Introduction

The global economic slowdown in 2011 was caused by the euro zone's fiscal and financial crisis, which deepened toward the end of the year. In this adverse global context, the Colombian economy grew by 5.9%, its third highest rate in the past thirty years, while inflation stood at 3.7%, within the target range of 2% - 4%. This process of economic recovery and consolidation has been accompanied by a monetary policy designed to keep inflation around a long term target of 3% and use of resources around the economy's potential capacity.

The global economy, after growing by 5.2% in 2010, seemingly announcing the final end of the 2008 crisis, slowed to a growth rate of 3.8% last year, according to IMF estimates. The slowdown in 2011 was caused by factors connected with the economic crisis in Europe, which deepened steadily over the year and became critical in the fourth quarter. Though Greece was long known to be in difficulty, its economic situation worsened in 2011 due to the lack of a credible rescue plan, which was successively postponed amid political tensions among the major European governments over how to share the costs of the rescue. This prolonged inaction in the face of a worsening crisis led to a loss of confidence in the region, causing symptoms of contagion to appear in other countries such as Ireland and Portugal. The contagion then spread to the larger economies of Spain and Italy, and fears arose about the viability of the euro, given the danger of these countries' public debt becoming generally unsustainable.

The US economy showed mixed signals during 2011 and in the early part o this year.

The US economy, for its part, showed mixed signals during 2011 and in the early part of this year. Although the country's GDP slowed from 3% in 2010 to 1.7% in 2011, its performance has been improving gradually. In the first half of 2011, interruption in the Japanese supply

In 2011, as in previous years, global growth was driven by emerging economies, albeit at a slower pace.

chain, debate over the US debt ceiling and high oil prices were reflected in a slowdown of US economic activity, with annualized quarterly growth barely reaching 0.4% in the first quarter and 1.3% in the second. However, as some of these factors were gradually surmounted and the US economy managed to withstand the European crisis, confidence began to rise, household spending became stronger, and manufacturing started to expand. Thus, in the third quarter US GDP grew by 1.8% (annualized quarterly rate) and in the fourth quarter by 3.0%. This may be regarded as a favorable performance, considering that the structural imbalances that led to the crisis have not yet been fully dealt with. As evidence of improvement in the US economy, the unemployment rate has began to decrease, claims for unemployment insurance have fallen, and consumer confidence and consumption show positive signs.

In 2011, as in previous years, global growth was driven by emerging economies, albeit at a slower pace. The IMF estimates that these economies expanded by 6.2% in 2011, compared with 7.3% in 2010. The slowdown was partly caused by weaker external demand, and by the lagged effect of restrictive monetary and fiscal policies adopted in 2010 by several emerging Asian and Latin American countries after detecting some symptoms of overheating.

In this highly unequal global context with the prospect of continued uncertainty, the Colombian economy's performance has been outstanding.

In this highly unequal global context with the prospect of continued uncertainty, the Colombian economy's performance has been outstanding. GDP grew by 4% in 2010 and improved increasingly in 2011, rising to a high of 7.5% in the third quarter, comparable to the quarterly rates seen in 2006 and 2007, when world production was expanding apace and external demand was a major driver of economic activity in Colombia. Although fourth-quarter growth slowed to 6.1% in 2011, as a result of weaker external demand and the progressive withdrawal of monetary stimulus, the growth rate for the year as a whole stood at 5.9%, one of the highest rates in decades. This result clearly shows that Colombia has managed to withstand the negative shock of the European crisis, in conditions in which the US, the country's main trading partner, has been growing at moderate rates.

Colombia's favorable economic growth in 2011 was driven by the strengthening of domestic demand.

With the external context deteriorating and uncertain, Colombia's favorable economic growth in 2011 was driven by the strengthening of domestic demand, which expanded by 8.8%, comparable with peak growth in 2006. As detailed in this Report, fixed capital investment was the strongest spending item of domestic demand, growing by 16.6%, the second highest rate since 2000. Investment in machinery and equipment and transport equipment stands out in this item, which was

Fixed capital investment was the strongest spending item of domestic demand.

driven by high international commodity prices and by low commercial interest rates over much of the year. Investment in buildings (including housing) also grew well, by 5.3%, after shrinking for two years in a row. Investment in civil works continued to expand briskly, by 6.7%, a higher rate than the average for the two previous years.

