | 5,136 | 5,626 | 9.5 |
| Public M3 | 17,145 | 19,163 | 11.8 | 16,621 | 19,278 | 16.0 | 18,474 | 19,473 | 5.4 | 19,149 | 20,383 | 6.4 |
| Checking accounts | 3,790 | 4,091 | 7.9 | 3,666 | 4,415 | 20.5 | 3,780 | 3,956 | 4.7 | 5,041 | 5,510 | 9.3 |
| CDs | 1,566 | 2,365 | 51.0 | 2,064 | 2,395 | 16.1 | 2,614 | 2,392 | (8.5) | 2,276 | 2,179 | (4.3) |
| Savings | 6,542 | 9,637 | 47.3 | 7,255 | 10,165 | 40.1 | 7,870 | 10,838 | 37.7 | 8,307 | 9,834 | 18.4 |
| Repos | 3,405 | 922 | (72.9) | 1,589 | 0 | (100.0) | 2,265 | 0 | (100.0) | 1,194 | 0 | (100.0) |
| Other | 1,842 | 2,147 | 16.6 | 2,047 | 2,302 | 12.5 | 1,945 | 2,288 | 17.6 | 2,330 | 2,860 | 22.7 |
| M3 total | 83,699 | 96,915 | 15.8 | 86,115 | 100,057 | 16.2 | 87,949 | 103,821 | 18.0 | 97,116 | 112,596 | 15.9 |

Source: Financial Superintendency.

It is noteworthy that over the year the private sector's government-bond holdings surged by 36.2%, on average, as shown in Table 12.

3. Loan portfolio and credit institutions' asset quality

The credit institutions' main balance-sheet items registered positive real growth rates in 2005, despite a slowdown in the second half of the year. At December 2005, asset growth was 12%, reflecting the behavior of the two main asset components: loan portfolio (11.3%, corrected for securitizations) and investments (13.0%). For their part, deposits grew by 11.9%, a slower pace than in 2004; this had to do with the better behavior of Repos in the interbank market.

A growing disparity is discernible between the performances of the different loan types (Chart 37). In December 2005, real annual growth in

TABLE 12

REAL SECTOR'S FINANCIAL PORTFOLIO
(BILLIONS OF PESOS)

| | | Total real sector | | | | | | | | |
|---------------------------------------|----------------|-------------------|-------------|----------------|---------------|-------------|---------------|--------------------|-------------|----------------|
| | | Total | | | Public sector | | | Private sector (*) | | |
| | | M3 | TES | M3 + TES | M3 | TES | Total | M3 | TES | Total |
| Balances | | | | | | | | | | |
| 2003 | December | 82,390 | 31,613 | 114,003 | 15,450 | 16,612 | 32,061 | 66,941 | 15,001 | 81,942 |
| 2004 | March | 83,699 | 34,320 | 118,019 | 17,145 | 16,774 | 33,919 | 66,554 | 17,546 | 84,100 |
| | June | 86,115 | 33,449 | 119,564 | 16,621 | 17,137 | 33,758 | 69,495 | 16,311 | 85,806 |
| | September | 87,949 | 35,821 | 123,770 | 18,474 | 18,167 | 36,641 | 69,475 | 17,654 | 87,130 |
| | December | 97,116 | 36,408 | 133,524 | 19,149 | 16,869 | 36,018 | 77,967 | 19,539 | 97,506 |
| 2005 | March | 96,915 | 40,671 | 137,586 | 19,163 | 18,029 | 37,192 | 77,752 | 22,643 | 100,395 |
| | June | 100,057 | 43,595 | 143,652 | 19,278 | 19,540 | 38,818 | 80,779 | 24,055 | 104,835 |
| | September | 103,821 | 45,436 | 149,257 | 19,473 | 21,339 | 40,813 | 84,347 | 24,097 | 108,444 |
| | December | 112,596 | 49,241 | 161,836 | 20,383 | 24,369 | 44,752 | 92,213 | 24,872 | 117,085 |
| Absolute annual change | | | | | | | | | | |
| 2004 | December | 14,725 | 4,795 | 19,521 | 3,700 | 257 | 3,956 | 11,026 | 4,539 | 15,564 |
| 2005 | March | 13,216 | 6,351 | 19,567 | 2,018 | 1,254 | 3,272 | 11,199 | 5,097 | 16,295 |
| | June | 13,942 | 10,146 | 24,088 | 2,658 | 2,402 | 5,060 | 11,285 | 7,744 | 19,028 |
| | September | 15,872 | 9,615 | 25,486 | 1,000 | 3,172 | 4,172 | 14,872 | 6,442 | 21,314 |
| | December | 15,480 | 12,833 | 28,313 | 1,234 | 7,500 | 8,734 | 14,246 | 5,333 | 19,579 |
| Annual % change at the end of: | | | | | | | | | | |
| 2004 | | 17.9 | 15.2 | 17.1 | 23.9 | 1.5 | 12.3 | 16.5 | 30.3 | 19.0 |
| 2005 | March | 15.8 | 18.5 | 16.6 | 11.8 | 7.5 | 9.6 | 16.8 | 29.0 | 19.4 |
| | June | 16.2 | 30.3 | 20.1 | 16.0 | 14.0 | 15.0 | 16.2 | 47.5 | 22.2 |
| | September | 18.0 | 26.8 | 20.6 | 5.4 | 17.5 | 11.4 | 21.4 | 36.5 | 24.5 |
| | December | 15.9 | 35.2 | 21.2 | 6.4 | 44.5 | 24.2 | 18.3 | 27.3 | 20.1 |
| | Average | 17.0 | 26.3 | 19.6 | 13.5 | 16.7 | 14.8 | 18.0 | 36.2 | 21.6 |

(*) Excluding financial sector's TES holdings.
Source: Banco de la República.

commercial loans was 6.3%, half the rate registered seven months before. By contrast, consumer loans' pace of growth surged ever higher, reaching 31.9% at the end of 2005. Lastly, mortgage loans continued to shrink, at a real rate of 6.6%, even when adjusted for securitizations (-8.3% unadjusted).

a. Quality and coverage ratios

The falling trend in the ratio of overdue loans to gross loans that still existed at the end of 2004 continued throughout 2005, taking the ratio down to its lowest historical levels since comparable figures began to be estimated 12 years before. The ratio's fall signifies lower credit-risk exposure for financial intermediaries (Chart 38).

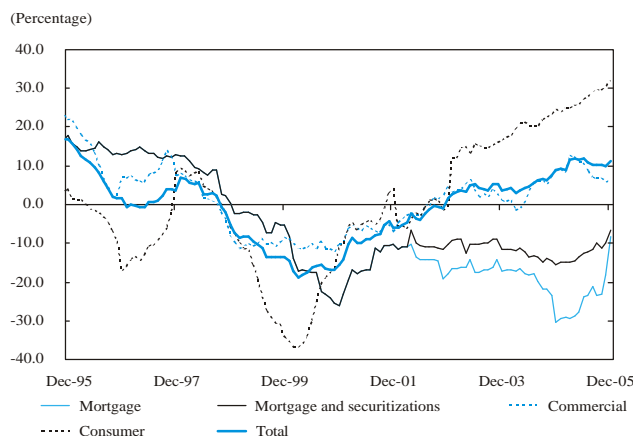
In addition, during 2005 portfolio coverage, in terms of provisioning per unit of overdue loans, stood at levels close to the historical peak, reaching 163% last December (Chart 39).

b. Profitability and capital soundness

At December 2005, profits accumulated by credit institutions over the preceding twelve months amounted to 3,42 trillion pesos, equivalent to a profit-to-asset ratio of 2.8%, about the same ratio as in May 2005. By type of intermediary, there was still a difference of almost one percentage point between Colombian and foreign institutions (Chart 40). Asset profitability for the latter was around 1.7%, lower even than public institutions' asset profitability ratio of 2.3% in December.

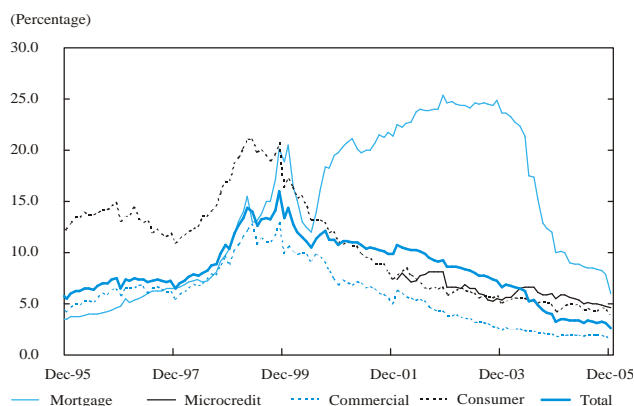
The credit institutions' good situation is also reflected by high solvency levels, which, despite their declining trend all through 2005, remained far above the 9% minimum capital requirement imposed by the

CREDIT INSTITUTIONS' GROSS LOAN PORTFOLIO (REAL ANNUAL GROWTH)



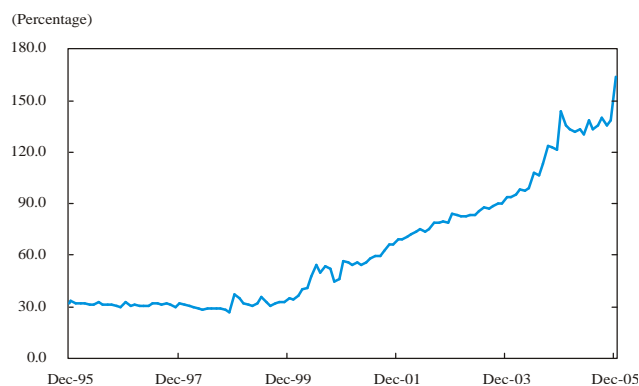
Source: Banco de la República.

PORTFOLIO QUALITY, BY TYPE OF LOAN (*)



(*) The portfolio-quality index is calculated as overdue loans / gross loans. Source: Financial Superintendency; calculations by Banco de la República.

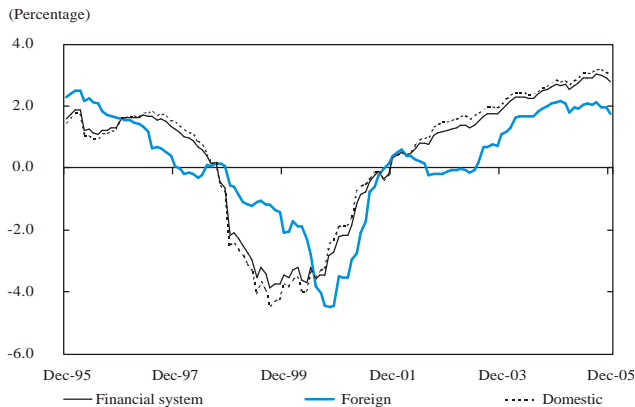
COVERAGE: PROVISIONS / OVERDUE LOANS



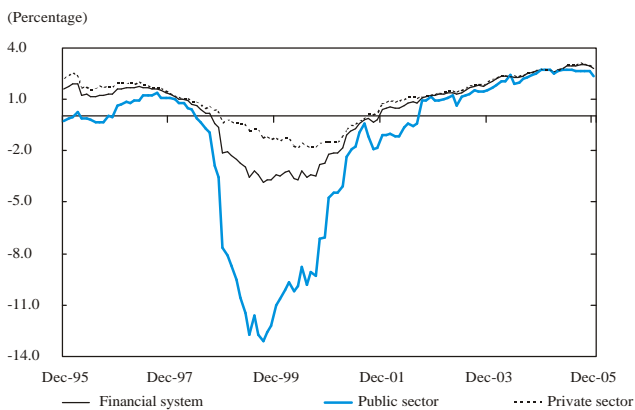
Source: Financial Superintendency; calculations by Banco de la República.

ASSET RETURN, BY TYPE OF FINANCIAL-SYSTEM INSTITUTION

FOREIGN AND DOMESTIC

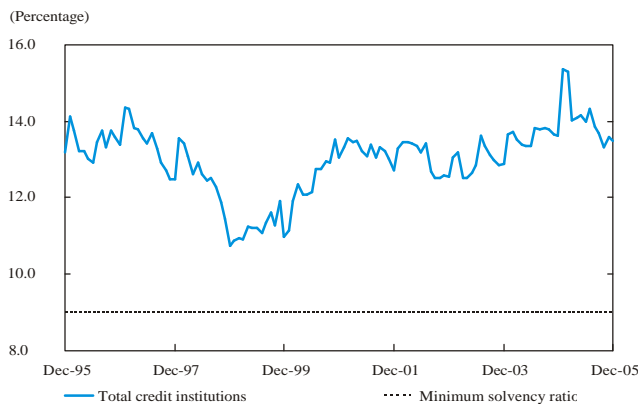


PUBLIC AND PRIVATE



Source: Financial Superintendency; calculations by Banco de la República.

CREDIT INSTITUTIONS' SOLVENCY RATIO (*)



(*) The solvency ratio is calculated as technical capital / risk-weighted assets. Source: Financial Superintendency; calculations by Banco de la República.

Financial Superintendency; the solvency ratio stood at 13.5% in December (Chart 41).

c. Potential risks for the financial system

i. Credit, market and liquidity risks

Notwithstanding the good situation reflected by the financial system's main balance-sheet accounts, high portfolio quality and a high level of capital soundness, adverse movements in the macroeconomic variables might affect financial stability. In this respect, analyzing the consequences of extreme situations on the financial system (stress testing) is an essential tool for the Board of Directors' policy decision-making. For this reason, the Banco de la República's previous Financial Stability Reports attach great importance to stress testing, particularly in respect of credit, market and liquidity risks.¹³ Most stress tests assume movements in variables as drastic as those that occurred in the late nineties.¹⁴ The main findings of the stress tests are described in greater detail further below in Box 3.

The first type of risk is traditionally associated with credit activity. Credit risk reflects in particular the possibility that debtors will fail to meet their debt-repayment commitments to financial intermediaries, which may in the most serious cases cause the latter to become bankrupt. The impact of macroeconomic shocks on credit risk

¹³ Greater detail on the stress testing described above is provided in the Potential Risks section of the December 2005 *Financial Stability Report*; and at the end of that *Report*, under the heading Financial Stability Issues, a number of articles deal in depth with particular cases of credit and market risks.

¹⁴ Stress testing for the consumer and mortgage portfolio assumed a 6.8% fall in economic activity, as observed in the second half of 1999, an interest-rate rise of 450 bp, as observed from May to June of 1998, and an 8% fall in housing prices, equal to the average of the falls over 1996-2000. In the case of the commercial portfolio, a 9% decrease in sales is assumed, as occurred in 1999.

operates through deterioration of the major debtors' balance sheets. For example, slower economic activity, rising interest rates or marked changes in assets prices can increase defaults by agents in the economy of their credit obligations.

The conclusion from stress testing is that, although credit risk is currently at historically low levels, a macroeconomic situation like the 1998-1999 crisis may cause huge losses to credit institutions (Box 3, Table B3.1). The impact of adverse macroeconomic shocks is particularly significant for certain institutions. The private sector's good situation, together with higher portfolio coverage, low delinquency levels, good profit levels and capital soundness of credit institutions, suggests that there is no credit risk, at least in the short term. Consumer-loan growth could become a source of instability in the medium and short term, as higher leverage makes households more sensitive to changes in the economic situation.

Moreover, since the financial-intermediation business is developing toward greater involvement in trading in short-term asset portfolios, market risk is a further threat to the financial system. Market risk reflects the vulnerability of banks' portfolio value to sudden price changes in the component assets. The losses incurred by intermediaries in this connection increase with portfolio size and the magnitude of price shocks. Because of the large share of public-debt securities (TES) in the financial institutions' balance sheets, tests were conducted to quantify valuation losses resulting from higher TES rates.¹⁵ Such losses are large for both credit institutions and pension-fund managers, suggesting that the financial system's main vulnerability is to market risk (Box 3, Table B3.2). In the case of credit institutions, losses would be concentrated in commercial banks.

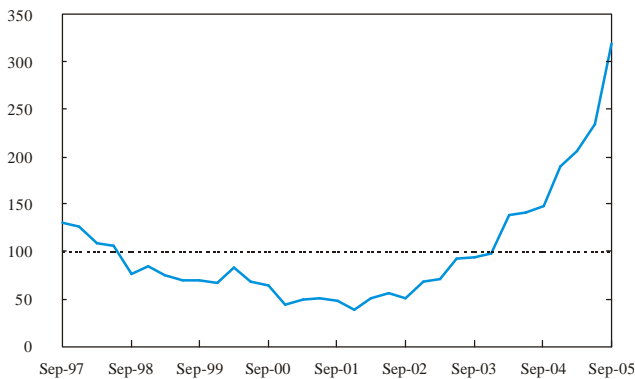
Lastly, liquidity risk reflects the possibility that intermediaries will be unable to meet their depositors' demand for resources. In other words, the disparity between asset and liability maturities may leave a bank with insufficient available resources to cover withdrawal of funds by its creditors. In the worst case, that might turn into a rush of withdrawals that would affect the soundness of the financial system. The tests conducted indicate that credit institutions are operating with an adequate level of liquidity, far higher than during the crisis and sufficient to cope with an extreme situation of withdrawals.

The conclusion from stress testing is that, although credit risk is currently at historically low levels, a macroeconomic situation like the 1998-1999 crisis may cause huge losses to credit institutions.

Since the financial-intermediation business is developing toward greater involvement in trading in short-term asset portfolios, market risk is a further threat to the financial system.

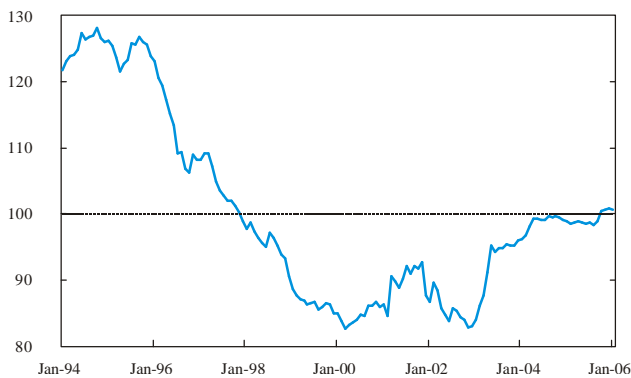
¹⁵ The spot curve in particular is assumed to undergo a 200 bp parallel shift; that is, the rates for all maturities are affected by this amount.

RATIO OF COLOMBIA STOCKMARKET GENERAL INDEX TO RETURN ON CAPITAL DEVIATION FROM LONG-TERM AVERAGE (1997-2005)



Source: Colombia Stockmarket report; calculations by Banco de la República.

