Introduction

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Colombia's economy continues to grow apace. Gross domestic product went up by 8% in the first quarter of 2007, the third consecutive quarter with a GDP rise of over 7%. Investment and household consumption drove first-quarter growth, while public spending decreased in keeping with this year's consolidated deficit target. This composition of aggregate demand can undoubtedly be considered appropriate.

Investment, mainly fueled by higher gross capital formation in public infrastructure and in machinery and equipment, has favored sustainable growth by increasing the economy's potential output and raising its productivity. Higher household consumption has spread the benefits of economic growth to broad segments of the population, at the same time as public consumption has moderated. On the external front, exports continue to increase at a healthy pace, of over 9% in real terms. Imports, too, show strong growth, reflecting a booming economy that needs to import capital goods and raw materials to improve its competitivity and continue expanding.

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On the supply side, the fastest expansion has been in construction, industry, commerce and the sector of transport and communications. The strength of the economy is being gradually reflected in lower unemployment and higher quality of employment. This is evidenced by recent figures from DANE (the national statistics agency), despite the difficulty in comparing statistics because of the methodological changes introduced in 2006 in DANE's household surveys.

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as confirmed by surprising figures on foreign investment and by high bids for state and private assets sold at public auction.

The interest-rate increases made by the Banco de la República's Board of Directors over the past fifteen months are intended to maintain and prolong this favorable state of affairs. Just as an athlete needs to husband his strength on a marathon, so does the economy need to moderate its growth to avoid exhaustion. In economic terms this means it is important to try to smooth the economic cycle, so that growth will not exceed the economy's production capacity and result in runaway inflation or unsustainable external imbalances, which undermine confidence, scare away investors and cause the loss of a historic-and difficult to regain-opportunity for economic development.

Inflation rose steadily over the first four months of 2007, from 4.5% in December to 6.3% in April, overshooting the ceiling of the 3.5-4.5% target range for the year but edged down in May and June, to 6%. As explained in this report, various factors were responsible for the pick-up in inflation. Supply shocks, for one, pushed up food prices to an annual inflation rate of 9.7%, to June. Food inflation was also driven by the climatological phenomenon, El Niño, by higher world prices for the commodities used in making biofuels, and by strong demand from Venezuela-particularly for meat. An 11% increase in overall domestic demand put heavy price pressure on other items of the CPI basket besides food. Although some factors, such as El Niño, were transitory and their effects have therefore begun to disappear, others are longer-lasting and have consequently called for action from the monetary authority.

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In April 2006 the Bank's Board of Directors, recognizing the lasting nature of some of those shocks and the fact that excessive aggregate demand could intensify inflationary pressures, began to tighten monetary policy gradually. By anticipating inflationary pressures the Board managed to buy time for the monetary-policy transmission mechanisms to begin to operate. As discussed in this document, these mechanisms operated slowly, partly because of a very rapid rise in bank credit, associated with a shift in bank portfolios away from investments in TES and toward loans. In view of this situation, to accelerate transmission of monetary policy toward credit and aggregate demand, the Board decided at the beginning of May to set a marginal reserve requirement on banking-system liabilities. The timely interest-rate decisions and the recently imposed marginal reserve requirement have been of critical importance in forestalling a surge in inflation expectations, which would have introduced another pressure factor on the general level of prices.

Another variable the Board has focused on in the first half of this year is exchange-rate behavior. A section of this report analyzes real and nominal exchange-rate movements, their short- and long-term determinants, and the policy of intervention in the exchange market. A significant conclusion is that appreciation against the US dollar is a common phenomenon among numerous currencies in Latin America and other regions of the world. This is why Colombia's real bilateral exchange rate with respect to several countries appreciated only marginally in 2003-2006 and even depreciated in some cases, for instance against the Venezuelan bolívar. For this and other reasons the loss of competitivity has not been as pronounced as it might have been. This is borne out by the continuing strength of exports, which grew by 17.3% in dollars between January and April, and of tradables, which showed a real first-quarter increase of 8.5%, greater than the nontradables' 7.8%

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The report also analyzes real exchange-rate determinants in detail and comes to the conclusion that a confluence of permanent and transitory factors accounts for the Colombian peso's appreciation. The permanent factors include, among others, devaluation of the dollar, productivity gains, and higher remittances from Colombian workers abroad. Among transitory but prolonged factors the report points to favorable terms of trade, rising foreign direct investment, expanding domestic demand, lower risk premiums, and interest-rate differentials in favor of Colombia. The emphasis on the real exchange rate helps in understanding the role of aggregate demand and relative prices in determining this variable. It also explains the reasons why public and private efforts to save help to reduce pressure toward appreciation, particularly in the face of strongly rising public and private investment, such as has been occurring.

In the above context, the report reviews the different stages that exchange-market intervention policy has gone through since 2003. The analysis shows that the macroeconomic conditions in which intervention is made are crucial to its effectiveness. More specifically, for intervention to achieve its aims a necessary condition is that monetary and exchange-rate policies be consistent the one with the other, in the sense that interest-rate decisions reinforce the market signal that the intervention provides. Experience has demonstrated this. As discussed in the report, the episodes of intervention in 2003 and 2005 were effective in terms of modifying exchange-rate behavior, for the two policies were consistent, in that interest-rate movements did not go against the aims of the interventions but reinforced them.

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feels a rate rise is needed to secure the inflation target, as has been the case since the second quarter of 2006, this could prove inconsistent with an intervention policy designed to moderate appreciation. Developments between January and April 2007clearly demonstrate this. Despite discretionary currency purchases during this period in an amount similar to purchases during the whole of 2005, very little was achieved in terms of moderating appreciation. In such circumstances, discretionary monetary intervention cannot be persistently applied. To do so could jeopardize meeting the inflation target and weaken the inflation-targeting scheme. Accordingly, discretionary interventions ceased from May on, and the only intervention applied today is through options to control volatility.

Moreover, the onset of a strong net inflow of private capital, originating from external borrowing, led the Board of Directors to introduce a six-month unremunerated peso deposit, equivalent to 40% of foreign-loan disbursements. Subsequently, the government extended this measure to the capital portfolio. The latest data on the foreign-exchange balance show that this measure has already begun to be instrumental in discouraging the inflow of short-term capital, thereby moderating pressure on the peso to appreciate.

This report consists of seven chapters. The first one presents inflation results for the first half of 2007, with the inflation outlook for the second half of the year. Chapter II analyzes the results of economic activity and employment in the first quarter of 2007. Chapter III discusses monetary policy and foreign-exchange intervention strategy; it also reviews movements in financial markets, interest rates and monetary aggregates and evaluates the financial establishments' quality and risk indicators. Chapters IV and V deal with balance-of-payments and fiscal-policy behavior, respectively. Chapter VI discusses the level of international reserves and indicators of external vulnerability. The last chapter, VII, presents the Banco de la República's financial situation.

The report also contains a number of boxes on topics considered of importance in analyzing the current economic situation: Box 1: Macroeconomic context of currency appreciation in Latin American countries; Box 2: Import and export movements, 2005-2006; and Box 3: Drug-trafficking economy in Colombia: measurements and studies.