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.

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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).

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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

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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.

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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.

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

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.

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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,

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).