RATIO OF HOUSING PRICES TO RENTS DEVIATION FROM LONG-TERM AVERAGE (1994-2005)



Source: National Planning Department's new-housing price index, and DANE's CPI housing component index. Calculations by Banco de la República.

ii. Asset-price bubble

A reversal in asset prices can affect financial stability. To evaluate the hypothesis of what may occur in a bubble (over-valuation) scenario in the stockmarket and the mortgage market, price/return ratios are estimated and shown in Chart 42.

According to Chart 42, there may be a speculative bubble in the stockmarket, whereas there seems to be no evidence of one in the housing market. It should be pointed out however that a sharp reversal in share prices would not significantly affect the financial system's stability, given that: i) shares are not assets used as collateral in the financial system; ii) only a small proportion of agents in the economy hold them in their investment portfolios; and iii) unlike housing, they are not the main component of agents' wealth (see Box 1).

STRESS TESTING FOR POTENTIAL RISKS TO THE FINANCIAL SYSTEM

The experience of the late nineties' financial crises revealed the need to improve the traditional financial-stability analyses, which were based exclusively on monitoring traditional indicators. Stress testing has emerged as a good complement to these, for it seeks to evaluate the soundness of the financial system in extreme but likely scenarios. The Banco de la República's Financial Stability Reports of December 2005 and March 2006 give preponderant weight to stress testing for Colombia, particularly as regards credit, market and liquidity risks, which are discussed below in detail.

Credit risk

The impact of adverse macroeconomic conditions on counterparty risk to the financial system operates through balance-sheet deterioration of its major debtors. In particular, falls in economic activity, rising interest rates or marked changes in asset prices can cause an increase in defaults of credit obligations by agents in the economy.

Different tests were conducted by the Banco de la República to quantify the impact of such adverse conditions by type of loan. For the consumer-loan portfolio, a model was estimated in which a 6.8% fall in GDP and a 450-bp rise in interest rates deteriorated portfolio quality and affected the health of intermediaries in two ways: through higher provisioning and lower interest received. A similar exercise was conducted for the mortgage portfolio, with an 8% housing-price fall replacing interest rates. Lastly, in the case of the commercial portfolio, the impact was estimated of a 9% fall in sales and a rise in interest rates as indicated above.

The simulations corresponded to actual developments in the late nineties. The consumer- and loan-portfolio tests assumed a fall in economic activity, such as occurred in the second half of 1999; an interest-rate rise, such as occurred between May and June 1998; and a housing-price fall equivalent to the average for 1996-2000. In the case of the commercial portfolio, sales were assumed to fall by 9%, as occurred in 1999.

Table B3.1 presents the impact of these shocks, both individually and simultaneously (Shock 3), on intermediaries' profits. The conclusion is that, though in the current

situation credit risk is at historically low levels, a scenario like that of the 1998-1999 crisis would cause considerable losses to credit institutions.

TABLE B3.1
COST OF SHOCKS OCCURRING
(PERCENTAGE OF PROFITS)

| | Shock 1 1/ | Shock 2 2/ | Shock 3 |
|------------|-------------------|-------------------|----------------|
| Commercial | 4.0 | 54.0 | 57.0 |
| Consumer | 20.0 | 26.0 | 39.0 |
| Mortgage | 12.0 | 11.0 | 19.0 |
| Total | 40.0 | 91.0 | 114.0 |

1/ For the commercial portfolio a 9% fall in sales is considered and for the consumer and mortgage portfolios a GDP fall of 6.8%.

2/ For the commercial and consumer portfolios an interest-rate rise of 450 basis points is considered, and for the mortgage portfolio an 8% fall in the housing-price index.

Source: Banco de la República.

It is therefore necessary to make further progress in developing methodologies that reveal balance-sheet risks. To this end, the Financial Superintendency has been working on setting up the Credit-Risk Management System (SARC) and designing a counter-cyclical provisioning scheme for distributing the cost of provisions over the entire cycle rather than concentrating it in the crisis phase.¹

Market risk

Given the growing share of investments (mostly TES) in the institutions' assets, the market risk they face has increased. In particular, substantial rises in TES interest rates may cause intermediaries to suffer large losses. Table B3.2 shows that a 200-bp rise in TES rates over the entire yield curve would cause credit institutions valuation losses amounting to 31.4% of their annualized profits, with such losses highly concentrated among commercial banks.

Liquidity risk

Lastly, given that the nature of the credit institutions' business involves maturity transformation, the risk of a bank's being unable to meet its obligations (e.g., making payments to depositors) for lack of liquid funds jeopardizes financial stability. In a

¹ See Martínez, Pineda and Salamanca (2005).

TABLE B3.2
LOSSES FROM A 200-BP RATE-RISE SHOCK IN TREASURY SECURITIES
(MILLIONS OF PESOS)

| | Fixed-rate (pesos) | Real Value Units | Total | Percentage of profits (*) |
|---|-----------------------|---------------------|------------------|------------------------------|
| Total credit institutions | 812,157 | 261,151 | 1,073,308 | 31.4 |
| Commercial banks | 762,649 | 255,066 | 1,017,715 | 34.3 |
| CFC (commercial finance and leasing companies) | 2,587 | 380 | 2,967 | 1.6 |
| <i>Corporaciones financieras</i> (real-sector development institutions) | 46,921 | 5,705 | 52,626 | 21.1 |
| Pension fund managers | 670,037 | 383,280 | 1,053,317 | |

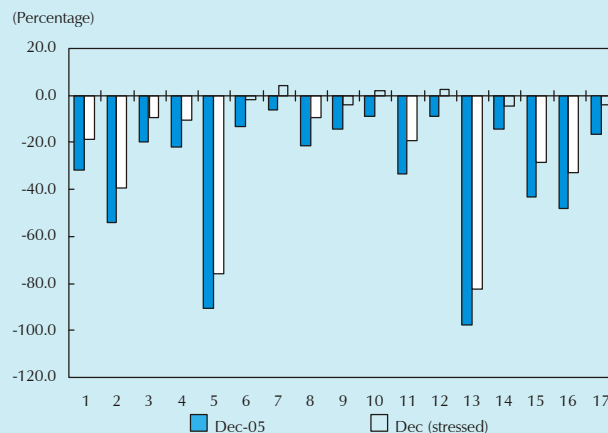
(*) Past 12 months (Dec-05).
Source: Banco de la República.

situation of illiquidity, intermediaries may have to sell part of their non-liquid portfolios, thereby incurring losses that undermine their soundness.

To measure this risk you need to know the potential demand for resources that banks may face. To this end, you estimate the uncovered-liability ratio,² which shows the percentage of nonliquid assets that would have to be liquidated to meet obligations in respect of liquid liabilities and the transitory component of stocks (such as savings deposits and current accounts).

Stress testing also took into account the part of the nonliquid portfolio that would need to be realized in the event of a further fall of 12% in the amount of deposits.³

CHART B3.1
SENSIBILITY ANALYSIS: UNCOVERED-LIABILITY RATIO OF COMMERCIAL AND MORTGAGE BANKS



Source: Banco de la República.

² The uncovered-liability ratio = [(TrL + LL) - LA] / TA - LA, where TrL is the transitory component of savings and checking-account deposits, LL liquid liabilities, TA total assets, and LA liquid assets. The more negative the value of the ratio the better the bank's liquidity position.

Chart B3.1 shows both the current situation of the uncovered- liability ratio for 17 banks and the hypothetical situation of the ratio in the scenario considered. It may be seen that the financial system manages an adequate level of liquidity, and that even in the case of banks that would have to liquidate part of their nonliquid portfolio (i.e., those showing a positive uncovered-liability ratio) the liquidated amount would be small (3% on average).

³ This percentage is the average of the worst falls in the selected banks' stock of deposits during the financial crisis of 1998-1999.

Box 4

PENSION FUND MANAGERS' PORTFOLIOS

In November 2005 the Pension Fund Managers' portfolio of mandatory pension funds amounted to 35.5 tr pesos, more than double the amount registered in December 2001 (Table B4.1). An even stronger growth has occurred in the voluntary pension funds: in November they stood at 6.8 tr pesos, more than three times their value four years earlier. Severance-pay funds totaled 3.7 tr pesos in November.¹

Breakdown of the overall portfolio by issuer of securities² reveals clearly that public-debt securities made up the greater part of all three types of fund (Tables B4.2 and

TABLE B4.1
SIZE OF THE PORTFOLIO ADMINISTERED BY PENSION FUND ADMINISTRATORS
(MILLIONS OF PESOS OF NOVEMBER 2005)

| | Pensiones | | Severance pay |
|--------|------------|-----------|---------------|
| | Mandatory | Voluntary | |
| Dec-01 | 14,315,125 | 2,376,966 | 2,684,825 |
| Dec-02 | 18,453,458 | 3,488,139 | 2,837,292 |
| Dec-03 | 22,486,639 | 4,170,845 | 3,027,671 |
| Dec-04 | 27,712,233 | 4,707,919 | 3,279,158 |
| Nov-05 | 35,471,668 | 6,827,873 | 3,690,234 |

Source: Financial Superintendency; calculations by Banco de la República.

¹ The value of the funds includes valuation gains on available-for-sale investments.

² The value of the funds includes valuation gains on available-for-sale investments.

B4.3). The share of government securities in the mandatory pension funds has remained very close to the regulatory limit of 50% set by the Financial Superintendency. In contrast, the share of paper issued by foreign institutions is below the regulatory 20% limit but has been rising steadily in recent years, with a significant exposure to the real sector, mostly in the form of shares.³

The voluntary pension funds exhibit a shift in composition in favor of the share of securities issued by the real sector (bonds and shares) and the financial sector (particularly in the past year), and to the detriment of exposure to foreign institutions.

TABLE B4.2
MANDATORY AND VOLUNTARY PENSION FUNDS:
EXPOSURE BY COUNTERPARTY
(PERCENTAGE OF PORTFOLIO)

| | Dec-01 | Dec-02 | Dec-03 | Dec-04 | Nov-05 |
|-------------------------|--------|--------|--------|--------|--------|
| Mandatory pension funds | | | | | |
| Central government | 48.67 | 49.38 | 48.64 | 48.52 | 47.13 |
| Real sector | 17.89 | 19.53 | 18.62 | 19.62 | 22.06 |
| Financial sector | 22.49 | 20.07 | 18.50 | 16.62 | 15.04 |
| Foreign institutions | 4.12 | 4.55 | 7.08 | 9.53 | 11.69 |
| Other | 6.83 | 6.48 | 7.16 | 5.71 | 4.08 |
| Voluntary pension funds | | | | | |
| Central government | 39.90 | 41.92 | 37.19 | 42.35 | 41.61 |
| Real sector | 8.96 | 12.35 | 13.34 | 15.17 | 16.71 |
| Financial sector | 13.82 | 13.01 | 13.81 | 13.79 | 18.15 |
| Foreign institutions | 30.43 | 28.95 | 30.84 | 22.72 | 16.17 |
| Other | 6.90 | 3.77 | 4.82 | 5.97 | 7.36 |

Source: Financial Superintendency, calculations by Banco de la República.

In the case of the severance-pay funds (Table B4.3), the share of government securities (57.78%) is again the largest, larger than in the mandatory pension funds—for the 50% limit does not apply here. But it fell sharply in 2005, in contrast to exposure to the real sector, which increased significantly through a rise in shareholdings.

Breakdown of the portfolio by currency, both in the case of the pension funds (mandatory and voluntary) and in the case of the severance-pay funds, shows a rise in recent years in peso securities and a fall in foreign-currency securities (both in dollars and in other currencies) (Table B4.4). Although the share of dollar-

³ At November 2005 equity investments made up 11.75% of the pension fund managers' portfolio of mandatory pension funds.

TABLE B4.3
SEVERANCE PAY FUNDS:
EXPOSURE BY COUNTERPARTY
(PERCENTAGE OF PORTFOLIO)

| | Dec-01 | Dec-02 | Dec-03 | Dec-04 | Nov-05 |
|----------------------|--------|--------|--------|--------|--------|
| Central government | 48.68 | 71.19 | 71.83 | 68.24 | 57.78 |
| Real sector | 16.20 | 15.60 | 16.53 | 15.36 | 20.38 |
| Financial sector | 27.55 | 10.78 | 6.78 | 9.10 | 15.21 |
| Foreign institutions | 3.14 | 1.17 | 1.84 | 3.73 | 4.97 |
| Other | 4.42 | 1.26 | 3.02 | 3.58 | 1.66 |

Source: Financial Superintendency; calculations by Banco de la República.

TABLE B4.4
MANDATORY AND VOLUNTARY PENSION FUNDS AND SEVERANCE PAY FUNDS:
EXPOSURE BY CURRENCY
(PERCENTAGE OF PORTFOLIO)

| | Dec-01 (*) | Dec-02 (*) | Dec-03 (*) | Dec-04 | Nov-05 |
|--------------------------------|------------|------------|------------|--------|--------|
| Mandatory pension funds | | | | | |
| Pesos | 43.46 | 32.94 | 33.60 | 42.69 | 49.40 |
| UVR | 27.90 | 38.00 | 40.83 | 39.17 | 35.21 |
| Dollars | 23.02 | 23.01 | 19.21 | 11.88 | 11.87 |
| Euros | 5.32 | 6.05 | 6.02 | 6.26 | 2.32 |
| Other | 0.29 | 0.00 | 0.33 | 0.00 | 1.20 |
| Voluntary pension funds | | | | | |
| Pesos | 24.87 | 33.49 | 30.19 | 44.51 | 58.20 |
| UVR | 13.14 | 35.04 | 36.38 | 28.55 | 26.80 |
| Dollars | 52.60 | 30.31 | 30.50 | 22.78 | 13.13 |
| Euros | 9.11 | 1.16 | 2.93 | 3.72 | 0.69 |
| Other | 0.27 | 0.00 | 0.00 | 0.43 | 1.18 |
| Severance pay funds | | | | | |
| Pesos | 42.87 | 22.23 | 19.41 | 32.04 | 50.03 |
| UVR | 19.70 | 36.41 | 39.65 | 41.94 | 36.61 |
| Dollars | 32.26 | 35.53 | 33.20 | 18.43 | 11.04 |
| Euros | 4.52 | 5.83 | 7.75 | 7.58 | 1.25 |
| Other | 0.65 | 0.00 | 0.00 | 0.00 | 1.07 |

(*) Estimates based only on the funds' fixed-rate portfolios.
Source: Financial Superintendency; calculations by Banco de la República.

denominated assets has decreased, the dollar is still the foreign currency to which the pension fund managers' portfolio is most exposed. About one third of this portfolio is denominated in Real Value Units (UVR) or other denominations tied to CPI inflation.

IV. FISCAL POLICY

At the end of 2005 the consolidated public-sector deficit stood at 24.4 bn pesos, a situation close to fiscal balance for the first time in over a decade.

A. 2005 FISCAL RESULTS

At the end of 2005 the consolidated public-sector deficit stood at 24.4 bn pesos, a situation close to fiscal balance for the first time in over a decade. This result is attributable to the decentralized sector's substantial surplus (4.5% of GDP), which made up for the central government's deficit. That surplus stemmed from an accumulation of resources in some social security funds, and from the favorable situation of sub-national finances and of some companies, particularly Ecopetrol (Table 13).

The central government's finances were in deficit by 13,599 bn pesos, or 4.9% of GDP. This was a smaller deficit than in 2004, thanks largely to stronger revenues. In annual terms, total revenues rose by 14.8% and expenditures by 10.3%. Among revenue items, tax receipts grew by 15.1%, notably income tax (14.3%), internal VAT (13.3%), external VAT (23.2%) and customs revenues (26.4%). The factors responsible for higher tax receipts included, among other things, the VAT rate increase from 7% to 10% for some goods and services, good economic growth in 2004—which improved the profits of major taxpayers—, improvement in tax administration, and higher imports. Much of the increase in tax revenues and external VAT came from higher imports (Table 14).

The central government's finances were in deficit by 13,599 bn pesos, or 4.9% of GDP. This was a smaller deficit than in 2004 thanks largely to stronger revenues.

Central-government expenditures registered a 4% fall in interest on debt, a 15.2% increase in operating expenses, and a 0.5% rise in investment costs. The fall in interest payments is largely attributable to the premium obtained in the placement of domestic-debt securities (TES), which amounted to 2,000 bn pesos (about one point of GDP) in 2005. Among operating expenses, personal services grew by 5.6%, overhead by 11.5%, and transfers by 17.8%. The rise in transfers came from a 37.3% surge in pension payments. These

TABLE 13

CONSOLIDATED PUBLIC SECTOR
FISCAL BALANCE 2004-2005

| Item | Billions of dollars | | Percentage of GDP | |
|---|---------------------|-----------------|-------------------|--------------|
| | 2004 | 2005 (pr) | 2004 | 2005 (pr) |
| A. Total nonfinancial public sector (1 + 2) | (3,586) | (955) | (1.4) | (0.3) |
| 1. National government | (13,983) | (13,599) | (5.5) | (4.9) |
| 2. Subtotal decentralized sector | 10,397 | 12,644 | 4.1 | 4.5 |
| Power sector | 499 | 359 | 0.2 | 0.1 |
| Emcali (Cali municipal utilities co.) | 271 | 161 | 0.1 | 0.1 |
| EPM (Medellín municipal utilities co.) | 502 | 193 | 0.2 | 0.1 |
| FAEP (oil stabilization fund) | 167 | 637 | 0.1 | 0.2 |
| Ecopetrol | 296 | 1,134 | 0.1 | 0.4 |
| Telecom | 257 | 17 | 0.1 | 0.0 |
| Rest of entities | 1,527 | 2,022 | 0.6 | 0.7 |
| Social security | 4,009 | 5,844 | 1.6 | 2.1 |
| Regional and local | 2,832 | 2,153 | 1.1 | 0.8 |
| National Coffee Fund | 37 | 124 | 0.0 | 0.0 |
| B. Banco de la República cash profit and loss | 1,225 | 669 | 0.5 | 0.2 |
| C. Fogafin (deposit insurance agency) cash profit and loss | 720 | 610 | 0.3 | 0.2 |
| D. Financial restructuring costs | (920) | (1,233) | (0.4) | (0.4) |
| E. Adjustments | (886) | 885 | (0.3) | 0.3 |
| F. Total consolidated public sector (A + B + C + D + E) | (3,447) | (24) | (1.3) | 0.0 |

(*) Preliminary.

Source: Confis (fiscal policy council).

transfers originated mostly from depletion of the reserves of the Social Security Institute, which required funds for the nation amounting to 3,657 bn pesos in 2005. Net loan operations, in respect of credit extended by the government to various public institutions, amounted to 324.0 bn pesos in 2005.