Similar to investment, in 2011 growth in household spending was as strong as in the peak periods and, at registered an expansion of 6.5%, which is almost two percentage points higher than in 2010. The items that contributed the most to this performance were durable and semi-durable goods, with average growth rates close to 20%. Consumption of these goods benefited from abundant credit at relatively low interest rates and also from rising consumer confidence.

In 2011 growth in household spending, as in investment, was as strong as in the peak periods.

The economic activities that contributed most to growth in 2011 were mining, transport and communications, and trade. Mining continued to show double-digit expansion as in the previous four years, driven by increasing oil production thanks to high crude prices, favorable conditions for investment, and relatively successful exploration. The extraction of coal and other minerals also increased at a good pace as a result of high international prices and large inflows of foreign investment. Good performance by the sectors of transport and communications and trade was consistent with the behavior of household spending.

The economy's growth in 2010 and its further strengthening in 2011 have begun to produce positive effects on the labor market. Job creation has been expanding at record rates, significantly reducing unemployment, down to levels not seen in decades. Lower unemployment nationwide is particularly significant, considering that it has occurred in a context of rising labor supply, as measured by the global participation rate. This means that people desirous of entering the labor market have managed to find job opportunities. Job creation has been strongest in the sectors of trade, industry, construction and services. This behavior of the labor market confirms the economy's robust growth, driven in particular by domestic demand. Despite the foregoing, the informal sector accounts for a high share of the job market, and Colombia's unemployment rate continues to be one of the highest in Latin America.

The economy's growth in 2010 and its further strengthening in 2011 have begun to produce positive effects on the labor market.

The process of economic recovery and consolidation has been accompanied by a monetary policy designed to play its part by keeping inflation around the target and the use of resources near the economy's potential capacity. This should help to make growth sustainable, so as to avoid the traditional excesses that experience has repeatedly shown

Monetary policy has accompanied the process of economic recovery and consolidation, playing the part expected of it.

to be costly to well-being. To this end, starting from February 2011 the monetary stimulus began to be gradually withdrawn, by means of nine increments of 25 basis points in the policy interest rate. Thus, the one-day expansion repo rate was raised from 3%, appropriate for an economy on the brink of recession, to 5.25%, more consistent with strong domestic demand and a positive output gap.

Every decision by Banco de la República's Board of Directors has been taken after rigorous analysis of the economic situation and outlook, and after careful assessment of risks. In particular, as the threat of a European crisis began to intensify last September, it was decided to make a long pause in the adjustment process, in the expectation of greater information that would provide a clearer idea of the fate of the region and its capacity to cause contagion to Colombia's economy. Adjustments were resumed in November, when it was concluded that the Colombian economy was showing great strength despite adverse external conditions.

The incremental increases to Colombia's policy rate have been transmitted to borrowing and lending rates in the economy, in both nominal and real terms. This has helped to begin a moderation of the sharply rising trend in borrowing observed all through 2011, particularly corporate borrowing. Yet, credit continues to grow apace. In February this year the financial system's overall loan portfolio increased at an average real annual rate of almost 16% and consumer credit at 21%. This behavior was displayed last year by several Latin American countries, where, as in Colombia, debt as a share of GDP has increased.

The rapid expansion of credit in Colombia has led the Bank's Board of Directors to take great care in periodically monitoring credit quality and risks to the financial system. As described in this Report, no increase has been seen in default indicators or debt-quality deterioration that could compromise the financial system's stability. However, risky consumer loans and microcredit have been growing faster, and it is therefore important to continue monitoring them.

Every decision by the Bank's Board of Directors has been taken after rigorous analysis of the economic situation and outlook, and after careful assessment of risks

In a context of high economic growth, rising domestic demand and overall expansion in credit as described above, inflation rose in 2011, ending the year at 3.37%, compared with 3.17% in 2010. Although this result can hardly be classed as inflation overflow–for it stands within the 2%-4% target range–, it does cause the Board concern because inflation in 2011 continued to move away from the long-term target set at 3%. The monetary authority cannot feel too pleased with this situation, in a setting in which inflation expectations for a year or more

The evolution of annual consumer inflation over the first two months of 2012 has been promising.

ahead run close to 4%, and demand is rising at levels liable to use up spare capacity. The Board has therefore been taking decisions that it considers to be timely and appropriate, as stated above.

