

INFLATION STRATEGY AND ITS OBJECTIVE IN COLOMBIA

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is intended primarily to keep inflation low and to ensure stable long-term growth in output. Therefore, monetary policy objectives combine the goal of price stability with maximum sustainable growth in output and employment. In doing so, monetary policy complies with the constitution and contributes to the well being of the Colombian population.

HORIZON AND IMPLEMENTATION

The Board of Directors of Banco de la República (BDBR) defines quantitative inflation targets for the current year and the next. BDBR policy initiatives are designed to meet each year's target and to provide for long-term inflation at around 3%. The annual variation in the consumer price index (CPI) is the inflation measurement used.

THE DECISION-MAKING PROCESS

Monetary policy decisions are based on an analysis of the current state of the economy and its prospects for the future and on an assessment of the inflation forecast compared to the targets. If the assessment suggests, with enough certainty, that inflation will deviate from its target under current monetary-policy conditions, and that said deviation would not be due to temporary shocks, the BDBR modifies its policy stance. This is done

primarily by changing the intervention interest rate (charged by Banco de la República on short-term liquidity operations).

COMMUNICATION AND TRANSPARENCY

Decisions on monetary policy are made at meetings of the Board of Directors and announced immediately thereafter, in a press bulletin posted on the Bank's website (www.banrep.gov.co). The inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and add to its credibility. Specifically, they i) let the public know how the Board of Directors and the Technical Governor of the Bank view recent and anticipated changes in inflation and its short and medium-term determinants; ii) explain the implications of those determinants for monetary-policy management, within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions taken during the quarter; and iv) provide information that helps economic agents to form their own expectations about future developments in for inflation and growth in output.

ASSESSMENT OF INFLATION AND POLICY DECISIONS

INFLATION SUMMARY

Annual consumer inflation began to decline again during the second quarter of 2007, as was forecast. By June, it was 6.0%, which is similar to the rate in March and 22 basis points (bp) below the high point registered in April. Annual inflation had increased steadily between October 2006 and April of this year, propelled largely by higher food prices and by major adjustments in fuel prices and fares for public transportation. However, as expected, some of these pressures began to subside in May, allowing for the reduction in inflation.

The various core inflation indicators, which usually filter temporary price shocks, also showed a break in trend as of May. They had climbed almost continuously since mid-2006, exceeding the target range set by the Board of Directors of Banco de la República (JDBR) for this year. However, annual non-food inflation was 4.4% in June, which marks a return to the target range.

The decline in inflation during recent months was due primarily to favorable developments in perishable food prices and to a more moderate, although less of a change in the price of various tradables. Prices for certain goods and regulated services also saw relatively low adjustments in the last two months.

The recent food price trends, which were anticipated by the BDBR in several bulletins and interventions, are the result the climate returning to normal after El Niño weather in late 2006 and early 2007. At the time, El Niño caused sharp but temporary hikes in the price of most perishable foods. This partly explains the strong surge in inflation at March. The decline in tradable inflation between March and June is associated with peso appreciation as of mid-2006. However, given the extent of appreciation (14.8% year to date), the reaction of tradable inflation to the exchange rate still is limited.

In general, the outcome for inflation up to June coincides with the forecast published in the last edition of this quarterly report. Even so, total inflation at June remained high: 1.5 bp above the ceiling

of the target range for 2007. At the same time, annual inflation in non-tradables, excluding food and regulated prices, was 5.1%, which is more than in March (4.9%) and December (4.8%). This indicates that most of the pressure on prices identified in previous reports had an effect and could continue, to some extent, throughout the remainder of the year. The following facts support this statement:

1. Despite the decline in food inflation, processed food prices continued to rise, mainly because of higher meat prices. At this point in time, three factors could continue to exert pressure on food inflation; namely, strong domestic demand, an increase in food exports to Venezuela, and high external prices for input used to produce bio-fuels. Consequently, it is more likely that the shock in food prices witnessed up to March could extend during the second half of the year.
2. Although inflation expectations for the end of the year declined in recent months, on par with the break in price trends, they are still high (5% for the end of the year) and exceed the target for this year and the target range announced for 2008 (between 3% and 4%).
3. Inflation in the producer price index has dropped sharply in recent months, mainly due to accumulated peso appreciation. Nonetheless, that decline is not likely to be reflected quickly or to any great degree in the consumer price index (CPI), partly because of the significant differences in methodology and coverage that exist between the PPI and the CPI. These differences are due largely to the fact that the producer price index (PPI) does not include services; the CPI does, which gives the tradable component in the first of these baskets far more weight. Moreover, there are indications of a sizeable increase in mark ups during the year to date. This development, which could be related to increased domestic and Venezuelan demand, would prevent the reduction in producer inflation from translating entirely into less consumer inflation, at least while demand continues to grow at the present rate.
4. Economic growth is above its historic average, surpassing the market's expectations and those of Banco de la República. In the first quarter, growth was 8%, led once again by domestic demand (11%), including private consumption. The figures available at June suggest this trend in the economy continued throughout the second quarter, with no clear signs of moderation. As a result, the growth forecast for 2007 had to be increased to a rate similar to the one observed last year.
5. That forecast is justified, since most of the factors behind the recent growth are still in effect. Such is the case with real interest rates, which remain low in historic terms; domestic demand, which continues to be extremely dynamic; highly favorable terms of trade; and credit, which continued to grow at nominal rates on the order of 30%. Prices for assets such as housing and stocks have increased as well, and can reinforce the growth in spending.

6. The past month saw a build-up in the pass-through of policy interest rates to market lending and deposit rates. Even so, the impact on real lending and deposit rates during the period from April 2006 to June of this year remains limited, particularly with respect to ordinary and consumer loans. There has been more of an increase in real rates for preferred and treasury loans, which are now slightly above their historic averages. The rate on term deposits (DTF in Spanish) is still below the interbank rate (TIB in Spanish), showing that pass through is not complete.
7. The different loan segments continued to grow substantially, although certain types, such as ordinary and consumer loans, witnessed a bit of a slowdown. However, these two types of credit are still growing at a high rate: 44.2% for consumer loans and 25.1% for commercial credit. The same is true of the annualized monthly growth in credit (excluding the seasonal component and the statistical noise in the series), which also shows a great deal of momentum: 38% for consumer loans and 18% for ordinary loans. This calculation, which is the most apt in showing a possible break in trend, suggests that the increase in certain types of credit would be declining. However, this would be happening slowly and from very high levels. Moreover, it would be offset in part by the mortgage portfolio, which tended to accelerate during the second quarter.
8. Most indicators suggest the growth in aggregate demand during the first half of the year surpassed the economy's productive capacity. In April and May, all the indicators of installed capacity use were at historically high levels, despite considerable investment in machinery and equipment during the last two years. At any rate, it is important to point out that the growing trend in those indicators during recent quarters was interrupted in the last few months and some of them even declined slightly.
9. Given the higher forecasts for growth, aggregate demand might continue to exceed the economy's productive capacity during the remainder of the year, and the gap between these two variables could become a bit wider.
10. Available figures on wages and productivity suggest that, up to now, the movement in these variables remains aligned. However, the increase in employment has accelerated during the last few months in sectors such as industry, commerce and construction, particularly in the country's major urban areas.
11. Finally, the exchange rate continues to be shrouded by a great deal of uncertainty, perhaps even more than was indicated in the March report. This is the result of increased expectations about international interest rates associated with the recent rise in risk perception. Even so, developments in the balance of payments show terms of trade are more favorable than those envisaged earlier. They also signal good growth for trading partners and significant capital flows, particularly for direct foreign investment. As a whole, these factors point to a relatively stable exchange rate during the rest of the year, similar to what was forecast in the March report. Accordingly, this variable is not expected to exert strong inflationary pressure.

POLICY DECISIONS

The BDBR adopted measures on a variety of fronts during the first four months of the year.