Funding for the central-government deficit, including financial restructuring costs, amounted to 5.3% of GDP and came largely from domestic borrowing, in application of recent years' policy of replacing external debt by domestic debt.

Funding for the central-government deficit, including financial restructuring costs, amounted to 5.3% of GDP and came largely from domestic borrowing, in application of recent years' policy of replacing external debt by domestic debt. Net domestic indebtedness rose by 17,410 bn pesos, the result of disbursements of 26,832 bn pesos and debt repayments of 9,422 bn pesos. By contrast, external indebtedness fell by 1,079 bn pesos, for new disbursements, amounting to 7,059 bn pesos, were less than debt repayments, totaling 8,138 bn pesos. Debt repayments included external-loan prepayments of 1,890 bn pesos. As usual, domestic borrowing was mainly through placement of TES-B bonds, amounting to 25,053 bn pesos in 2005, with 14,774 bn pesos of this amount placed through auctions. Transfer of profits from the Banco de la República's operations came to 454 bn pesos.

As a result of the financing operations carried out in 2005, the balance of central-government debt stood at 50.3% of GDP at the end of the year.

GOBIERNO NACIONAL CENTRAL
CENTRAL GOVERNMENT FISCAL BALANCE (2004-2005)
(BILLIONS OF PESOS)

| | 2004 | 2005 (pr) | Annual growthl 2004-2005 |
|---|-----------------|-----------------|-----------------------------|
| I. Total revenues (A + B + C + D + E) | 39,952 | 45,876 | 14.8 |
| A. Tax revenues | 36,735 | 42,288 | 15.1 |
| Income tax | 15,182 | 17,349 | 14.3 |
| Internal IVA | 10,074 | 11,412 | 13.3 |
| External IVA | 4,882 | 6,016 | 23.2 |
| Impost | 2,233 | 2,823 | 26.4 |
| Gasoline tax | 1,057 | 1,143 | 8.1 |
| Financial-transactions levy | 2,238 | 2,401 | 7.3 |
| Wealth tax | 452 | 463 | 2.4 |
| Other | 617 | 681 | 10.4 |
| B. Non-tax revenues | 202 | 482 | 138.6 |
| C. Special funds ³⁸ 1 | 472 | 23.9 | |
| D. Capital resources | 2,509 | 2,511 | 0.1 |
| Financial returns | 381 | 440 | 15.5 |
| Financial surplus | 1,845 | 1,773 | (3.9) |
| Other | 283 | 298 | 5.3 |
| E. Accrued interest | 125 | 123 | (1.6) |
| II. Total expenditures (A + B + C + D + E) | 53,935 | 59,475 | 10.3 |
| A. Interest | 10,264 | 9,857 | (4.0) |
| External | 4,320 | 4,268 | (1.2) |
| Internal | 5,944 | 5,589 | (6.0) |
| B. Operating expenses ^{1/} | 38,548 | 44,426 | 15.2 |
| Personal services | 6,704 | 7,077 | 5.6 |
| Overhead | 2,584 | 2,880 | 11.5 |
| Transfers | 29,260 | 34,469 | 17.8 |
| C. Investment ^{1/} | 4,210 | 4,232 | 0.5 |
| D. Net loans | 298 | 324 | 8.7 |
| E. Accrued payments | 615 | 636 | 3.4 |
| III. Deficit or surplus (I - II) ^{2/} | (13,983) | (13,599) | (2.7) |
| Financial restructuring costs | 1,383 | 1,233 | (10.8) |
| IV. Funding (A + B + C + D) | (15,366) | (14,832) | (3.5) |
| A. Net external credit | 3,446 | (1,079) | (131.3) |
| Disbursements | 6,978 | 7,059 | 1.2 |
| Debt repayments | 3,532 | 8,138 | 130.4 |
| B. Net domestic credit | 7,630 | 17,410 | 128.2 |
| Disbursements | 16,480 | 26,832 | 62.8 |
| Debt repayments | 8,850 | 9,422 | 6.5 |
| C. Banco de la República's profits | 803 | 454 | (43.5) |
| D. Other | 3,487 | (1,953) | (156.0) |
| V. Deficit as percentage of GDP | (5.5) | (4.9) | |

(pr) Preliminary.

^{1/} Including payments and floating debt.

^{2/} Excluding financial-restructuring costs.

Source: Financial Superintendency.

While the balance of external public debt as a percentage of GDP dropped from 20.8% in 2004 to 16.9% in 2005, the domestic component climbed from 29.2% to 33.3%.

While the balance of external public debt as a percentage of GDP dropped from 20.8% in 2004 to 16.9% in 2005, the domestic component rose from 29.2% to 33.3%. These figures confirm the substitution of domestic debt for external debt, which has characterized public-borrowing policy in recent years.

B. 2006 FINANCIAL PLAN

For 2006 the Council for Fiscal Policy (Confis) has approved a fiscal-deficit target of 2.0% of GDP for the consolidated public sector.¹⁶ Meeting this target, which is within the medium-term fiscal framework, involves generating a 5.2% deficit in the central government's fiscal accounts and a 3.1% surplus in the decentralized sector—as a share of GDP (Table 15).

The central government's finances will not undergo any major deterioration in 2006, despite the expansion in overall spending, which is expected to run to 15.1%.

¹⁶ The 2006 financial plan was presented in Confis Consultants' Documents No. 5 dated June 15, 2005 and No. 1 dated January 18, 2006.

TABLE 15

CONSOLIDATED PUBLIC SECTOR FISCAL BALANCE 2005-2006

| Item | Billions of dollars | | Percentage of GDP | |
|---|---------------------|-----------------|-------------------|----------------|
| | 2005 | 2006 (pj) | 2005 | 2006 (pj) |
| A. Total nonfinancial public sector (1 + 2) | (955) | (6,208) | (0.3) | (2.1) |
| 1. National government | (13,599) | (15,669) | (4.9) | (5.2) |
| 2. Subtotal decentralized sector | 12,644 | 9,461 | 4.5 | 3.1 |
| Power sector | | 359 | 378 | 0.1 0.1 |
| Emcali (Cali municipal utilities co.) | | 161 | 432 | 0.1 0.1 |
| EPM (Medellín municipal utilities co.) | | 193 | 222 | 0.1 0.1 |
| FAEP (oil stabilization fund) | | 637 | 599 | 0.2 0.2 |
| Ecopetrol | 1,134 | 200 | 0.4 | 0.1 |
| Telecom | 17 | (104) | 0.0 | (0.0) |
| Rest of entities | 2,022 | 1,202 | 0.7 | 0.4 |
| Social security | 5,844 | 4,556 | 2.1 | 1.5 |
| Regional and local | 2,153 | 2,044 | 0.8 | 0.7 |
| National Coffee Fund | 124 | (68) | 0.0 | (0.0) |
| B. Banco de la República cash profit and lossa | 669 | 1,027 | 0.2 | 0.3 |
| C. Fogafin (deposit insurance agency) cash profit and loss | 610 | 396 | 0.2 | 0.1 |
| D. Financial restructuring costs | (1,233) | (1,361) | (0.4) | (0.4) |
| E. Adjustments | | 885 | 0 | 0.3 0.0 |
| F. Total consolidated public sector (A + B + C + D + E) | (24) | (6,146) | 0.0 | (2.0) |

(pj) Projection.

Source: Confis (fiscal policy council).

The biggest increases in tax receipts are projected to occur in income tax (17.9%) and internal VAT (10.8%). Capital funds are expected to grow by 63.4%, thanks to the transfer of financial surpluses from state-owned companies, especially Ecopetrol—whose profit transfers should amount to some 2,000 bn pesos in 2006.

As in 2005, the central government's deficit will be financed largely from domestic borrowing.

Central-government expenditures will register an increase of 30.7% in interest payments, 9.9% in operating expenses and 33.9% in investment costs. Among operating expenditures, personal services will grow by 14.8%, overhead by 13.3% and transfers by 8.6%. Growth in overhead and personal items is connected with the sector of defense and police, and with elections earlier in the year. Investment spending covers implementation of various highway and drinking-water programs and projects and integrated massive transport systems in several cities.

As in 2005, the central government's deficit will be financed largely from domestic borrowing. Domestic debt will grow by 7,622 bn pesos, the net result of bond sales of 24,694 bn pesos and debt repayments of 17,072 bn pesos. External debt will increase by 2,855 bn pesos, resulting from disbursements of 5,693 bn pesos, less debt repayments of 2,838 bn pesos. Financing from Treasury operations and other sources of funds, including privatizations, will exceed 6,000 bn pesos.

The decentralized public sector's fiscal situation will not be as favorable as in 2005, especially because of smaller surpluses in Ecopetrol and the social-security sector. Ecopetrol is expected to spend more on fixed-capital formation and to increase its profit transfer to the government. The social-security surplus will be smaller than in 2005, mainly because both the Solidarity and Guarantee Fund (Fosyga) and the Subnational Pension Liabilities Fund (Fonpet) received extraordinary revenues in 2005 and will not be doing so in 2006.

The decentralized public sector's fiscal situation will not be as favorable as in 2005, especially because of smaller surpluses in Ecopetrol and the social-security sector.

Lastly, at the time of this writing the government was revising the consolidated fiscal-deficit target for 2006. Adjustments to the annual financial plan will be officially announced by April.

V. BALANCE OF PAYMENTS

Although the current-account deficit is acceptable, it might pose a major risk in future. For besides recurrent revenue such as remittances, the account contains other, less certain revenue items such as sales of crude oil from depleting reserves.

A. BALANCE-OF-PAYMENTS BEHAVIOR IN 2005

The current-account deficit widened in 2005 to 1.7% of GDP, up from 1.0% in 2004¹⁷ (Table 16), because of a 27% rise in imports, resulting from growth of the economy. In particular, capital-goods imports surged by 39%, driven by higher investment. Net factor-income payments also increased substantially in 2005, as a result of recent years' foreign investment inflows and of the profits obtained in such sectors as oil and mining.

The fact that faster economic growth, reaching 5% in the preceding two years, did not produce a greater widening of the current-account deficit is a sign that higher aggregate spending has gone hand in hand with higher revenues. The recent years' higher world prices for our commodity exports, the world economy's good performance, and a stronger orientation toward exports in some sectors such as manufacturing have helped to make Colombia's exports buoyant and to generate goods-account surpluses averaging around 1.4% of GDP between 2004 and 2005 (Chart 43). It is well to recall that besides the trade surplus there is transfer income—particularly family or workers' remittances—, which has in the past four years become the second largest source of current income in the country's balance of payments, representing 2.7% of GDP in 2005 (Chart 44).

In the past four years transfer income, particularly family or workers' remittances, has become the second largest source of current income in the country's balance of payments, representing 2.7% of GDP in 2005.

¹⁷ At the time of submission of this Report, no preliminary figures were available on the balance of payments at the close of 2005.

COLOMBIA'S SUMMARY BALANCE OF PAYMENTS

| | Millions of Dollars | | | Percentage of GDP | | | Difference 2005-2004 Millions of Dollars (e) |
|---|---------------------|----------------|----------------|-------------------|--------------|--------------|--|
| | 2003 | 2004 (pr) | 2005 (e) | 2003 | 2004 | 2005 (pr) | |
| I. Current account | (991) | (950) | (2,115) | (1.2) | (1.0) | (1.7) | (1,165.3) |
| Income | 19,864 | 24,111 | 29,496 | 25.0 | 24.8 | 24.1 | 5,384.7 |
| Outlays | 20,855 | 25,062 | 31,612 | 26.2 | 25.8 | 25.8 | 6,550.1 |
| A. Nonfactor goods and services | (877) | (303) | (526) | (1.1) | (0.3) | (0.4) | (222.9) |
| 1. Goods | 567 | 1,368 | 1,644 | 0.7 | 1.4 | 1.3 | 275.9 |
| Exports | 13,825 | 17,246 | 21,736 | 17.4 | 17.8 | 17.8 | 4,490.1 |
| Imports | 13,258 | 15,878 | 20,092 | 16.7 | 16.3 | 16.4 | 4,214.2 |
| 2. Nonfactor services | (1,444) | (1,671) | (2,170) | (1.8) | (1.7) | (1.8) | (498.7) |
| Exports | 1,923 | 2,277 | 2,467 | 2.4 | 2.3 | 2.0 | 190.1 |
| Imports | 3,368 | 3,948 | 4,637 | 4.2 | 4.1 | 3.8 | 688.8 |
| B. Factor income | (3,446) | (4,303) | (5,519) | (4.3) | (4.4) | (4.5) | (1,216.7) |
| Income | 548 | 663 | 1,091 | 0.7 | 0.7 | 0.9 | 427.3 |
| Outlays | 3,994 | 4,966 | 6,610 | 5.0 | 5.1 | 5.4 | 1,644.0 |
| C. Current transfers | 3,333 | 3,656 | 3,930 | 4.2 | 3.8 | 3.2 | 274.2 |
| Income | 3,568 | 3,925 | 4,202 | 4.5 | 4.0 | 3.4 | 277.2 |
| Outlays | 235 | 270 | 273 | 0.3 | 0.3 | 0.2 | 3.0 |
| II. Capital and financial account | 746 | 3,207 | 3,306 | 0.9 | 3.3 | 2.7 | 98.3 |
| 1. Long-term financial flows | 1,009 | 2,462 | 3,585 | 1.3 | 2.5 | 2.9 | 1,122.6 |
| Net foreign director investment in Colombia | 863 | 2,987 | 5,298 | 1.1 | 3.1 | 4.3 | 2,310.8 |
| Net loans | 512 | (399) | (1,710) | 0.6 | (0.4) | (1.4) | (1,310.6) |
| Net leasing | (337) | (76) | 25 | (0.4) | (0.1) | 0.0 | 100.7 |
| Other long-term movements | (29) | (50) | (29) | (0.0) | (0.1) | (0.0) | 21.6 |
| 2. Short-term financial flows ^{1/} | (263) | 745 | (279) | (0.3) | 0.8 | (0.2) | (1,024.3) |
| III. Net errors and omissions | 61 | 284 | 380 | 0.1 | 0.3 | 0.3 | 95.9 |
| IV. Change in gross international reserves ^{2/} | (184) | 2,541 | 1,570 | (0.2) | 2.6 | 1.3 | (971.2) |
| V. Gross international reserves | 10,921 | 13,540 | 14,957 | 13.7 | 13.9 | 12.2 | 1,416.8 |
| VI. Net international reserves | 10,916 | 13,536 | 14,947 | 13.7 | 13.9 | 12.2 | 1,411.5 |
| Months of goods imports | 9.9 | 10.2 | 8.9 | | | | |
| Months of goods and services imports | 6.4 | 6.6 | 5.7 | | | | |
| Nominal GDP in millions of dollars | 79,459 | 97,139 | 122,296 | | | | |
| VII. Change in net international reserves | (186) | 2,543 | 1,565 | (0.2) | 2.6 | 1.3 | (978.0) |

(pr) Preliminary.

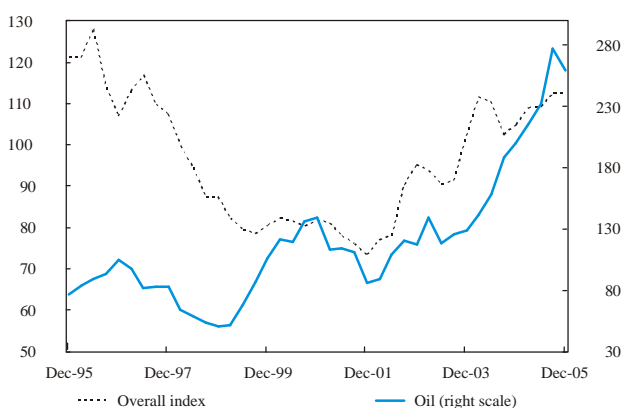
(e) Estimated.

^{1/} Including portfolio investment, direct loans and commercial credit.^{2/} According to balance-of-payments methodology.

Source: Banco de la República.

CHART 43

OVERALL COMMODITY PRICE INDEX EXCLUDING OIL AND OIL INDEX



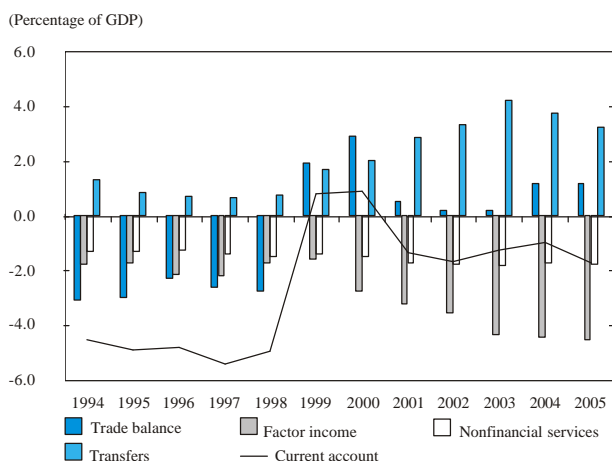
Source: EIU.

Although the current-account deficit is acceptable, it might pose a major risk in future. For besides recurrent revenues such as remittances, the account contains other, less certain revenue items such as sales of crude oil from depleting reserves. The authorities should therefore be on the alert to avert any unbounded increase in aggregate spending or an excessive appreciation of the real exchange rate that moves this variable away from its equilibrium level.

A detailed analysis follows of the different balance-of-payments components in 2005 and their prospects for 2006.

CHART 44

COMPOSITION OF THE CURRENT ACCOUNT (*)



(*) A change of methodology introduced in 1994 for measuring the balance of payments makes comparison with previous years difficult. The figures for 2005 are estimates. Source: Banco de la República.

1. Current account

In 2005 the current-account deficit widened by \$1,165 m relative to 2004, despite a trade-surplus increase of \$276 m. The widening stemmed from a \$1,217 m rise in net factor-income payments, consisting largely of profit and dividend payments from the oil sector and other sectors.

The increase in the trade-surplus was the net result of goods exports rising by \$4,490 m (or 26.6%) relative to 2004 and goods imports by \$4,214 m (or 26.7%). Growth in exports occurred mainly in oil and oil byproducts, followed by coal, coffee and ferronickel, all of

which benefited from the considerable pick-up in their world prices. By volume, exports of coffee, ferronickel and coal increased, whereas exports of oil and oil byproducts fell by around 3%, relative to 2004. Nontraditional exports went up by 19.3% in value over 2005, largely on the back of industrial products (Table 17).

By export destination, Venezuela and the United States strengthened their positions in 2005 as Colombia's chief trading partners (Table 18).