The evolution of annual consumer inflation over the first two months of 2012 has been promising. In February annual CPI change stood at 3.5%, almost 20bp down from what it was at the end of 2011, interrupting its trend of moving away from the 3% target. Over the same period the average of core inflation indicators also fell slightly, from 3.15% to 3.05%. This improved behavior was achieved despite the continued rise in fuel prices caused by higher world oil quotes. Two items contributed to this improvement. First, food inflation began to ease as rainfall became normal once more and led to recovery in food supply. Second, inflation in tradable goods has also slowed, in part because of the lower exchange rate. The easing of core inflation over the first two months of this year may indicate that the adjustment made to monetary policy is beginning to operate appropriately. According to the technical staff's forecasts, this favorable trend in consumer inflation may continue over the coming months.

The easing of core inflation over the first two months of this year may indicate that the adjustment made to monetary policy is beginning to operate appropriately.

During 2011 changing economic conditions in Colombia and abroad caused the nominal exchange rate to behave differently over certain periods of the year, in a context of intervention by Banco de la República in the foreign exchange market with daily auctions of twenty million dollars ($20m) in the first nine months. From January to the end of June 2011 the Colombian peso tended to appreciate, amid lower risk premiums and expectations of a higher public debt rating, which was finally granted in May and June. Later, from August to December 2011 the peso displayed a depreciation trend, associated with market nervousness over the sharpening crisis in Greece and other European countries and the IMF's announcement of fewer prospects of world economic growth. These opposite behaviors of the peso's exchange rate against the dollar tended to offset each other, so that the nominal exchange rate at the end of 2011 showed only a 1.5% depreciation relative to a year earlier. The real exchange rate, for its part, is influenced by inflation differentials between countries and provides a better diagnosis of Colombia's competitiveness by showing that the peso depreciated in 2011 against the currencies of the country's main trading partners. This Report analyses these indicators in detail and also the variables that determine them.

The intervention program was resumed on February 6 with daily US$20m competitive auctions.

An appreciation trend occurred again in the first two months of 2012 in both nominal and real terms. It resulted from less uncertainty about the fate of the European economy, improved data on the US economy's

The economic outlook for 2012 is positive, with growth estimated as likely to range between 4% and 6%.

performance, and renewed confidence in the Colombian economy, backed by its good performance in 2011 and favorable outlook for this year. In this context, the intervention program that had been interrupted on September 30, 2011, was resumed on February 6. The Board of Directors has announced that such interventions shall continue to be made at least until August in daily amounts of not less than US$20m.

As described in this Report, the economic outlook for 2012 is positive, with growth estimated as likely to range between 4% and 6%, depending on how the European situation develops and how it affects the global economy and Colombia's economy. Although global demand is expected to weaken, the emerging economies' growth will help to keep commodity prices high, boosting foreign investment flows into Colombia and the country's revenues through favorable terms of trade. Private demand is also expected to stay strong as a result of consumer and investor confidence remaining at record levels. Expansion in public investment will probably contribute to this scenario. The leading indicators of economic activity for the first two months of 2012 confirm that the Colombian economy continues to perform well.

The present *Report to Congress* contains four chapters. Chapter I reviews the international context, analyzing the background to and development of the European crisis, and also the developed and emerging economies' performance in 2011 and their prospects for 2012. Chapter II provides a detailed assessment of Colombia's economic results in 2011 in terms of economic activity, employment, and the financial sector and external sectors. It also describes the main aspects of the country's monetary, fiscal and exchange rate policy that contributed to macroeconomic stability, and analyzes the outlook for the present year. Chapter III reviews the behavior of Colombia's international reserves, as regards their composition, management policy, investment performance and status of claims. Lastly, Chapter IV describes Banco de la República's financial position. As is customary, the Report deals in greater depth with specific subjects, presented in individual Boxes, to provide a better understanding of Colombia's economy and the global economy, and also of the work of Banco de la República.