- Intervention interest rates were increased by 75 bp, which placed them at 8.5% in April.
- Auctions of interest-bearing non-reserve deposits at 7 and 14 days were activated as of April 2. The BDBR then initiated auctions of 30, 60 and 90 day deposits. It also authorized unlimited deposit-taking at seven days in the form of interest-bearing deposits that do not constitute reserves held by Banco de la República.
- At a meeting on May 6, 2007, it imposed a non-remunerative marginal reserve ratio, with different rates for current and savings accounts, certificates of deposit maturing in less than 18 months, and similar deposits.
- The private external debt deposit stipulated in External Resolution 08/ 2000 was reinstated. It comes to 40% of the disbursed amount, liquidated at the representative market rate of exchange (TRM in Spanish) on the date the loan is furnished.
- Finally, the leveraged position of derivative operations by market intermediaries was limited to 500% of their technical capital.

To supplement the reserve measures adopted in May, the BDBR unified the ratios on June 15 for current and savings accounts. This was done in recognition of the fact that, at present, these financial assets have similar characteristics in terms of liquidity. The ordinary reserve requirement for those deposits was unified at 8.3% and the marginal requirement, at 27%. The base date for calculating the marginal requirement (May 7, 2007) was not changed.

Between January and April, the BDBR continued its discretionary exchange market intervention to reduce peso appreciation. This type of intervention was suspended in May.

As explained at the time, all decisions made in connection with the interest rates hikes are intended to reinforce their impact. The interest-bearing non-reserve deposits, in particular, increase the banks capacity to offset the monetary effects of exchange market intervention. The measures dealing with reserve requirements are designed to lessen the growth in credit and aggregate demand, directly supplementing the job of the rates. The external borrowing measures are intended to limit the entry of short-term capital.

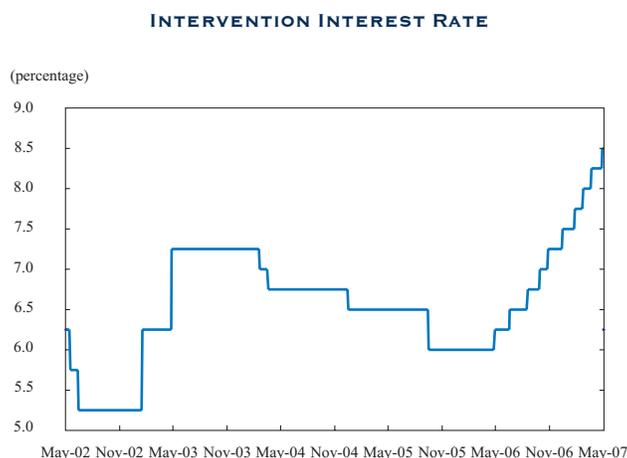
These measures began to show some results as of May. Net short-term capital inflow, which had increased considerably during the first four months of the year, dropped off sharply with adoption of the measures on foreign borrowing. In addition, pass-through of the Bank's repo rate to market rates

gained speed in the last two month, possibly due, in part, to the measures on marginal reserve requirements.

Considering these facts and the persistence of inflation pressure on various fronts, the BDBR felt the risks weighing on long-term price stability during the second quarter and up to July were still important and warranted action to reinforce the measures adopted earlier. Specifically, the BDBR took the following factors into account:

1. Consumer inflation was above the established targets.
2. Non-tradable inflation had continued to rise.
3. The growth forecasts had increased substantially in recent months.
4. Tradable inflation had yet to fully reflect appreciation in the exchange rate.
5. Inflation is quite likely to end the year above the target range, as indicated in the forecasts developed by the Bank's technical team, which are presented in this report.

Consequently, the BDBR continued to lower its monetary stimulus in recent months by raising the Bank's intervention interest rates, which were increased by 25 basis points on three occasions (May, June and July), placing the repo auction rate at 9.25% by the end of July (Graph).



Source: Banco de la República.

The BDBR has not exercised discretionary intervention in the exchange market since May, nor has it made permanent acquisitions or sales of TES. However, during this period, Banco de la República did intervene to control volatility on various occasions, through put and call operations, as was customary in the past.

The BDBR believes the normalization of monetary conditions since the second quarter of 2006 has begun to affect the growth in credit and monetary aggregates. Similarly, the increase in repo rates is

expected to have more of an impact on market rates in the months ahead, which also could contribute to the shift in the make-up of financial institution assets towards TES and other portfolio investments. All of this should mean that economic activity, and particularly domestic demand, will grow at a more sustainable rate that is consistent with the long-term target for inflation (3%).

Board of Directors
Banco de la República