Some 46% of import growth came from capital-goods purchases, which expanded by 38% relative to 2004 of (Table 19). Under this item the

EXPORTS, BY MAIN PRODUCT AND ECONOMIC SECTOR

| | 2004 Millions of Dollars | 2005 (pr) Millions of Dollars | Change | | Contribution to growth | |
|---|--------------------------------|-------------------------------------|------------------------|-------------|---------------------------|----------------------|
| | | | Absolute ^{1/} | Percentage | Percentage points | Percentage points |
| Traditional exports | 7,659 | 10,366 | 2,707 | 35.3 | 16.2 | 60.7 |
| Coffee | 950 | 1,471 | 521 | 54.9 | 3.1 | 11.7 |
| Oil and oil byproducts | 4,227 | 5,559 | 1,332 | 31.5 | 8.0 | 29.9 |
| Coal | 1,854 | 2,598 | 745 | 40.2 | 4.4 | 16.7 |
| Ferronickel | 628 | 738 | 110 | 17.5 | 0.7 | 2.5 |
| Nontraditional exports ^{2/} | 9,072 | 10,822 | 1,749 | 19.3 | 10.5 | 39.3 |
| Nonmonetary gold | 561 | 517 | (44) | (7.8) | (0.3) | (1.0) |
| Emeralds | 74 | 72 | (2) | (3.0) | (0.0) | (0.0) |
| Other than gold and emeralds | 8,438 | 10,233 | 1,795 | 21.3 | 10.7 | 40.3 |
| Farming sector | 1,618 | 1,969 | 351 | 21.7 | 2.1 | 7.9 |
| Industrial sector | 6,616 | 7,887 | 1,271 | 19.2 | 7.6 | 28.5 |
| Mining sector ^{3/} | 204 | 378 | 174 | 85.3 | 1.0 | 3.9 |
| Total exports | 16,731 | 21,187 | 4,456 | 26.6 | 26.6 | 100.0 |

(pr) Preliminary.

^{1/} In millions of dollars.^{2/} Excluding temporary exports, re-exports and others, but including balance-of-payments adjustments.^{3/} Excluding gold and emeralds.

Source: DANE and Banco de la República.

behavior of capital-goods imports for industry was striking, reflecting the buoyancy displayed by investment and industrial activity throughout the year. Likewise, imports of raw materials, which grew substantially for industrial use (16.4%), accounted in all for 36% of overall import growth. Hence, more than 80% of import growth in 2005 was associated with a higher rate of investment in the economy and, to a lesser extent, with input demand stemming from stronger economic activity. The past two years' real exchange-rate appreciation also contributed to this result.

Profit and dividend transfers to parent companies grew considerably in 2005, a consequence of recent years' direct foreign investment inflows into the Colombian economy. Such transfers by oil-sector companies are estimated at \$1,944 m and by all other sectors of the economy at \$1,715 m, the total representing an increase of 36% on 2004.

Lastly, net transfers rose by \$277 m (or 7.5%) in 2005 relative to 2004, reaching an estimated value of \$3,930 m. Workers' remittances accounted for \$3,313 m of this amount, growing by an estimated 4% last year, much more slowly than their average growth of 19.9% a year between 2000 and 2004 (Box 5).

More than 80% of import growth in 2005 was associated with higher investment in the economy and, to a lesser extent, with input demand stemming from stronger economic activity.

TABLE 18

COLOMBIA'S NONTRADITIONAL EXPORTS, BY COUNTRY OF DESTINATION (PR)
(JANUARY-DECEMBER 2005)

| | United States | Venezuela | Ecuador | Japan | Germany | Mexico | All others | Total |
|---|----------------|----------------|----------------|--------------|--------------|--------------|----------------|-----------------|
| Annual percentage change in dollar value: | | | | | | | | |
| Total | 25.7 | 29.2 | 31.0 | 26.0 | 28.0 | 16.4 | 27.2 | 26.6 |
| Traditional | 31.2 | 15.8 | 214.5 | 33.7 | 40.4 | 42.1 | 38.2 | 35.3 |
| Nontraditional | 17.4 | 29.3 | 22.2 | (2.9) | 10.2 | 8.2 | 17.0 | 19.3 |
| Farming sector | 25.7 | 11.9 | 2.0 | 14.6 | 22.4 | 12.2 | 20.8 | 21.7 |
| Industrial sector | 13.5 | 32.7 | 17.3 | 9.7 | (7.7) | 8.1 | 18.4 | 19.2 |
| Food, beverages and tobacco | 1.4 | (1.0) | 32.0 | 12.7 | 1.6 | (34.2) | 29.7 | 15.3 |
| Yarns and fabrics | 1.0 | 9.7 | 34.5 | 0.0 | 37.3 | 21.6 | 14.8 | 16.2 |
| Garments | (8.0) | 40.4 | 17.9 | 68.4 | (14.6) | 30.1 | (1.6) | 2.9 |
| Plastic and rubber products | 25.2 | 55.2 | 28.1 | n,a, | 217.4 | 9.8 | 30.9 | 30.5 |
| Leather and leather goods | 16.0 | 35.4 | 8.7 | 2.1 | 23.1 | 9.5 | (0.8) | 8.6 |
| Wood and wood products | 2.1 | 96.2 | 53.1 | (33.3) | 61.5 | (25.8) | 15.0 | 22.0 |
| Graphic arts and publishing | 27.1 | 12.5 | 4.4 | 23.4 | (47.4) | 7.4 | 14.9 | 12.9 |
| Chemical industry | 45.1 | 11.3 | 13.3 | 20.8 | (17.2) | 24.2 | 12.9 | 16.1 |
| Nonmetallic minerals | 16.6 | 52.1 | 20.7 | 200.0 | (29.6) | 40.1 | 12.9 | 20.0 |
| Common-metals industry | 53.5 | 26.0 | 25.9 | (15.8) | (63.4) | 8.0 | 38.9 | 38.3 |
| Machinery and equipment | 21.3 | 42.8 | 11.6 | (78.8) | (73.8) | (29.2) | 7.2 | 14.7 |
| Transport materials | 104.1 | 80.6 | 19.2 | 100.0 | (92.6) | 16.4 | 73.4 | 61.7 |
| Optical, cinema and other apparatuses | 84.8 | 70.8 | 5.0 | 87.0 | 215.0 | 14.4 | 7.0 | 23.4 |
| Other industries | 5.2 | 40.2 | 4.9 | (52.9) | 306.8 | 22.4 | 28.7 | 20.7 |
| Mining sector (*) | 15.9 | 29.0 | 68.3 | (32.6) | 57.3 | 83.7 | (5.9) | 15.3 |
| Value of 2005 exports (millions of dollars): | | | | | | | | |
| Total | 8,850.9 | 2,097.6 | 1,324.4 | 330.2 | 339.2 | 610.9 | 7,634.0 | 21,187.2 |
| Traditional | 5,551.0 | 17.1 | 144.9 | 276.3 | 220.0 | 179.6 | 3,976.5 | 10,365.5 |
| Nontraditional | 3,299.9 | 2,080.5 | 1,179.4 | 53.9 | 119.2 | 431.3 | 3,657.5 | 10,821.7 |
| Farming sector | 997.4 | 290.0 | 6.6 | 19.8 | 75.5 | 1.8 | 577.5 | 1,968.5 |
| Industrial sector | 1,730.5 | 1,780.7 | 1,012.3 | 21.6 | 41.9 | 428.7 | 2,871.1 | 7,886.7 |
| Mining sector (*) | 571.9 | 9.8 | 160.6 | 12.5 | 1.8 | 0.9 | 208.9 | 966.4 |
| Contribution to growth (percentage points): | | | | | | | | |
| Total | 10.8 | 2.8 | 1.9 | 0.4 | 0.4 | 0.5 | 9.8 | 26.6 |
| Traditional | 7.9 | 0.0 | 0.6 | 0.4 | 0.4 | 0.3 | 6.6 | 16.2 |
| Nontraditional | 2.9 | 2.8 | 1.3 | (0.0) | 0.1 | 0.2 | 3.2 | 10.5 |
| Farming sector | 1.2 | 0.2 | 0.0 | 0.0 | 0.1 | 0.0 | 0.6 | 2.1 |
| Industrial sector | 1.2 | 2.6 | 0.9 | 0.0 | (0.0) | 0.2 | 2.7 | 7.6 |
| Mining sector (.) | 0.5 | 0.0 | 0.4 | (0.0) | 0.0 | 0.0 | (0.1) | 0.8 |

(pr) Preliminary.

(*) Including gold and emeralds.

Source: DANE and Banco de la República.

FOB IMPORTS, BY ECONOMIC USE OR DESTINATION

| | January-December | | Change | | Contribution to growth | |
|-----------------------------------|--------------------|--------------------|------------------------|---------------|------------------------|--------------|
| | 2004 ^{1/} | 2005 ^{1/} | Absolute ^{1/} | % | % points | % |
| Consumer goods | 2,944 | 3,674 | 730 | 24.8 | 4.7 | 17.5 |
| Durables | 1,516 | 1,958 | 442 | 29.2 | 2.8 | 10.6 |
| Nondurables | 1,429 | 1,716 | 287 | 20.1 | 1.8 | 6.9 |
| Intermediate goods | 7,612 | 9,151 | 1,539 | 20.2 | 9.8 | 36.9 |
| Fuel and lubricants ^{2/} | 244 | 520 | 276 | 113.5 | 1.8 | 6.6 |
| For farming | 605 | 668 | 62 | 10.3 | 0.4 | 1.5 |
| For industry | 6,499 | 7,566 | 1,068 | 16.4 | 6.8 | 25.6 |
| Construction materials | 265 | 397 | 133 | 50.1 | 0.8 | 3.2 |
| Capital goods | 5,042 | 6,956 | 1,915 | 38.0 | 12.3 | 45.9 |
| For farming | 52 | 59 | 7 | 14.4 | 0.0 | 0.2 |
| For industry | 3,239 | 4,610 | 1,372 | 42.3 | 8.8 | 32.8 |
| Transport equipment | 1,751 | 2,287 | 536 | 30.6 | 3.4 | 12.8 |
| Unclassified goods | 31 | 17 | (8) | (43.8) | (0.1) | (0.2) |
| Total imports | 15,629 | 19,799 | 4,175 | 26.7 | 26.7 | 100.0 |

^{1/} In millions of dollars.

^{2/} Including byproducts of both oil and coal.

Source: DANE and DIAN (tax administration).

2. Capital and financial account

In 2005 the capital and financial account showed a net inflow of funds estimated at \$3,306 m (resulting from net long-term inflows of \$3,585 m and net short-term outflows of \$279 m).

Regarding long-term flows, preliminary estimates put net inflows of foreign direct investment at around \$5,300 m, or 4.3% of GDP, an unprecedented percentage in recent Colombian history, only exceeded in 1997, when it reached 4.5% of GDP (or \$4,753 m), driven among other things by the privatization programs of various state-owned companies. In 2005 a number of major companies, notably Bavaria, Coltabaco and Granahorrar were sold

Preliminary estimates put net FDI inflows at around \$5,300 m, or 4.3% of GDP, an unprecedented percentage in recent Colombian history, only exceeded in 1997, when it was 4.5% of GDP (or \$4,753 m).

In 2005, for the first time in the present decade the consolidated (financial and nonfinancial) public sector showed net outflows of capital and reduced its net external liabilities.

to private investors. The mining and oil sectors also received considerable inflows of foreign investment, totaling some \$3,100 m.

Capital inflows were partly offset by net payments on external debt and the accumulation of overseas public-sector assets amounting to \$2,956 m. In particular, in 2005 the government prepaid foreign debt in the amount of \$1,891 m; and it substituted domestic debt for external debt, which involved repaying external debt of \$666 m, over and above scheduled repayments. The government increased its assets abroad by \$264 m. This was the first time in the present decade that the consolidated (financial and nonfinancial) public sector showed net outflows of capital and reduced its net external liabilities (Table 20).

The private sector is estimated to have reported net capital inflows worth \$964 m in 2005 from external borrowing and portfolio investments, compared with \$256 m the year before. As in 2004, net long-term debt flows were negative in 2005, by \$458 m, whereas net short-term financing, including both external debt and portfolio capital flows, was positive, by \$1,422 m. Short-term financing was largely connected with growth of commercial activity, particularly higher imports.

TABLE 20

PUBLIC AND PRIVATE CAPITAL FLOWS: 2000-2005
(MILLIONS OF DOLLARS)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 (e) |
|--|----------------|----------------|--------------|----------------|--------------|----------------|
| Total capital and financial account | 58 | 2,459 | 1,279 | 746 | 3,207 | 3,306 |
| I. Total private sector | (394) | 1,023 | 931 | 368 | 3,244 | 6,262 |
| A. Net foreign investment in Colombia | 2,069 | 2,509 | 1,258 | 863 | 2,987 | 5,298 |
| B. Rest of private sector, excl. FDI | (2,463) | (1,485) | (327) | (495) | 256 | 964 |
| Long term | (1,108) | (369) | (1,346) | (1,095) | (1,263) | (458) |
| Short term | (1,355) | (1,117) | 1,019 | 600 | 1,519 | 1,422 |
| II. Total public sector | 452 | 1,435 | 349 | 378 | (36) | (2,956) |
| A. Nonfinancial | 1,253 | 1,906 | 475 | 665 | 382 | (2,142) |
| B. Financial | (800) | (471) | (126) | (287) | (419) | (814) |
| Nonfinancial public sector | 1,253 | 1,906 | 475 | 665 | 382 | (2,142) |
| Government | 2,026 | 2,650 | 771 | 1,673 | 864 | (1,419) |
| Long term | 1,920 | 3,788 | (648) | 1,933 | 1,352 | (1,155) |
| Disbursements | 2,870 | 5,485 | 2,246 | 4,786 | 2,750 | 3,935 |
| Debt repayments | 950 | 1,697 | 2,894 | 2,853 | 1,398 | 5,090 |
| Short term (loans and debt) | 106 | (1,138) | 1,419 | (260) | (488) | (264) |
| Rest of institutions | (773) | (744) | (296) | (1,007) | (482) | (723) |
| Long term | (298) | (360) | (473) | (505) | (490) | (60) |
| Disbursements | 368 | 259 | 224 | 130 | 140 | 378 |
| Debt repayments | 666 | 619 | 697 | 635 | 631 | 438 |
| Short term (loans and debt) | (475) | (384) | 177 | (502) | 9 | (663) |

(e) Estimated.

Source: Banco de la República.

External borrowing by the private sector has been declining since 2000, in both long-term and short-term debt. This is in contrast to what occurred during 1993-1997, when external borrowing was a major source of financing, exceeding in some years inflows of foreign direct investment. As shown by Chart 45, FDI flows have been the chief source of long-term external funding in the past four years.

Lastly, the country's overall external-debt balance in December 2005 is estimated at \$39,097 m (or 32.0% of GDP), with the public sector accounting from \$24,493 m (63%) of this debt and the private sector for \$14,604 m (37%) (Table 21). The short-

COMPOSITION OF LONG-TERM CAPITAL FLOWS
(FDI AND THE REST)

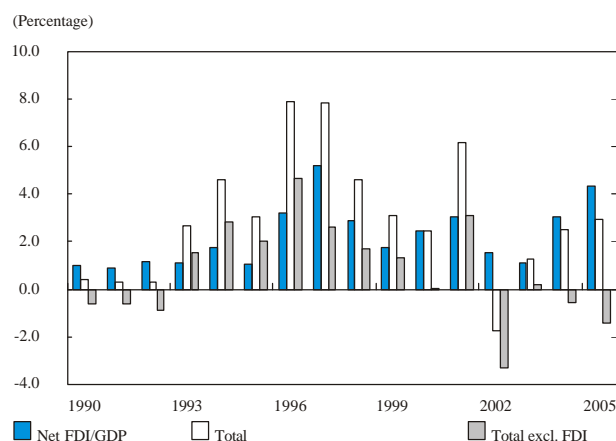


TABLE 21

COLOMBIA'S EXTERNAL-DEBT BALANCE

| | Millions of Dollars | | | | | Percentage of GDP | | | | |
|--|---------------------|---------------|---------------|---------------|---------------|-------------------|-------------|-------------|-------------|-------------|
| | 2001 | 2002 | 2003 | 2004 (pr) | 2005 (e) | 2001 | 2002 | 2003 | 2004 | 2005 |
| Overall balance | 39,109 | 37,336 | 38,066 | 39,455 | 39,097 | 47.7 | 46.0 | 47.9 | 40.6 | 32.0 |
| Public sector | 23,468 | 22,781 | 24,527 | 25,779 | 24,493 | 28.6 | 28.1 | 30.9 | 26.5 | 20.0 |
| Private sector | 15,640 | 14,555 | 13,538 | 13,676 | 14,604 | 19.1 | 17.9 | 17.0 | 14.1 | 11.9 |
| 1. Medium and long term | 35,986 | 33,844 | 34,700 | 34,522 | 32,838 | 43.9 | 41.7 | 43.7 | 35.5 | 26.9 |
| a. Public sector according to borrower | 23,053 | 22,262 | 24,228 | 25,321 | 24,103 | 28.1 | 27.4 | 30.5 | 26.1 | 19.7 |
| Nonfinancial public sector | 22,020 | 21,428 | 23,634 | 24,856 | 23,678 | 26.9 | 26.4 | 29.7 | 25.6 | 19.4 |
| Government | 18,188 | 18,013 | 20,663 | 22,320 | 21,194 | 22.2 | 22.2 | 26.0 | 23.0 | 17.3 |
| Decentralized institutions | 3,832 | 3,415 | 2,970 | 2,536 | 2,485 | 4.7 | 4.2 | 3.7 | 2.6 | 2.0 |
| Financial public sector | 1,033 | 834 | 594 | 465 | 424 | 1.3 | 1.0 | 0.7 | 0.5 | 0.3 |
| b. Private sector | 10,332 | 9,145 | 8,369 | 7,173 | 6,681 | 12.6 | 11.3 | 10.5 | 7.4 | 5.5 |
| Financial | 434 | 216 | 166 | 151 | 421 | 0.5 | 0.3 | 0.2 | 0.2 | 0.3 |
| Nonfinancial | 9,898 | 8,928 | 8,203 | 7,022 | 6,260 | 12.1 | 11.0 | 10.3 | 7.2 | 5.1 |
| c. Leasing | 2,601 | 2,438 | 2,104 | 2,029 | 2,054 | 3.2 | 3.0 | 2.6 | 2.1 | 1.7 |
| Public | 95 | 91 | 76 | 67 | 58 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 |
| Private | 2,507 | 2,347 | 2,028 | 1,962 | 1,995 | 3.1 | 2.9 | 2.6 | 2.0 | 1.6 |
| 2. Short term | 3,122 | 3,492 | 3,365 | 4,933 | 6,259 | 3.8 | 4.3 | 4.2 | 5.1 | 5.1 |
| a. Public sector | 320 | 429 | 224 | 391 | 332 | 0.4 | 0.5 | 0.3 | 0.4 | 0.3 |
| b. Private sector | 2,802 | 3,063 | 3,141 | 4,542 | 5,927 | 3.4 | 3.8 | 4.0 | 4.7 | 4.8 |
| Memo item: | | | | | | | | | | |
| Overall balance excl. leasing | 36,507 | 34,899 | 35,962 | 37,427 | 37,043 | 44.5 | 43.0 | 45.3 | 38.5 | 30.3 |
| Public | 23,373 | 22,691 | 24,452 | 25,712 | 24,435 | 28.5 | 28.0 | 30.8 | 26.5 | 20.0 |
| Private | 13,134 | 12,208 | 11,510 | 11,715 | 12,609 | 16.0 | 15.0 | 14.5 | 12.1 | 10.3 |

(e) Estimated.

