

INFLATION AT MARCH AND THE OUTLOOK

- In March, annual inflation was 4.1%. This is less than in December 2005 (4.9%), mainly because of favorable in prices for regulated goods and utilities. During the same period, the annual increase in these items declined from 6.7% to 4.2%. The drop in regulated inflation was associated with the trend in public transportation fares and public utility rates.
- The reduction in inflation also contributed to lower food inflation (which was down from 6.6% to 5.2%) and the minor adjustments in prices for tradable goods (food and regulated items not included). Inflation in non-tradable goods and services (food and regulated items not included) stayed between 4.5% and 4.6%, a level maintained since last June. As part of this group, inflation in rentals had climbed to 4.7% by March, as opposed to 4.1% in December 2005.
- The world economy began the year on a more forceful note than anticipated. The momentum in worldwide demand, coupled with some supply problems, pushed prices for raw materials—especially oil and metals—higher than was forecast in the last quarterly inflation report. More pressure on prices has added to the likelihood of further monetary policy adjustments, not only in the United States, but also in Japan and the euro zone. As a result, the exchange markets in Colombia and Latin America have been more volatile and local currencies have tended to depreciate.
- In the case of Colombia, the representative market nominal exchange rate (TRM: Spanish acronym) climbed from a minimum of COP\$2,246 in March to COP\$2,374 on April 27, which is equivalent to 5.7% nominal depreciation. This tendency prompted a sharp rise in interest rates on treasury bonds (TES: Spanish acronym) since March, especially on the long-term bonds. It still is difficult to know if the recent volatility on the TES market signals a change in tendency toward a larger share of dollar denominated assets in investors' portfolios. If so, the forecast for the exchange rate would have to be raised and, with it, the forecast for inflation in tradable goods. A change in this direction is contemplated in this edition of the *Inflation Report*, and the inflation forecasts take into account an average exchange rate in 2006 that is slightly above the prediction published in the last report.

- The Colombian economy grew by 5.1% in 2005 and by 4.6%, on average, in the last three years. First-quarter indicators of supply and demand suggest the economy continues to expand, perhaps at even faster rates than those forecast in the last edition of this report. The growth in retail sales, consumer credit and consumer confidence points to a continued sharp rise in consumer expectations for spending. The same is true of private investment. The increase in this item is reflected in imports of capital goods and in industrial production of machinery and equipment in general. Moreover, favorable prices for some of the country's major exports have allowed for a situation where national income has grown faster than production.
- Monetary policy has contributed to the growth in aggregate demand by keeping real interest rates below their neutral level. Since February, the rate on fixed-term deposits (DTF: Spanish acronym) has converged with the interbank rate (TIB: Spanish acronym) and is now close to 6% in nominal terms, while broad monetary aggregates, such as M3, continue to grow faster than nominal gross domestic product (GDP). These conditions, coupled with a larger supply of credit, including mortgage loans, reinforce the expansionary effect of the country's monetary policy.
- Without jeopardizing the inflation targets, this expansionary bias has been the distinctive feature of Colombia's monetary policy during the current decade. However, the Board of Directors at Banco de la República (BDBR) believes less monetary stimulus is now needed, as economic growth rests on a solid foundation explained by domestic and external variables that will remain in effect during the coming quarters. Under these conditions, the country's monetary policy must guarantee sustainable growth in output and employment, while the economy moves gradually towards price stability on a sure footing, which is the ultimate goal of any inflation-targeting strategy.
- Moreover, as mentioned in several earlier reports, the country's monetary policy operates with a relatively long variable lag. Accordingly, changes in its stance must be made well in advance, so as not to jeopardize future inflation targets or the credibility of the policy itself.
- Given these considerations and the recent trend in domestic and international financial markets, the Board of Directors decided to raise the Bank's intervention interest rates by 25 basis points (bp) on April 28, 2006. The goal is to keep future growth in output and employment within an environment of low and stable inflation. Accordingly, the base rate for expansion auctions went from 6% to 6.25%.

Board of Directors
Banco de la República