

INFLATION AT DECEMBER AND THE OUTLOOK

- Consumer inflation was 4.85% in 2005. This is within the target range for annual inflation (4.5% to 5.5%) and 65 basis points (bp) below inflation in 2004. The drop in non-food inflation, which offset the rise in food inflation, explains the reduction with respect to 2004. The other core inflation indicators were down as well. Within the Consumer Price Index (CPI), both tradable and non-tradable inflation declined.
- The bulk of the reduction in annual inflation occurred during the first half of the year. In the second half, it remained stable despite a temporary rise in food inflation, which reversed itself in November and December.
- External conditions continued to be favorable for the Colombian economy. The country's trading partners reported good growth. Moreover, terms of trade remained high and international liquidity kept the country-risk coefficients down. In this context, the Colombian economy should have grown by almost 5% in 2005. Domestic demand was the driving force of economic growth. The acceleration in household consumption, coupled with continued growth in investments, both public and private, were the high points in this respect. The Colombian economy now has completed three consecutive years of growth above 4%.
- According to various indicators, the use of production capacity continued to rise during the third and fourth quarters of 2005. Also, most of these indicators are back at their long-term levels or slightly above. This suggests there was increasingly less surplus capacity in the economy.
- No major changes in global economic growth trends are anticipated for 2006. A moderate rise in interest rates the world over is expected, and international commodity prices should remain high. In this context, favorable conditions for growth above 4.5% during 2006 continue to persist. The low level of real interest rates compared to historical averages contributes to this outcome, as does growth in productivity and continued confidence on the part of economic agents.
- The trend in core inflation during the next four to eight quarters will be determined primarily by changes in the exchange rate, the existence of surplus capacity, inflationary expectations

and the presence or absence of inflationary pressures on costs and wages. The following are the principal tendencies anticipated in this respect:

- No increase in tradable inflation is anticipated for 2006, although conditions might be different in 2007.
- In 2006, surplus production capacity should contribute less to containing demand-pull inflationary pressures than in earlier years.
- Surveys show that inflationary expectations are more consistent with the target than in past years. This favors inflation performance.
- Recent wage hikes, including a higher minimum wage, could begin to exert pressure on costs, although this will depend on the extent and continuity of gains in productivity.
- During 2006, inflation in regulated goods and utilities is expected to be similar to what it was at the end of 2005 (around 6%).
- With respect to food inflation, the forecasts show a significant decline as of the first quarter of 2006 compared to late 2005 (6.5%). This confirms the temporary nature of the food-price shocks observed in the final quarter of 2005. However, these predictions are highly uncertain, particularly in terms of how big the changes will be, even in the short-term.
- Considering these factors and the extreme likelihood that the 2006 inflation target will be met, the Board of Directors of Banco de la República (BDBR) agreed to leave the interest rate on expansion repos at 6%. This decision was taken at a BDBR meeting on January 27, 2006. Furthermore, based on an assessment of the exchange situation and balance-of-payment projections, the Board of Directors agreed to continue its discretionary intervention in the exchange market.

Board of Directors
Banco de la República
(Central Bank of Colombia)