(pr) Preliminary.

Source: Banco de la República.

The country's overall external-debt balance in December 2005 is estimated at \$39,097 m (or 32.0% of GDP), with the public sector accounting from \$24,493 m (63%) of this debt and the private sector for \$14,604 m (37%).

term external-debt balance stood at \$6,259 m (or 5.1% of GDP) in December, 95% of it owed by the private sector.

3. Movements in international reserves

By the balance-of-payments methodology, in 2005 the Banco de la República accumulated gross international reserves of \$1,570 m,¹⁸ bringing the balance to \$14,947 m, or 12.1% of GDP. This balance is equivalent to 8.9 months of imports of goods, 5.7 months of imports of goods and services, and 1.3 times the value of public- and private-debt repayments in one year. As stated earlier, in 2005 the Banco de la República made discretionary foreign-exchange purchases of \$4,658 m and sold foreign currency worth \$3,250 m to the government (see Table 4). Chapter VI provides more detailed information on the country's international reserves.

B. BALANCE-OF-PAYMENTS OUTLOOK FOR 2006

The current account is forecast to show a deficit of \$2,692 m (2% of GDP) for 2006, mainly because the goods trade surplus is expected to plunge from \$1,644 m (1.3% of GDP) in 2005 to \$125 m (0.1% of GDP) in 2006 (Table 22).

¹⁸ The figure \$1,1570 m as variation in gross international reserves refers to a balance-of-payments concept that does not include valuation gains or losses on the reserves from exchange-rate differentials or interest rates. As explained in the chapters on reserves and the Bank's

TABLE 22

COLOMBIA'S PROJECTED BALANCE OF PAYMENTS

| | Millions of Dollars | | | Percentage of GDP | | |
|--|---------------------|-------------|----------------|-------------------|-------------|----------------|
| | 2004 | 2005 (e) | 2006 (proj) | 2004 | 2005 (e) | 2006 (proj) |
| I. Current account | (950) | (2,115) | (2,693) | (1.0) | (1.7) | (2.0) |
| A. Nonfactor goods and services | (303) | (526) | (1,883) | (0.3) | (0.4) | (1.4) |
| 1. Goods | 1,368 | 1,644 | 125 | 1.4 | 1.3 | 0.1 |
| 2. Nonfactor services | (1,671) | (2,170) | (2,008) | (1.7) | (1.8) | (1.5) |
| B. Factor income | (4,303) | (5,519) | (4,802) | (4.4) | (4.5) | (3.5) |
| C. Transfers | 3,656 | 3,930 | 3,992 | 3.8 | 3.2 | 2.9 |
| II. Capital and financial account and change in gross international reserves | 950 | 2,115 | 2,693 | 1.0 | 1.7 | 2.0 |
| A. Net direct investment | 2,987 | 5,298 | 3,806 | 3.1 | 4.3 | 2.8 |
| B. Other capital movements 1/ | (2,037) | (3,183) | (1,113) | (2.1) | (2.6) | (0.8) |

(proj) Projection.

(pr) Preliminary.

1/ Includes public- and private-sector transactions, errors and omissions, and change in gross international reserves.

Source: Banco de la República.

The deficit in factor income is projected to shrink by \$717 m in 2006 relative to its estimated value for 2005. The shrinkage would result from the combined effect of higher interest income earned on international reserves and lower interest payments on public and private external debt.

Lastly, the current-account deficit in 2006 is expected to be more than financed from net foreign direct investment, which is forecast to remain buoyant mainly in the oil and coal sector.

The current-account deficit in 2006 is expected to be more than financed from net foreign direct investment, which is forecast to remain buoyant mainly in the oil and coal sectors.

balance sheet, valuation losses were incurred on international reserves and if taken into account would reduce the gross variation in reserves to \$1,417 m.

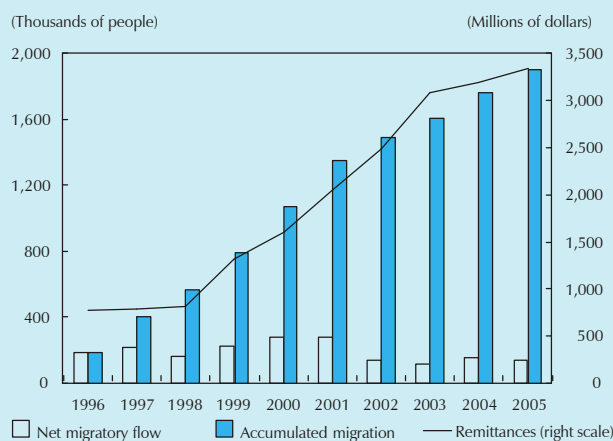
WORKERS' REMITTANCES AND THEIR ECONOMIC IMPACT

The number of Colombians migrating abroad has increased considerably since 1996. According to Security Administration data, between 1996 and 2005 some 1,905,000 Colombians left the country for good. This process has generated a substantial inflow of workers' remittances to Colombia. Over the past four years remittances have become the second largest source of balance-of-payments current income, growing at annual rates of over 20%. Thus, while in 1996 remittance income amounted to \$745 m, in 2005 it reached the sum of \$3,313 m. But the pace of growth had begun to slow from two years before, when the annual increase in remittances was around 5% (Chart B5.1). Despite their recent slowdown, remittances have become significant as a percentage of GDP, rising from 1.9% in 2000 to 3.3% in 2004 and running at 2.7% in 2005 (Table B5.1).

In general, family remittances are mainly used to finance household consumption, followed by education and health expenses, producing a direct impact and also marginal effects on the country's social and economic variables. There is evidence of the positive impact of remittances on economic indicators such as poverty, education and health levels, the labor market, and saving and investment capacity of the economy.

A full analysis of recent years' movements in workers' remittances to Colombia and their economic impact is to be found in the Editorial Notes of the November and December 2005 issues of *Revista del Banco de la República*. As illustrated in the

CHART 5.1
COLOMBIA: EMIGRATION AND WORKERS' REMITTANCES



Source: Security Administration (DAS); calculations by Banco de la República. The figure for 2005 is a preliminary estimate, subject to revision.

TABLE R5.1
BALANCE OF PAYMENTS: FOREIGN-EXCHANGE INCOME FROM WORKERS' REMITTANCES

| | 1999 | 2000 | 2001 (p) | 2002 (p) | 2003 (pr) | 2004 (pr) | 2005 (e) |
|--|-------|-------|-------------|-------------|--------------|--------------|-------------|
| As % of GDP | 1.51 | 1.88 | 2.47 | 3.02 | 3.84 | 3.27 | 2.70 |
| As % of balance-of-payments current income | 7.81 | 8.42 | 10.86 | 13.71 | 15.41 | 13.15 | 11.23 |
| As % of goods exports | 10.78 | 11.50 | 15.73 | 19.92 | 22.13 | 18.38 | 15.24 |
| As a proportion of: | | | | | | | |
| Foreign direct investment income (%) | 86.04 | 65.89 | 80.06 | 116.04 | 169.91 | 101.28 | |

(p) Provisional.

(pr) Preliminary.

(e) Estimated.

Source: Banco de la República.

Revista, surveys conducted in the country's center-west metropolitan region show that remittances are an essential source of funding for current expenditure, and that they it makes it possible for recipient households to save. Thus, in 2004 around 85% of the value of remittances received by households in the region was used for recurrent expenses. And of the 13.4% of the region's households that were able to save money, 14.5% could do so thanks to remittances.

Regarding the contribution of remittances to investment, remittance transfers for home purchasing in Colombia have increased substantially, as deduced from information collected in different cities in the United States and Spain, where Colombians residing abroad are concentrated. Figures from the foreign-exchange balance show that remittance transfers for home purchasing amounted to \$104 m in 2005.

There is evidence that remittances help to reduce poverty, though their impact is not that large. In effect, in the center-west region of the country, 59.4% of households receiving remittances are below the poverty line, compared with 64.3% of those lacking such income.

Remittances have an ambiguous impact on the labor market. On the one hand they affect it directly, for example by reducing labor supply through emigration of workers, and by creating jobs in the countries receiving remittances. On the other hand they affect the market indirectly by boosting consumption of nontradables, thereby increasing demand for labor in nontradables sectors, or possibly by discouraging labor effort by beneficiaries.

Kugler (2006) has modeled for Colombia the impact of remittance income on job creation and human-capital formation. He has found that these foreign-currency

flows increase opportunities for school attendance, thereby contributing to human-capital formation. The increase in qualified manpower induces job creation and the demand for this resource in the receiving economy.

Bibliographical reference

Kugler, Maurice (2006). "Migrant Remittances,
Capital Formation and Job Creation

Externalities in Colombia," in Borradores de
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VI. INTERNATIONAL RESERVES

At December 2005 net international reserves totaled \$14,947.3 m, a level deemed adequate. An adequate volume of reserves reduces the very likelihood of an external crisis and, should one occur, acts as a funding cushion that minimized the need for making an abrupt adjustment to the economy.

International reserves amounted to \$14,947.3 m at December 2005.¹⁹ During the year reserves of \$4,658.4 m were bought through discretionary intervention, foreign exchange of \$3,250 m was sold to the government, profits of \$196 m were transferred to it, and a net profit of \$81.4 m was obtained on international-reserves investments. The net result of these operations was an accumulation of international reserves of \$1,411.5 m, down from \$2,620 m in 2004. Section A below discusses the economy's vulnerability indicators associated with the level of reserves, and evaluation of their adequate level. Section B explains the composition of the international reserves and the criteria for their management.

A. LEVEL OF INTERNATIONAL RESERVES AND THE ECONOMY'S EXTERNAL VULNERABILITY

Emerging countries have accumulated a large stock of international reserves in recent years, after the late nineties' crisis in foreign-capital markets. Such reserves accumulation has generally been justified by the need to have an adequate degree of international liquidity to cope with unexpected developments such as terms-of-trade shocks, financial panics, contagion from other crises, and all other factors that could cause a reversal of capital flows. In this context, it is argued that keeping an adequate level of international

¹⁹ Net reserves are equal to the total of international reserves, or gross reserves, less the Bank's short-term external liabilities. These liabilities consist of foreign-currency demand obligations to nonresident agents. Unless otherwise indicated, all figures in this document are provisional and refer to the end of December 2005; any discrepancies would be caused by approximations.

reserves not only helps to deal with such shocks but may even make their occurrence less likely.

This is true even with a floating exchange rate, which is presumably more in line with its determinants and would not require a high level of reserves. International experience shows that unexpected shocks affect countries that have a flexible exchange rate, particularly those with excessive foreign-currency debt and no means of hedging against massive devaluations. This is why emerging countries with floating rates have also been seen to keep considerable levels of reserves.

After the 1999 crisis Colombia's accumulated international reserves were substantially increased, from \$8,100 m in late 1999 to \$10,900 m in December 2003. In 2003 the Banco de la República published a study explaining the different criteria for assessing the adequate reserve level.²⁰ Based on those criteria it was determined that Colombia did not have a large excess of international reserves. This result was obtained by reviewing the indicators most used by markets to measure the economy's external vulnerability, and by conducting a cost-benefit analysis. Such analysis recognizes that holding reserves may make the economy less vulnerable to external shocks but involves an opportunity cost, for financial yield on the reserves may be lower than if they were used for other purposes.

The study also concluded that two factors should be taken into account in deciding to use international reserves to prepay external public debt: i) the financial benefits of saving on interest, since the cost of external public debt is higher than the yield on reserves; and ii) the higher cost of future debt, because the decrease in reserves may affect the perception of country risk and make borrowing more costly by raising the spread. The conclusion reached in December 2003 was that there was not much scope for using international reserves to prepay external debt, for the extra cost of new funding would exceed the financial benefits of prepayment. It was therefore decided in 2004 to sell a moderate sum of reserves, \$500 m, to the government.

Between 2004 and 2005, amid changes in the external and internal environments, Colombia continued to amass international reserves. By December 2005 they stood at almost \$15,000, even after sales totaling

²⁰ See "Análisis del nivel adecuado de Reservas internacionales", especial edition, *Revista del Banco de la República*, december 2003, <<http://banrep.gov.co/publicaciones/ReservasInternacionales.pdf>>.

\$3,750 m made by the Bank to the government between 2004 and 2005. Favorable changes in the environment have also affected the factors determining the adequate level of reserves, such as GDP in dollars and the spread on Colombian external debt. As discussed below, movements in these variables suggest that the accumulation of reserves went hand in hand with a rise in their adequate level.

1. Movements in traditional indicators of external liquidity

Analysis of the economy's indicators of external vulnerability is centered on those that measure the impact of external borrowing both on its level and on the short-term payment obligations generated. These indicators are supplemented by inclusion of the current-account deficit. International markets generally consider that in these indicators a value less than one may be a warning sign of external vulnerability, depending on each country's characteristics.

Based on the foregoing, the more relevant indicators for determining sovereign country risk are:

Reserves / current- or following-year debt repayments: This indicator suffices for countries that have neither a current-account deficit nor an over-valued currency, so that the need for international liquidity is limited to external debt repayments.

Reserves / overall external debt service: a useful measure when a country needs to turn to the international market to finance payments not only of principal but also of interest on external debt.

Reserves / (debt repayments + current-account deficit): This ratio is indicative of the external vulnerability of countries that have large principal and interest obligations and a current-account deficit and, should international markets become closed, would want to make a gradual adjustment without sharp cuts in spending and output.

Other reserve indicators: Vulnerability indicators are supplemented by measuring the size of reserves relative to other economic variables: i) the traditional reserves / imports ratio; ii) the ratio of reserves to GDP; and iii) the ratio of reserves to the broad monetary aggregate, M3.

Table 23 shows movements in the above indicators for Colombia between 2002 and 2005. It will be seen that, under groups A and B, debt-repayment and external-liquidity indicators improved considerably until 2004, and that some of them (res. / debt repayments + current-account deficit) were still close to one at the end of 2005.

TABLE 23

COLOMBIA'S INTERNATIONAL-RESERVES INDICATORS

| | 2002 | 2003 | 2004 | 2005 (e) |
|---|--------|--------|--------|----------|
| Balance | | | | |
| Net international reserves (millions of dollars) | 10,841 | 10,916 | 13,536 | 14,947 |
| Indicators | | | | |
| A. External debt repayment indicator | | | | |
| External debt repayments (millions of dollars) | 10,146 | 10,173 | 8,961 | 13,120 |
| Net reserves / current-year external debt repayments | 1.07 | 1.07 | 1.51 | 1.14 |
| Net reserves / following-year external debt repayments | 1.07 | 1.22 | 1.03 | 1.30 |
| B. Adequate external liquidity position | | | | |
| NIR / current-year debt servicing | 0.86 | 0.87 | 1.18 | 0.93 |
| NIR / following-year debt servicing | 0.86 | 0.95 | 0.85 | 1.05 |
| NIR / (current-year debt repayments + current-year curr. acct. def.) | 0.94 | 0.98 | 1.37 | 0.98 |
| NIR / (following-year debt repayments + following-year curr. acc. def.) | 0.97 | 1.10 | 0.89 | 1.05 |
| C. Other international reserves indicators | | | | |
| NIR as months of imports | 8.46 | 7.88 | 8.19 | 7.25 |
| NIR / M3 (percentage) | 41.85 | 36.47 | 33.31 | 30.33 |
| NIR / GDP (percentage) | 13.36 | 13.58 | 13.76 | 12.08 |

(e) Estimated.

Source: Banco de la República.

Indicators of external vulnerability were influenced by the government's prepayment of external debt last year as part of its policy of substituting domestic debt for foreign debt. In particular: i) the indicators considering following-year debt repayment and debt servicing weakened in 2004 but improved in 2005; and ii) those considering current-year debt repayments and debt servicing were affected negatively in 2005. Since those foreign-debt prepayments had favorable repercussions on the profile and future trajectory of debt repayments, these indicators are expected to improve significantly in 2006.²¹

The third part of Table 23 reveals that the reserves have remained above seventh months' imports, a higher level than international standards for this indicator. You will notice also that, though the reserves balance has grown, its size relative to GDP in dollars has not risen, and relative to the amount of deposits in the financial system (M3) it has declined.

Comparing Colombia's various international-liquidity indicators with those of other countries of the region reveals that in terms of reserves as import cover

²¹ Es importante anotar que las amortizaciones de 2006 consideradas para el cálculo de los indicadores de Reservas/amortizaciones, y servicio de deuda del año 2006 no incluyen US\$600 m de prepago de deuda externa realizado por el Gobierno en la segunda semana de March; no obstante, si se incorpora este prepago estos mismos indicadores mostrarían una mejora con respecto a los de 2004,

Colombia ranks above Chile and Mexico but below Brazil, and in terms of reserves as a ratio of M3 Colombia ranks above all three (Chart 46). However, Colombia's ratio of reserves to debt repayments is lower than Chile's and Mexico's but higher than Brazil's, and its reserves-to-GDP ratio is lower than Chile's but higher than both Brazil's and Mexico's.

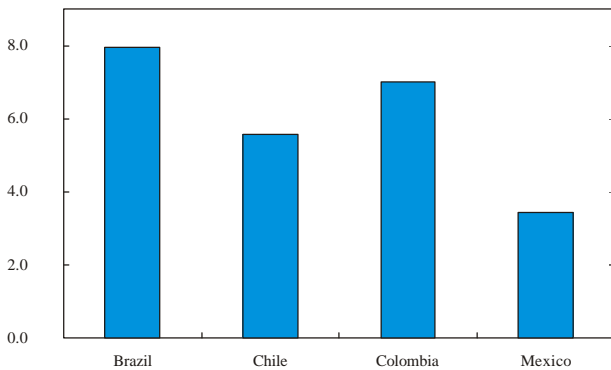
The above facts suggest that compared with similar countries of the region that are subject to similar external shocks, Colombia has not over-accumulated international reserves. In this connection, it should be noted that most emerging countries have accumulated large quantities of reserves since the foreign capital market crisis of the late nineties.

CHART 46

INTERNATIONAL-RESERVES INDICATORS FOR VARIOUS COUNTRIES

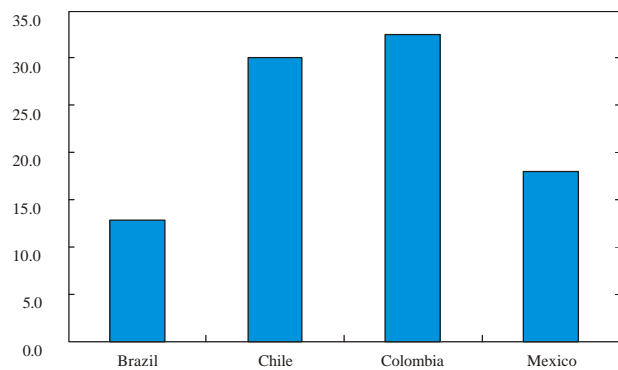
INTERNATIONAL RESERVES
DATA TO JUNE-05

(Months of imports)



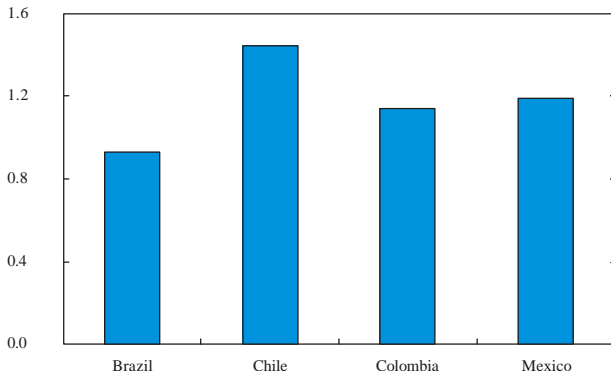
INTERNATIONAL RESERVES / M3
DATA TO SEPT-05

(Percentage)



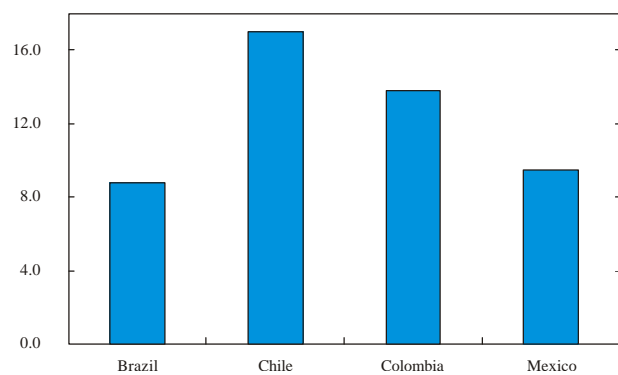
INTERNATIONAL RESERVES / DEBT REPAYMENTS
DATA TO DEC-05

(Percentage)



INTERNATIONAL RESERVES / GDP
DATA TO DEC-04

(Percentage)



Sources: For ratios of reserves to M3 and GDP and reserves as months of imports: IMF, calculations by Banco de la República. For the ratio of reserves to debt repayments: Goldman JP Morgan (Economic Research, Global Currency Strategy, World Financial Markets, December 2005), Goldman Sachs (Latin America Economic Analyst, January 2006); calculations by Banco de la República.

Compared with similar countries of the region that are subject to similar external shocks, Colombia has not over-accumulated international reserves.

2. Cost-benefit analysis for determining the adequate reserve level

Cost-benefit analysis is a complementary approach for evaluating the adequate reserve level. It recognizes that, though reserves accumulation may improve liquidity conditions and reduce the economy's external vulnerability, these benefits have to be balanced against the opportunity cost incurred when central banks invest in low-risk liquid assets yielding less than other uses (for example, prepayment of external debt). Hence, the adequate reserve level depends on the evolution of the variables that determine the costs and benefits of holding reserves. A description follows of these variables:

- *Benefits:* In these models the benefit of accumulating reserves is reflected in a lower probability of a crisis occurring and a smaller loss of output in averting it. Moreover, should a crisis occur, a higher level of international reserves makes it less costly to adjust spending. Thus, increases in the dollar value of GDP raise the benefit of accumulating reserves, whereas reducing the probability of a crisis occurring reduces the utility of having more reserves.
- *Costs:* The opportunity cost of accumulating reserves is measured as the difference between the cost of borrowing from abroad and the yield of overseas assets. This difference is usually expressed by the spread each country pays on the debt it issues. In this case, lower spreads reduce the opportunity cost of accumulating more reserves and vice versa.

A crucial ingredient of this model is the direct relationship between the spread on foreign-debt placement and the probability of crisis. In determining the foreign-debt spread (or surcharge), markets are implicitly evaluating the probability of a crisis occurring. Moreover, given that the spread depends on macroeconomic indicators, a relationship is established between these indicators and crisis probability. Hence, the probability of external crisis will depend on international-liquidity indicators (e.g., reserves / imports, or reserves / debt repayments), solvency indicators (e.g., debt / exports), the degree of economic liberalization, the contagion effect of other emerging economies, and other macroeconomic and financial variables.

Table 24 presents an updating of the results of the model used in December 2003. Given the difficulty of quantifying the cost of a crisis, since it depends on the size and duration of the crisis, optimum reserve levels were estimated for a range of cost assumptions going from 1% to 100% of quarterly GDP in dollars.²² For each period, the probability model was re-estimated and then the cost of the crisis was modified in terms of loss

of output. The results show that in every year the higher the loss of output, the greater the optimum reserve amount, pointing up the precautionary role of reserves in facing external shocks.

Note also that the estimated optimum reserve amounts increased for all levels of crisis cost between December 2003 and December 2004 and thereafter stabilized in most cases at around December-2004 levels. The increase in optimum reserve amounts was consistent with the changes in the domestic and external environments that led to accumulation of international reserves, as shown in Table 25.

²² This percentage is to be interpreted as loss of output over the duration of a crisis, expressed as a percentage of one quarter's GDP. In the original model of Ben-Bassat and Gottlieb (1991) the output loss from a crisis is estimated to last seven years.

TABLE 24

ESTIMATED OPTIMUM INTERNATIONAL RESERVES LEVEL, 2003-2005

| Cost of crisis (% of GDP) | Millions of dollars | | | | |
|---|---------------------|---------------|---------------|---------------|---------------|
| | Dec-03 | Jun-04 | Dec-04 | Jun-05 | Dec-05 |
| 1.0 | 5,885 | 7,085 | 8,660 | 8,715 | 8,825 |
| 4.0 | 9,075 | 11,155 | 13,240 | 13,185 | 13,025 |
| 5.5 | 9,925 | 12,235 | 14,465 | 14,385 | 14,175 |
| 10.0 | 11,685 | 14,465 | 17,005 | 16,885 | 16,585 |
| 40.0 | 16,675 | 20,925 | 24,400 | 24,195 | 23,695 |
| 100.0 | 20,095 | 26,085 | 30,625 | 30,555 | 29,895 |
| Actual international reserves (Quarterly average) | 10,729 | 11,464 | 12,933 | 13,473 | 14,648 |

Source: Estimated on the updated optimum-reserves model presented in the paper "Análisis del nivel adecuado de reservas internacionales," December 2003, Banco de la República.

TABLE 25

VARIABLE DETERMINANTS IN MODEL OF OPTIMUM INTERNATIONAL-RESERVES LEVEL

| Variable | Unit | Dec-03 | Jun-04 | Dec-04 | Jun-05 | Dec-05 |
|--|---------------------|--------|--------|--------|--------|--------|
| Six-month Libor | Percentage | 1.23 | 1.53 | 2.48 | 3.49 | 4.53 |
| Spread on Colombia's external debt | Basis points | 401 | 413 | 331 | 336 | 228 |
| Total private external debt balance | Millions of dollars | 13,539 | 13,303 | 13,677 | 13,663 | 14,631 |
| Total public external debt balance | Millions of dollars | 24,527 | 24,295 | 25,779 | 23,402 | 24,056 |
| International reserves (final quarter average) | Millions of dollars | 10,729 | 11,464 | 12,933 | 13,473 | 14,648 |
| GDP (quarterly) | Millions of dollars | 21,147 | 23,244 | 27,048 | 30,651 | 32,383 |
| Goods exports FOB (quarterly) | Millions of dollars | 3,372 | 3,977 | 4,613 | 5,533 | 5,110 |
| Goods imports FOB (quarterly) | Millions of dollars | 3,360 | 3,723 | 4,406 | 4,968 | 5,348 |
| Next four quarters' debt repayments | Millions of dollars | 5,595 | 7,097 | 8,207 | 6,710 | 4,768 |
| Spread on Latin American external debt | Basis points | 468 | 479 | 379 | 345 | 274 |

Source: Bloomberg, IMF and DANE; calculations by Banco de la República.

Movements in the variables presented in Table 25 affect determination of the adequate reserve level in the following ways:

Factors justifying a higher level of reserves:

- The fall in Colombia's foreign-debt spread represents a decrease in the opportunity cost of holding reserves. The fall in the spread has resulted from domestic and external factors, including notably a rise in the ratio of reserves to debt repayments, and a decline in the debt-to-exports ratio. Moreover, abundant liquidity in international capital markets has reduced the spread for Latin American countries, which in turn has favorably affected Colombia's spread.
- The rise in dollar GDP, driven both by exchange-rate revaluation and by the very growth of the economy, makes a potential crisis more costly and hence increases the benefit of holding reserves for precautionary reasons (should an external crisis occur).

Factors justifying a lower level of reserves:

- The reduction observed in the external-debt spread and the evolution of its determining variables imply a lower probability of crisis (or suspension of payments), reducing the need for accumulating reserves.
- According to the results, the rise in estimated optimum reserves indicates that factors favoring reserves accumulation have predominated in Colombia, that is, a reduction in opportunity cost (spread) and an increase in dollar GDP that makes the possibility of a crisis more costly.

During recent years of strong reserves accumulation, the Bank has sold reserves to the government in the following amounts: \$500 m in 2004, \$3,250 m in 2005, and \$1,000 m in the first quarter of 2006. These operations have been justified by the high reserves level reached. They have also allowed the Banco de la República to make definite purchases of TES securities without causing any net monetary effect and, hence, to hold a sufficient stock of public-debt securities in case it deems it appropriate to make permanent sterilization operations. The government, in turn, has used these resources to cover its financing needs and prepay external debt.

B. INTERNATIONAL-RESERVES COMPOSITION AND MANAGEMENT CRITERIA

The investment tranche is the main component of international reserves, making up 91.0%, or \$13,603.9 m, of the total.²³ The remaining balance is divided between: i) reserves positions at the International Monetary Fund and the

Latin American Reserves Fund, \$730.7 m; ii) special drawing rights, \$175.0 m; iii) gold, Andean pesos, and positive balances under international agreements, \$267.2 m; and iv) demand deposits and cash on hand, \$179.9 m). Short-term external liabilities stood at \$9.3 m (Table 26).

The criteria established by the Banco de la República for management of international reserves are, in order of importance, *security*, *liquidity* and *profitability*. In keeping with these criteria and to ensure that the country's external payment obligation are met, the reserves are invested in financial assets that have a large secondary market, and a part of them is held as working capital to ensure their immediate availability.

²³ The investment tranche refers to the resources of internally administered portfolios, delegated portfolios and the amount to be used for working capital.

TABLE 26

COMPOSITION OF INTERNATIONAL RESERVES

| Description | Dec-03 | | Dec-04 | | Dec-05 | |
|---|---------------------|--------------|---------------------|--------------|---------------------|--------------|
| | Millions of Dollars | Percentage | Millions of Dollars | Percentage | Millions of Dollars | Percentage |
| Cash | 77.9 | 0.7 | 16.4 | 0.1 | 179.9 | 1.2 |
| Cash on hand | 77.2 | 0.7 | 15.8 | 0.1 | 2.8 | 0.0 |
| Demand deposits | 0.7 | 0.0 | 0.5 | 0.0 | 177.1 | 1.2 |
| Investments | 9,770.5 | 89.5 | 12,336.3 | 91.1 | 13,603.9 | 91.0 |
| Direct portfolio | 4,519.3 | 41.4 | 6,947.5 | 51.3 | 6,499.1 | 43.5 |
| Portfolio under administration | 5,251.2 | 48.1 | 5,388.8 | 39.8 | 7,104.7 | 47.5 |
| Gold | 136.4 | 1.2 | 143.2 | 1.1 | 167.6 | 1.1 |
| On hand | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Under custody | 136.4 | 1.2 | 143.2 | 1.1 | 167.6 | 1.1 |
| International Monetary Fund | 597.2 | 5.5 | 626.7 | 4.6 | 583.5 | 3.9 |
| SDR | 172.5 | 1.6 | 182.9 | 1.4 | 175.0 | 1.2 |
| Reserves position | 424.7 | 3.9 | 443.9 | 3.3 | 408.5 | 2.7 |
| Latin American Reserves Fund | 333.3 | 3.1 | 340.2 | 2.5 | 342.2 | 2.3 |
| Contributions | 313.3 | 2.9 | 320.2 | 2.4 | 322.2 | 2.2 |
| Andean pesos | 20.0 | 0.2 | 20.0 | 0.1 | 20.0 | 0.1 |
| International agreements | 6.0 | 0.1 | 77.1 | 0.6 | 79.6 | 0.5 |
| Total gross reserves | 10,921.4 | 100.1 | 13,539.9 | 100.0 | 14,956.6 | 100.1 |
| Short-term liabilities | 5.8 | 0.1 | 4.1 | 0.0 | 9.3 | 0.1 |
| International agreements | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Overseas banks | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Latin American Reserve Fund | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Securities payable, purchase, investments | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Accrued interest on liabilities | 5.8 | 0.1 | 4.1 | 0.0 | 9.3 | 0.1 |
| Total net reserves | 10,915.6 | 100.0 | 13,535.8 | 100.0 | 14,947.3 | 100.0 |

Source: Banco de la República.

Accordingly, a proportion of the investment tranche of international reserves is administered by overseas fund managers, which are chosen through a rigorous selection process that evaluates their experience in the business, the size of the funds they administer, and the quality of their investing and risk management. As mentioned in previous reports, these firms have improved the yield on reserves through specialized management.

The Banco de la República itself managed \$6,499.1 m, or 47.8%, of the investment tranche, including working capital of \$1,461.9 m. The remaining 52.2% (\$7,104.7 m) was administered by the specialized firms of Barclays Global Investors, J.P. Morgan Investment, Stanley Management Inc., Goldman Sachs Asset Management, BlackRock Financial, Wellington Management and Pacific Investment Management Co. In 2005 Banco de la República revised the external management performance program, which led to one manager being excluded from the program and three new firms being hired. Box 6 outlines the development of this process.

The investment portfolio is mainly concentrated in the sovereign sector—including short- and long-term assets—, which makes up 69.3% of the portfolio. The remaining portion is distributed among the other sectors as follows: banking sector 15.7%, corporate sector 8.4%, supranational sector 1.3%, Bank for International Settlements 3.4%, and repurchase agreements at the Federal Reserve Bank of New York 1.9%. At December 2005 the distribution by credit quality according to the ratings of specialized agencies²⁴ was as follows: “P-1”²⁵ 25.0%; “P-2”²⁶ 0.6%; “AAA” 63.3%; “AA” 2.6%; “A” 3.2%; at BIS 3.4%; and Federal Reserve Bank of New York repurchase agreements 1.9%. The distribution of credit risk reflects the strict security criterion applied in managing the international reserves.

Table 27 shows the returns on the different portfolios making up the investment tranche of international reserves.

Regarding the main variables responsible for the return on the reserves’ investment tranche, it will be seen that in contrast to what occurred in the preceding years short-term US interest rates increased substantially in 2005, influenced by the rise in Fed Funds benchmark rate from 2.25% to 4.25% over the year. In addition, the US dollar appreciated by 12.98% against the euro and by 13.05% against the Japanese yen (Chart 47).

²⁴ Standard & Poor’s, Moody’s and Fitch Ratings.

²⁵ In the short-term ratings scale, “P-1” is the best.

²⁶ “P-2”-rated issuers have a strong capacity to repay their short-term debt.

**RETURN ON INTERNATIONAL-RESERVES PORTFOLIOS
(2005)
(PERCENTAGE)**

| Manager | Return on portfolios | | |
|--|----------------------|-----------------|------------|
| | Portafolio | Benchmark index | Difference |
| Banco de la República ^{1/} | 0.14 | 0.14 | 0.00 |
| Barclays Global Investors | (0.85) | (1.58) | 0.73 |
| J. P. Morgan Investment Management | (1.28) | (1.58) | 0.30 |
| Goldman Sachs Asset Management | 1.98 | 1.78 | 0.20 |
| Morgan Stanley Investments ^{2/} | 1.37 | 1.17 | 0.20 |
| BlackRock Financial ^{3/} | 0.85 | 0.80 | 0.04 |
| Wellington Management ^{3/} | 0.71 | 0.80 | (0.10) |
| Pacific Investment Management Co ^{3/} | 0.18 | 0.20 | (0.02) |
| Working capital | 3.15 | | |

Provisional figures, subject to revision.

^{1/} Excluding working capital.

^{2/} Measuring period: December 31, 2004 to October 31, 2005.

^{3/} Measuring period: October 31, 2005 to December 31, 2005.

Source: Banco de la República.

Since, by definition one function of international reserves is to serve as a source of liquidity in the event of closing of external markets, reserves investments are held in the main currencies in which most of the country's overseas obligations (debt and import payments) are concentrated. For this reason, the currency-composition aim of the reserves' investment portfolio is defined as follows: 85% in dollars, 12% in euros and 3% in yen.²⁷

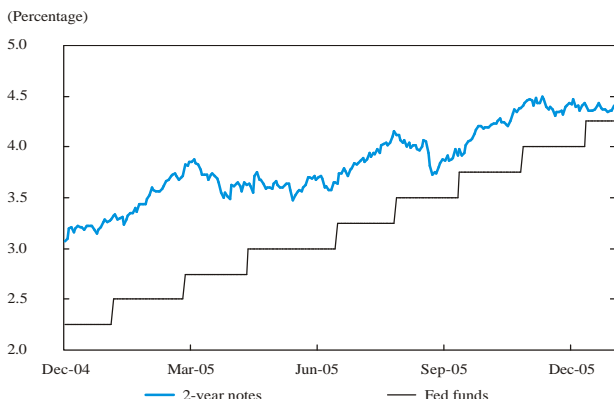
As the accounting for reserves is in US dollars, the dollar's strong appreciation against the euro and yen causes exchange-rate differential losses, as occurred in 2005. The Banco de la República, taking into account the high volatility of currencies against the dollar, keeps a reserve for currency fluctuations, which it increased in 2004 to 1,768.1 bn pesos, foreseeing a possible return to the dollar's devaluatory trend. In 2005 427.2 billion pesos of this reserve were used to cover exchange-rate differential losses incurred during the year.

The increase in US short-term benchmark rates also affected the valuation of dollar securities with maturities of more than one year, since interest-rate rises have a negative effect on the price of such assets, in which a large part of reserves investments are concentrated. In contrast, the rate rise benefited investments with maturities of less than one year, which also make up a

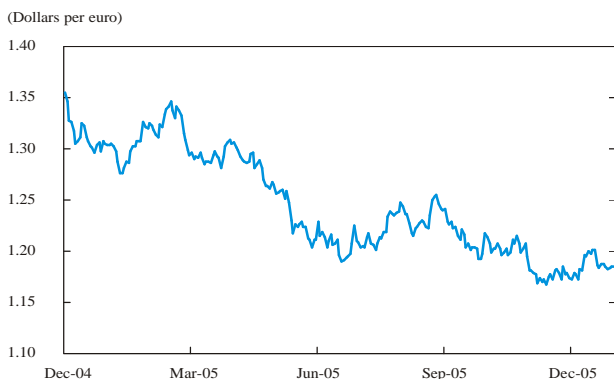
²⁷ This composition applies to the investment tranche, excluding the working capital.

MOVEMENTS IN US TREASURIES' INTEREST RATES AND IN THE DOLLAR AGAINST THE YEN AND EURO

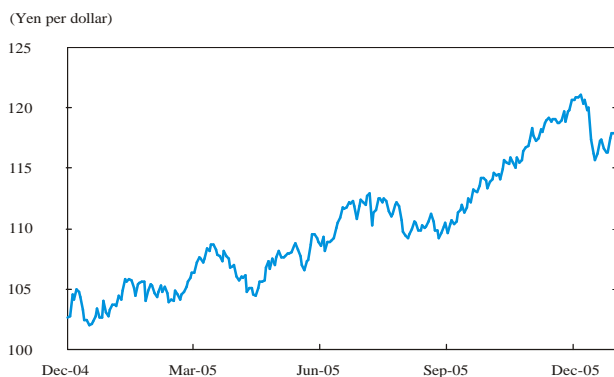
BEHAVIOR OF 2-YEAR TREASURY NOTES V. US FEDERAL FUNDS, 2005 ^{1/}



EURO V. DOLLAR, 2005 ^{2/}



YEN V. DOLLAR, 2005 ^{3/}



^{1/} The inverse ratio between price and rate of return implies that as the rate increases, the fixed-income asset price decreases.
^{2/} The direct quotation euro/dollar implies that the euro loses value as it approaches zero.
^{3/} The inverse quotation dollar/yen implies that the yen loses value as it moves away from zero.
 Source: Bloomberg.

substantial part of reserves investments. As a result interest-rate yield in 2005 was higher than in the preceding two years, when low interest rates predominated globally.

Net yield on total international reserves at December 31, 2005 was \$81.4 m. Losses from interest-rate movements and exchange-rate differentials amounted to \$296.9 m and were counterbalanced by earned-interest yields of \$378.4 m.

As a result of constantly rising interest rates during the year and the dollar's strengthening against the major developed-country currencies, yield on the reserves' investment tranche was the lowest for this decade, as forecast in 2004.

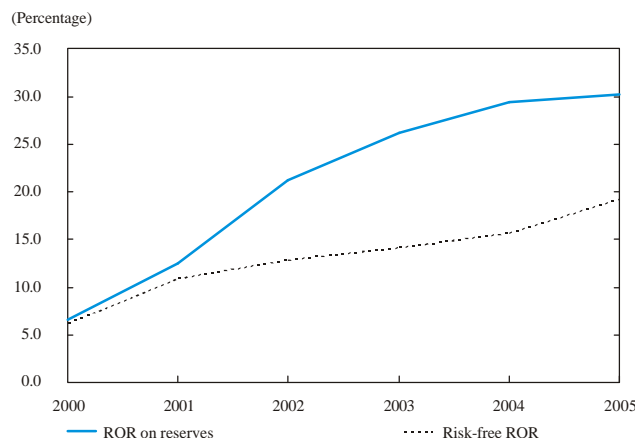
Chart 48 shows the reserves' accumulated yield rate, versus the risk-free dollar rate. It also presents a breakdown of the reserves' dollar return in terms of their fixed-income instruments' accruals and valuation gains (interest yield) and the exchange-rate differential against the US dollar (exchange-rate differential yield).

Lastly, it is important to reiterate, as in past reports, that the Banco de la República has an extensive control structure for reserves investments. In addition to the existence of internal controls, the Bank is audited by two sources: i) the external firm of Deloitte & Touche, hired in 2002, and ii) an auditing agency designated by the president of Colombia.

The control tasks performed by the Bank's auditing department in connection with investment of international reserves include, notably: i) continuous monitoring of investment operations, to verify, among other things, compliance with the rules set by the Internal Reserves Committee, the security and safeguarding of the assets acquired, discharge of the obligations arising from their administration, financial performance against the benchmark portfolio, and the administration's effectiveness in managing liquidity, exchange-rate, credit and market risks; ii) revising risk factors in

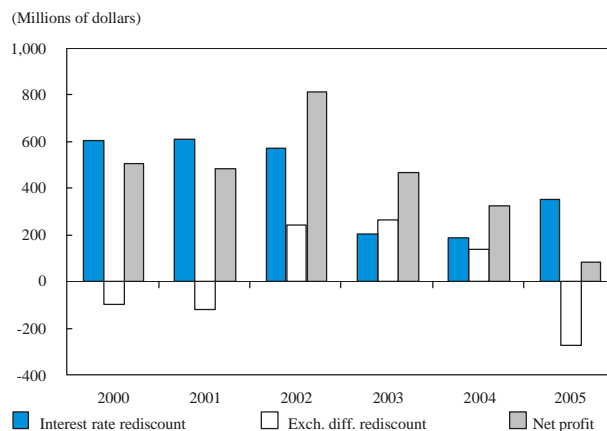
internal operating procedures; and iii) conducting periodic auditing visits to external portfolio managers and custodians to review the internal-control environment established by said institutions for the management and control of the assets placed under administration.

**ACCUMULATED RATE OF RETURN ON RESERVES
V. RISK-FREE RATE IN DOLLARS**



Source: Banco de la República.

RETURNS ON INTERNATIONAL RESERVES



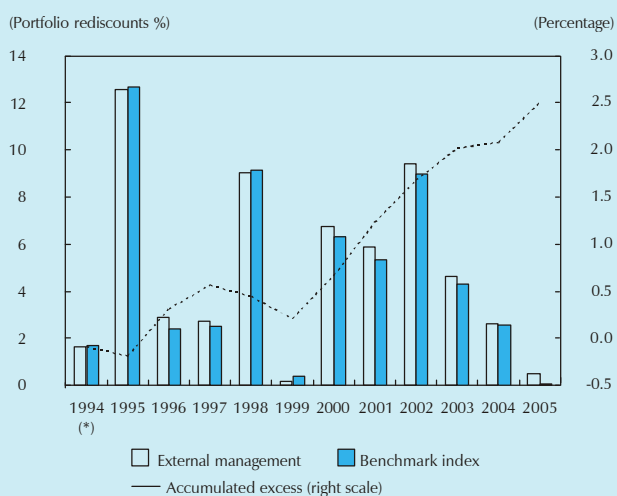
REVISION OF INTERNATIONAL-RESERVES EXTERNAL MANAGEMENT PROGRAM

Since 1994 the Banco de la República has been running a program of delegation of portfolios to firms with expertise in the management of fixed-income portfolios, to improve the profitability of reserves and benefit from the transfer of knowledge and technology these firms can provide. In 2002 the program was restructured and changes were made to the risk and return conditions to be applied to these delegated portfolios, in the light of the Bank's increased experience and knowledge regarding investment-portfolio management. The restructuring included establishing that the portfolio managers' administration would be evaluated every three years, based on attainment of each mandate's defined objectives and on generation of value added, as measured through excess return obtained within strictly defined risk parameters.

In December 2004 the Reserves Committee—the body ultimately responsible for international-reserves management policy—, taking into account the higher level of reserves and the possibility of replacing any management firm not meeting the aims of the program, decided to begin to search for firms better prepared for managing a portfolio like that of international reserves.

In February 2005 the world's ten largest fixed-income portfolio management firms, other than those already working with the Bank, were invited to submit proposals.

CHART 6.1
EXTERNAL MANAGEMENT PROGRAM'S PERFORMANCE: JUNE/94 - DEC/05



(*) The return for 1994 covers from June 30 to December 31.
Source: Banco de la República.

Information was sought on each firm’s capacities, with special emphasis on a detailed description of such aspects as its corporate structure, the size of the amounts under its administration, the type of clients it worked with, its legal status and standing. Great importance was also attached to analyzing each firm’s investment philosophy, decision-making process, and tools for risk analysis and control. Other factors assessed included the firm’s return on portfolios comparable to reserves portfolios, and its ability to generate excess returns constantly, relative to a benchmark index.

The search confirmed to the Bank that it was currently working with top-level firms and acquainted it with other firms having very robust processes and different styles of investment that could complement the existing program.

Out of the ten firms originally contacted, the four qualified as outstanding went on to the final stage, at which time the information provided in the Invitation for Proposal was checked and acquaintance was made with each finalist firm’s teams in charge of investments and risk control. In the meantime, owing to the low return obtained over the thirty months of the program, the Reserves Committee decided in August 2005 to cancel the contract with the firm of J.P. Morgan Stanley Investment Management Inc. as of October 31, 2005, thereby opening up the possibility of engaging more firms than originally planned. After six months of evaluation the Bank decided in August 2005 to engage three new management firms: BlackRock Financial Management and Wellington Management Company, to form part of the Rotation Mandate, and Pacific Investment Management Company, to form part of the Global Mandate. All these firms are recognized worldwide as leading fund managers.

TABLE B6.1

| Rotation mandate | Global Mandate |
|---|--|
| <p>The aim of the Rotation Mandate is to generate excess returns consistently against its benchmark index, by using relative-value strategies in the US fixed-income market. Relative-value strategies seek investment in assets with liquidity characteristics, credit quality and cash-flow structure different from those of government bonds. Rotation Mandate portfolios are currently being actively managed by Goldman Sachs Asset Management, BlackRock Financial Management and Wellington Management Company.</p> | <p>The aim of the Global Mandate is to generate excess returns consistently against the benchmark index by using directional strategies such as currency and duration positions, through the use of value strategies between different markets for developed-government bonds. Global Mandate portfolios are currently being actively managed by Barclays Global Investors, J.P. Morgan Asset Management, Pacific Investment Management Company and the Banco de la República.</p> |

TABLE B6.2

Pacific Investment Management Company (PIMCO) is a specialty fixed-income institutional fund manager operating as an independent subsidiary of Allianz A.G., one of the biggest insurance companies and financial-services providers in the world. PIMCO's head office is in Newport Beach, California, and it also has offices in New York, Singapore, Tokyo, London, Sydney, Munich and Toronto. It has assets under management totaling \$446 bn, with 93% of this amount concentrated in fixed-income securities, \$22.6 bn in short-duration portfolios, and \$4 bn administered for official institutions. PIMCO is not only one of the market leaders but the best positioned, as evidenced by the great availability of human and technical resources it employs to maintain this position.

BlackRock Financial Management provides fund and risk management and financial advisory services. Headquartered in New York, it also has offices in Boston, Edinburgh, Hong Kong, San Francisco, Singapore, Sydney, Tokyo and Wilmington. With a total of \$342 bn in assets under administration, 70% of it in fixed-income portfolios, BlackRock also manages \$3.4 bn for central banks. It stands out for its highly quantitative investing approach, not attempting to forecast market directions but to find value within a controlled-risk framework. BlackRock is one of the firms always at the cutting edge of technology, so much so that it provides risk-measuring services to such important firms as Freddie Mac in the United States, through its BlackRock Solutions subsidiary.

Wellington Management Co is one of the biggest independent investment firms in the world. It is a private company engaged exclusively in asset management, with \$470 bn under administration, 33% of this amount in fixed-income portfolios. Wellington believes its greatest strength is its independent, heavily manned, specialist market analysis team. It maintains offices in Boston, Atlanta, Chicago, San Francisco, Hong Kong, London, Singapore and Tokyo and boasts 77 years of experience in providing this service.

Greater information about the firms currently working with the Bank is available at the following links:

Goldman Sachs Asset Management: http://www.gs.com/client_services/asset_management/index.html

BlackRock Financial Management: <http://www.blackrock.com/>

Wellington Management Co: <http://www.wellington.com/>

Barclays Global Investors: <http://www.barclaysglobal.com/>

J, P, Morgan Asset Management: http://im.jpmorgan.com/imweb/impub/am_index2.jsp

Pacific Investment Management Co: <http://www.pimco.com/TopNav/Home/Default.htm>

Banco de la República: <http://www.banrep.gov.co/>

VII. BANCO DE LA REPÚBLICA'S FINANCIAL SITUATION

Pursuant to the Bank's bylaws, the Board ordered the distribution this year of 800.9 bn pesos, from 2005 profits (325.2 bn pesos) and part of the accumulated reserves for currency fluctuations (427.2 bn pesos) and for asset protection (48.5 bn pesos).

A. RESULTS AT DECEMBER 2005

The Bank obtained profits of 325 bn pesos in 2005, the net result of income of 1,174 bn pesos and expenditures of 849 bn pesos (Table 28). Profits were down by 503 bn pesos on 2004, because income fell by 395 bn pesos while expenditures rose by 108 bn pesos. The fall in income resulted mostly from a decline of 651 bn pesos in return on international reserves, partly offset by valuation gains of 271 bn pesos on the Bank's TES portfolio. Expenditures rose because of interest payments to the National Treasury under the new liquidity-management scheme agreed on with the government in May 2005, whereby the Nation shall deposit all its excess liquidity at the Bank at market rates.

Lower return on international reserves is explained by the fact that the euro and yen, which represent 15% of the reserves, depreciated against the dollar. Between 2004 and 2005 the euro fell from 1.3554 dollars/euro to 1.1795 (12.98% devaluation), and the yen moved from 102.63 yen/dollar to 118.03 (13.05% devaluation) (Table 29). Devaluation of the euro and yen explains last year's exchange-rate differential loss of \$271 m. In contrast, both had appreciated against the dollar in 2004 and contributed to higher return on reserves. Part of the income arising from their appreciation in 2004 was placed in the currency-fluctuation reserve fund, which is used to cover exchange-rate differential losses, such as those registered in 2005; it was thus possible to transfer higher profits to the government, as explained below.

Accrued interest increased by \$167.3 m in 2005, thanks to higher external interest rates and higher average balance of reserves, offset in part by the

BANCO DE LA REPÚBLICA'S INCOME STATEMENT, DECEMBER 2004-2005
 (BILLIONS OF PESOS)

| | Ejecución a | | Annual change | |
|--|-------------|-------------|---------------------|---------------------|
| | Dec-04 A | Dec-05 B | Porcentual (B/A) | Absoluta (B - A) |
| I. Operating budget | | | | |
| 1. Income | 1,569.0 | 1,174.0 | (25.2) | (395.0) |
| 1.1 Monetary income | 1,412.7 | 1,031.9 | (27.0) | (380.8) |
| 1.1.1 Interest and returns | 1,303.2 | 912.5 | (30.0) | (390.7) |
| International reserves | 834.9 | 184.1 | (78.0) | (650.8) |
| Credit and other portfolios | 6.1 | 10.3 | 67.4 | 4.1 |
| Liquidity operations: Repos & transitory support | 131.3 | 115.4 | (12.1) | (15.9) |
| Valuation gains on TES ^{1/} | 328.9 | 600.2 | 82.5 | 271.2 |
| Valuation gains on other securities | 2.0 | 2.6 | 29.9 | 0.6 |
| 1.1.2 Exchange-rate differences | 49.3 | 42.9 | (12.9) | (6.3) |
| 1.1.3 Coins | 38.1 | 54.5 | 42.9 | 16.4 |
| 1.1.4 Other | 22.1 | 22.0 | (0.4) | (0.1) |
| 1.2 Corporate income | 156.4 | 142.1 | (9.1) | (14.2) |
| 1.2.1 Fees | 135.8 | 124.6 | (8.3) | (11.2) |
| Banking services | 43.0 | 58.0 | 35.1 | 15.1 |
| Trust business | 58.9 | 66.5 | 12.8 | 7.5 |
| Foreign-exchange management | 33.9 | 0.1 | (99.7) | (33.8) |
| 1.2.2 Other | 20.5 | 17.5 | (14.6) | (3.0) |
| 2. Expenditures | 741.2 | 848.8 | 14.5 | 107.6 |
| 2.1 Monetary expenditures | 496.7 | 640.6 | 29.0 | 143.9 |
| 2.1.1 Interest and returns | 225.4 | 446.4 | 98.1 | 221.0 |
| Reserves in deposit accounts | 98.7 | 110.3 | 11.8 | 11.6 |
| National Treasury's deposit accounts | 85.8 | 308.0 | 259.1 | 222.2 |
| Foreign credit lines | 5.4 | 0.0 | (100.0) | (5.4) |
| Monetary-contraction Repo operations | 9.3 | 0.0 | (100.0) | (9.3) |
| International reserves' administration costs | 26.2 | 28.1 | 7.3 | 1.9 |
| 2.1.2 Exchange-rate difference | 193.2 | 63.0 | (67.4) | (130.2) |
| 2.1.3 Bills and coins issuance and distribution costs ^{2/} | 71.2 | 124.7 | 75.0 | 53.4 |
| 2.1.4 Other | 6.9 | 6.6 | (4.1) | (0.3) |
| 2.2 Corporate expenditures | 267.2 | 275.7 | 3.2 | 8.6 |
| 2.2.1 Personnel expenses | 165.7 | 174.5 | 5.3 | 8.8 |
| 2.2.2 Overhead | 43.8 | 42.3 | (3.4) | (1.5) |
| 2.2.3 Taxes | 6.1 | 7.0 | 14.5 | 0.9 |
| 2.2.4 Insurance | 9.2 | 7.6 | (17.5) | (1.6) |
| 2.2.5 Contributions and membership dues | 4.2 | 3.5 | (17.8) | (0.8) |
| 2.2.6 Cultural expenses | 6.6 | 7.2 | 10.1 | 0.7 |
| 2.2.7 Depreciations, provisioning, debt repayments and other (including deferred software expenses) | 31.5 | 33.6 | 6.5 | 2.1 |
| 2.3 Pensioners' expenses | (22.6) | (67.6) | 198.3 | (44.9) |
| 3. Operating result (1-2) | 827.8 | 325.2 | (60.7) | (502.6) |

^{1/} Including Law 546 TES.

^{2/} Including fixed costs not absorbed by production

Source: Banco de la República.

exchange-rate differential losses referred to above. To sum up, net profit from return on reserves amounted to \$81.4 m, down by \$243.1 m on 2004. Returns in pesos on the reserves declined because of the lower peso/dollar exchange rate, which fell from 2,626.1 pesos in 2004 to 2,321.3 in 2005 (Table 30).

Regarding interest rates,²⁸ the rate of return obtained on the international-reserves portfolio was higher in 2005 than in 2004 (3.33% against 1.58%) but lower than the average for 2000-2002 (6.76%) (Table 31). Accrued interest income was up by \$167.3 m on 2004. Movements in exchange-rate differentials, and interest rates resulted in a 0.61% rate of return on international reserves in 2005, weaker than in the preceding years.

Lastly, on the corporate side, income was derived from the trust business (66.5 bn pesos) and bank services (58.0 bn pesos), with growths of 12.8%

TABLE 29

INTERNATIONAL QUOTATIONS

| | Dec. 31/03 | Dec. 31/04 | Dec. 30/05 |
|------------------|------------|------------|------------|
| Euro/dollar | 1.2595 | 1.3554 | 1.1795 |
| Dollar/yen | 107.22 | 102.63 | 118.03 |
| Gold (per ounce) | 415.5 | 438.45 | 513 |

²⁸ Includes accrued interest and valuation gains or losses arising from movements in foreign-exchange rates.

Source: Bloomberg.

TABLE 30

RETURNS ON INTERNATIONAL RESERVES
(MILLIONS OF DOLLARS)

| Item | Year 2004 | Year 2005 | Difference |
|--|-----------|-----------|------------|
| 1. Interest-rate returns ^{1/} | 185.2 | 352.5 | 167.3 |
| 2. Exchange-rate differential | 139.3 | (271.0) | (410.3) |
| 3. Net returns (1 + 2) | 324.5 | 81.4 | (243.1) |
| Average market exch. rate (pesos per dollar) ^{2/} | 2,626.1 | 2,321.3 | |

^{1/} Includes accrued interest and valuation gains or loss from external interest-rate movements.
^{2/} Daily average of the market exchange rate observed each year.
Source: Banco de la República.

TABLE 31

INTEREST RATE RETURN

| Item | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|------|------|------|------|------|------|
| Interest rate return (*) | 8.05 | 6.70 | 5.52 | 1.73 | 1.58 | 3.33 |
| Overall return on investment portfolio (including working capital) | 6.61 | 5.45 | 7.89 | 4.08 | 2.53 | 0.61 |

(*) Excluding exchange-rate differential.
Source: Banco de la República.

an 35.1%, respectively. The corporate-income aggregate decreased (by 14.2 bn pesos), however, because of cancellation of the foreign-currency cash management service provided to market intermediaries. Corporate expenditures amounted to 275.7 bn pesos, after an annual growth of just 3.2%, which reflects the spending-control policy that was adopted several years back and is still giving satisfactory results. Personnel expenses stand out with a 5.3% increase, despite a 7% pay rise for employees covered by a collective bargaining agreement in 2005. The payroll was reduced by 69 employees last year; and overhead decreased by 3.4% relative to 2004.

B. ALLOCATION TO RESERVES AND PROFITS DISTRIBUTION

Pursuant to the Bank's bylaws, the Board ordered the distribution this year of 800.9 bn pesos, from 2005 profits (325.2 bn pesos) and part of the accumulated reserves for currency fluctuations (427.2 bn pesos) and for asset protection (48.5 bn pesos). Accordingly, after allocations to the reserves required by law and the bylaws, a sum of 793.0 bn pesos was transferred to the government in late February 2006 (Table 32).

Capital reserves thus showed the following balances: i) currency-fluctuation reserve 1,340.8 bn pesos;²⁹ ii) asset-protection reserve 44.6 bn pesos; and iii) exchange-rate result reserves, 12.3 bn pesos. In accordance with the bylaws,

²⁹ Reserves for covering possible losses from the dollar's fluctuations against other currencies that make up the international reserves.

TABLE 32

BANCO DE LA REPÚBLICA'S 2005-PROFITS DISTRIBUTION AND RESERVES UTILIZATION

| | (Billions of pesos) |
|--|---------------------|
| I. Funds distributable | 800.9 |
| A. 2005 profits | 325.2 |
| B. Utilization of reserves | 475.7 |
| For asset protection | 48.5 |
| For currency fluctuation | 427.2 |
| II. Allocation | 800.9 |
| A. National government | 793.0 |
| B. Net investment in goods for cultural activity | 2.2 |
| C. Exchange-rate result | 5.7 |

Source: Banco de la República.

no reserve has been established for monetary and exchange-rate stabilization, for no losses are expected for the next two years.

C. BANCO DE LA REPÚBLICA'S FINANCIAL STRUCTURE

1. Assets

The Bank's assets increased by 4,771.7 bn pesos (or 11.4%) to 45,617.7 bn pesos (Chart 33). The main items included the following:

- Gross international reserves, valued at market price, showed a balance of 34,164.9 bn pesos—equivalent to \$14,956.9 m—, after an increase of 1,808.0 bn pesos or \$1,417 m (Table 34). The variation in pesos is explained by the peso equivalent of the reserves accumulation (3,240.7 bn pesos), less the effect of the peso's revaluation against the dollar (1,432.7 bn pesos) as reflected in the exchange-rate adjustment to net worth.
- Foreign-exchange accumulation is accounted for by: i) net returns actually received, \$341.1 m; foreign-currency purchases through exchange-rate intervention, \$4,658.4 m; iii) higher value of the government's foreign-exchange deposits, \$173.0 m; iv) sales of foreign exchange to the government, \$3,250.0 m; v) transfer of 2004 profits in foreign currency to the government, \$195.9 m; and vi) decline in the value of valuation adjustments, \$281.4 m.
- The local-currency investment portfolio, valued at market price, showed a balance of 2,603.6 bn pesos, up by 1,619.6 bn on 2004, as a result of net TES purchases over the year.
- Repo operations, used to provide transitory liquidity, showed a balance of 4,050.4 bn pesos, some 1,538.6 bn higher than at December 31, 2004 because of the increase in Repos to financial intermediaries.

2. Liabilities

Liabilities amounted to 30,196.7 bn pesos, a rise of 6,373.0 bn pesos (or 26.8%) from a year earlier, attributable to the behavior of the monetary base and government deposits. The monetary base increased by 3,543.0 bn pesos (18.4%) to 22,804.6 bn pesos, on the back of higher demand for cash (2,498.8 bn pesos) and bank reserves (1,049.2 bn). Government deposits grew by 2,663.1 bn peso to 3,725.1 bn, as a result of the new liquidity scheme referred to at the beginning of this chapter.

BANCO DE LA REPÚBLICA'S BALANCE SHEET AT DECEMBER 2004 AND 2005
(MILLIONS OF PESOS)

| | December 2004 | | December 2005 | | Change | |
|---|-----------------|--------------|-----------------|--------------|------------------|--------------|
| | Balance | % share | Balance | % share | Absolute | % |
| Assets | 41,846.0 | 100.0 | 46,617.7 | 100.0 | 4,771.7 | 11.4 |
| Gross international reserves | 32,356.9 | 77.3 | 34,164.9 | 73.3 | 1,808.0 | 5.6 |
| Contributions at international organizations | 3,007.1 | 7.2 | 2,834.0 | 6.1 | (173.1) | (5.8) |
| Investments | 984.0 | 2.4 | 2,603.6 | 5.6 | 1,619.6 | 164.6 |
| Public sector: consolidated debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Public sector: monetary regulation | 928.0 | 2.2 | 2,550.5 | 5.5 | 1,622.5 | 174.9 |
| Capitalization bonds public banks and others | 56.1 | 0.1 | 53.1 | 0.1 | (3.0) | (5.3) |
| Credit portfolio | 4.1 | 0.0 | 2.4 | 0.0 | (1.7) | (41.5) |
| Public sector: National government | 2.4 | 0.0 | 2.1 | 0.0 | (0.3) | (14.1) |
| Banks | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| <i>Corporaciones financieras</i> (real-sector development credit) | 2.8 | 0.0 | 1.4 | 0.0 | (1.4) | (49.9) |
| Rest of financial sector | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other credits | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Provisions | (1.1) | (0.0) | (1.1) | (0.0) | 0.0 | (1.4) |
| Resale agreements and transitory liquidity supports | 2,511.8 | 6.0 | 4,050.4 | 8.7 | 1,538.6 | 61.3 |
| Accounts receivable | 47.5 | 0.1 | 36.0 | 0.1 | (11.5) | (24.3) |
| Other net assets | 2,934.6 | 7.0 | 2,926.4 | 6.3 | (8.2) | (0.2) |
| Liabilities and equity | 41,846.0 | 100.0 | 46,617.7 | 100.0 | 4,771.7 | 11.4 |
| Liabilities | 23,823.7 | 56.9 | 30,196.7 | 64.8 | 6,373.0 | 26.8 |
| Foreign-currency liabilities affecting int'l. reserves | 9.8 | 0.0 | 21.0 | 0.0 | 11.2 | 113.9 |
| Monetary base | 19,261.6 | 46.0 | 22,804.6 | 48.9 | 3,543.0 | 18.4 |
| Bills in circulation | 16,278.6 | 38.9 | 19,177.8 | 41.1 | 2,899.2 | 17.8 |
| Treasury coin | 409.5 | 1.0 | 461.2 | 1.0 | 51.7 | 12.6 |
| Banks' reserve-requirement deposits | 2,379.7 | 5.7 | 2,971.0 | 6.4 | 591.3 | 24.8 |
| Rest of financial sector current-account deposits | 193.8 | 0.5 | 194.6 | 0.4 | 0.8 | 0.4 |
| Other deposits | 49.0 | 0.1 | 131.8 | 0.3 | 82.8 | 169.1 |
| Government: National Treasury | 1,062.0 | 2.5 | 3,725.1 | 8.0 | 2,663.1 | 250.8 |
| Obligations to international organizations | 2,482.6 | 5.9 | 2,284.6 | 4.9 | (198.0) | (8.0) |
| Liabilities in respect of foreign credit lines | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Monetary and exchange-rate regulation securities | 0.3 | 0.0 | 0.3 | 0.0 | 0.0 | 0.0 |
| Contraction Repos | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Foreign-currency sec. for funding & deposits (Board Res5/97) | 0.3 | 0.0 | 0.3 | 0.0 | 0.0 | 8.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Accounts payable | 48.6 | 0.1 | 58.3 | 0.1 | 9.7 | 19.8 |
| Other liabilities | 909.8 | 2.2 | 1,171.0 | 2.5 | 261.2 | 28.7 |
| Total equity | 18,022.3 | 43.1 | 16,421.0 | 35.2 | (1,601.3) | (8.9) |
| Capital | 12.7 | 0.0 | 12.7 | 0.0 | 0.0 | 0.0 |
| Reserves | 1,524.1 | 3.6 | 1,867.7 | 4.0 | 343.6 | 22.5 |
| Capital surplus | 14,623.9 | 34.9 | 13,221.4 | 28.4 | (1,402.5) | (9.6) |
| Special Foreign-Exchange Account settlement | 453.5 | 1.1 | 453.5 | 1.0 | 0.0 | 0.0 |
| Foreign-exchange adjustment from 1993 on and surplus | 14,111.8 | 33.7 | 12,679.1 | 27.2 | (1,432.7) | (10.2) |
| Other | 58.7 | 0.1 | 88.8 | 0.2 | 30.1 | 51.4 |
| Property valuation gains/losses (art, cultural and real estate) | 1,033.8 | 2.5 | 994.0 | 2.1 | (39.8) | (3.8) |
| Results | 827.8 | 2.0 | 325.2 | 0.7 | (502.6) | (60.7) |
| Previous profit/loss | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Fiscal-year profit/loss | 827.8 | 2.0 | 325.2 | 0.7 | (502.6) | (60.7) |

Source: Banco de la República.

CHANGE IN INTERNATIONAL RESERVES: DECEMBER 31, 2004-2005

| Balance in millions of dollars | | | Balance in billions of pesos | | |
|--------------------------------|--------------|---------|------------------------------|--------------|---------|
| Dec. 31/2004 | Dec. 31/2005 | Change | Dec. 31/2004 | Dec. 31/2005 | Change |
| 13,539.9 | 14,956.9 | 1,417.0 | 32,356.9 | 34,164.9 | 1,808.0 |

Source: Banco de la República.

2. Capital

The balance stood at 16,421.0 bn pesos, down by 1,601.3 bn pesos, or 8.9%, as a result of: i) a smaller exchange adjustment surplus, 1,432.7 bn pesos, because the peso's appreciation lowered the value of international reserves; ii) the transfer to the government of 2004 profits of 454.1 bn pesos; and iii) a reduction of 39.8 bn pesos in the book value of real estate, works of art and cultural artifacts.

D. 2006 PROFIT FORECAST

The Bank is forecast to obtain profits of 926 bn pesos this year, 600 bn pesos more than last year (Table 35). This result is largely explained by projected higher returns on international reserves (1,138 bn pesos), and greater expenditures (323 bn pesos)—basically associated with pension expenses.

Increased income from the reserves portfolio is based on the expectation that the Federal Reserve will raise interest rates more slowly than over the past two years, when the benchmark rate was lifted from 1% to 4.25%. Assuming no large changes in external interest rates, the negative impact on the price of reserves assets will be small, resulting in higher profits. Income from international reserves is projected on an interest rate of 4.48%, higher than the 0.61% observed in 2005. It is pointed out that the estimation does not include the possible effects of in exchange-rates variations in the reserve portfolio's currencies. Expected income is therefore subject to uncertainty over the dollar's movement against the euro and yen compared with its positions in early 2006.

This year's profits are forecast to be 926 bn pesos, an increase of 600 bn pesos on last year.

Higher expenditures are largely explained by pension expenses, estimated to exceed the previous year's by 242.3 bn pesos for the following reasons: i) an estimated decrease of 123.8 bn pesos in pension portfolio returns, projected at the securities' year-end 2005 trading interest rates and therefore subject to the uncertainty of possible rate changes; ii) higher actuarial provisions, 100.1 bn pesos, estimated on the actuarial calculation for 2006, rather than 2005, when no provisioning was required upon modification of the pension system by Constitutional Amendment No. 1 of 2005; and iii) an increase of 18.3 bn pesos in spending on pensioners.

Lastly, projections for other important items are: i) income from TES-portfolio returns, \$253 bn pesos, down by 339 bn pesos, on the assumption that market rates for these securities, whose 2005 behavior accounted for the item's good

TABLE 35

BANCO DE LA REPÚBLICA'S INCOME STATEMENT, 2005-2006
(BILLIONS OF PESOS)

| | Executed | Projected | Change | |
|--|---------------|-------------|------------|---------------------|
| | Dec-05 (A) | 2006 (B) | % (B/A) | Absolute (B - A) |
| I. Total income | 1,174.0 | 2,006.7 | 70.9 | 832.7 |
| 1. Operating income | 1,160.3 | 1,999.7 | 72.3 | 839.4 |
| Interest and returns | 912.5 | 1,785.7 | 95.7 | 873.2 |
| International reserves | 184.1 | 1,322.5 | 618.5 | 1,138.5 |
| Valuation gains on TES thro' monetary-expansion operations | 593.0 | 253.5 | (57.2) | (339.5) |
| Transitory securities purchases and allocations | 115.4 | 204.3 | 77.0 | 88.9 |
| Other 1/ | 20.1 | 5.4 | (73.3) | (14.7) |
| Fees | 124.6 | 122.6 | (1.6) | (2.0) |
| Exchange-rate differences | 42.9 | 9.5 | (77.8) | (33.4) |
| Other 2/ | 80.3 | 81.9 | 2.0 | 1.6 |
| 2. Non-operating income 3/ | 13.7 | 7.1 | (48.5) | (6.7) |
| II. Total expenditures | 848.8 | 1,080.9 | 27.3 | 232.1 |
| Interest and returns | 446.4 | 456.4 | 2.2 | 10.0 |
| Reserve-requirements and deposit accounts | 418.3 | 432.6 | 3.4 | 14.3 |
| Transitory sales of securities | 0.0 | 0.0 | | |
| Other operations 4/ | 28.1 | 23.8 | (15.3) | (4.3) |
| Exchange-rate differences | 63.0 | 25.5 | (59.5) | (37.5) |
| Cost of issuing and distributing bills and coins | 124.7 | 117.8 | (5.5) | (6.9) |
| Personnel costs | 174.5 | 185.8 | 6.5 | 11.3 |
| Pensioners' costs | (67.6) | 174.7 | (358.6) | 242.3 |
| Overhead | 42.3 | 43.9 | 3.8 | 1.6 |
| Other 5/ | 65.4 | 76.7 | 17.3 | 11.3 |
| III. Profit or loss for the year | 325.2 | 925.9 | 184.7 | 600.7 |

1/ Includes, among other things, valuation gains on TES-A securities, on non-monetary gold, and on public-debt bonds; and credit portfolios.

2/ Includes, among other things, coins issued and precious metals.

3/ Includes sale of gold for industrial use, rented out property, income from social and cultural welfare programs, fines and penalties.

4/ Includes administration costs of reserves and foreign credit lines.

5/ Includes, among other things, other monetary outlays, taxes, insurance, contributions, cultural expenses, depreciations, provisions, and debt repayments.

Source: Banco de la República.

results, will remain at levels observed at the end of February, 2006,³⁰ and the further assumption that scheduled maturities will shrink the portfolio; ii) personnel expenses, 185.8 bn pesos, up by a projected rate of 6.5%, reflecting commitments under the collective bargaining agreement; as in previous years, however, they are expected to turn out lower than projected, as a result of a number of employees opting for retirement, and the Bank's continuing austerity policy, which has led to a reduction of payroll staff; and iii) overhead, 43.9 bn pesos, up by a projected rate of 3.8%, reflecting the Bank's policy to rationalize overhead, a commitment undertaken from some years back.

³⁰ It should be mentioned that the more representative TES securities, maturing in September 2014, were traded at the end of February 2006 at 7.09%, compared with 8.7% in December.