Report by the Board of directors to the Congress of the Republic

March 2007

Banco de la República

Central Bank of Colombia

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March 28, 2007

Honorable Chairmen and Members
Third Standing Constitutional Committees of
The Senate and
The House of Representatives

Dear Sirs,

Pursuant to Article 5, Law 31/1992, the Board of Directors of Banco de la República hereby submits to the Congress of the Republic of Colombia, for its consideration, a report on the macroeconomic results for 2006 and 2007 to date, including the targets adopted by the Board of Directors for the 2007 and the forecasts for the main macroeconomic variables. The last two chapters contain information on the composition of international reserves and projections on Banco de la República's financial situation in 2007.

Yours truly.

José Darío Uribe Escobar
Governor

Introduction

In 2006, the rate of economic growth in Colombia (6.8%) surpassed all projections, even those calculated by Banco de la República.

In 2006, the rate of economic growth in Colombia (6.8%) surpassed all projections, even those calculated by Banco de la República. This represents a surge in economic activity compared to 2004 (4.9%) and 2005 (4.7%), consolidating a healthy increase that makes Colombia one of the countries in Latin America with the fastest growing economy.

The characteristics of the increase in 2006 bode well for continued growth in the years ahead. For example, the increase in gross capital formation, especially in machinery, equipment and construction, was largely responsible for the expansion in the economy, contributing to an increase in productive capacity and productivity.

The outcome for 2006 is clear. Economic growth encompasses a number of goods and service sectors, such as the construction industry, commerce and transport. Performance in the agricultural sector, which saw 4% growth during the fourth quarter of 2006, is another high point and was mainly the result of a good coffee crop. The recovery in household consumption, which was hard hit during the crisis in the nineties was consolidated in 2006. This introduces an important factor for economic growth that will be a fundamental driving force in the months ahead.

The context surrounding the consolidation of economic growth during 2006 was one of less inflation. Consumer inflation that year was 4.5%, precisely at the center of the target range and below inflation in 2005 (4.9%). The rate of inflation in 2006 completes three consecutive years of rigorous compliance with the targets set by the Board of Directors of Banco de la República (BDBR). This adds to the credibility of its monetary policy, helping to focus inflationary expectations on the announced targets. It also is an important step forward, by reducing the inflationary inertia that was common in the past and made it difficult to lower inflation.

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Figures from the Home Survey conducted by the National Bureau of Statistics (DANE) show an increase in unemployment, which seems strange in an economy with a healthy growth rate. A number of factors that might offer an explanation are analyzed in this report. One could be the difficulty in comparing figures, because of the changes introduced in the survey as of the second half of 2006. However, other sources of information, such as direct surveys of the business community, point to the possibility of strong employment gains in specific sectors. Commerce and industry are two examples. The increase in the number of affiliates in the social security system also seems to reflect the positive impact of economic growth on employment.

The favorable economic environment, with fast growth and lower inflation, has been accompanied by gradual appreciation of the Colombian peso. This has sparked logical concern in sectors that export and compete with imports. It is particularly important to understand that peso appreciation originates largely with the force of the Colombian economy, which has bolstered confidence among foreign and domestic entrepreneurs, who are investing heavily in the country or repatriating resources saved abroad. The appreciation of currencies against the dollar is a phenomenon that affects most economies and is associated with the imbalances in the United States economy and the surplus liquidity in its markets. Moreover, a great deal of capital from the sale of public and private assets entered the country in the early months of 2007.

Under these circumstances, the objective of the exchange market intervention policy is to tone down abrupt and temporary appreciation or depreciation, without trying to modify the trends explained by the economy's fundamental determinants. At the same time, intervention in the exchange market is done within the limits determined by the inflation-targeting strategy, without jeopardizing compliance with the target for inflation. In fact, as demonstrated by the outcome for inflation between 2004 and 2006, respect for the limits on exchange market intervention has been no obstacle to meeting the targets for inflation.

The build-up in economic indicators also reflects the positive trend in the Colombian economy. As discussed in this report, there have been major improvements in the external vulnerability indicators, represented in net international reserves that now exceed US$17 billion (b). This amount of reserves offers the economy important protection against the serious consequences that could come with a negative external shock.

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The same is true of the risk and performance indicators for the financial system. Profitability indicators are at historically high levels and the system's capital soundness far exceeds the required minimum. The vigorous loan growth during 2006 occurred in a context of good loan portfolio quality indicators and high coverage.

Given the favorable economic environment, it is important not to ignore the risks to economic stability and sustainable growth. Obviously, the increase in demand could exceed productive capacity, exerting inflationary pressures that could undermine confidence and eventually affect economic growth. To keep this from happening, the Board of Directors has gradually raised the intervention interest rate in the money market since April, based on a careful technical analysis. The objective is to slowly eliminate the monetary stimulus being provided to the economy, which now is unnecessary.

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Another risk involves the rapid expansion in aggregate demand, which could raise the current account deficit in the balance of payments to an unsustainable level. The gradual increase in interest rates helps to prevent this from happening by curbing the aggregate demand and, with it, excess spending of economic earnings. In a macroeconomic sense, the latter is tantamount to the current account deficit.

If criteria on lending and risk are relaxed during an economic boom, accelerated growth in the loan portfolio can jeopardize portfolio quality. The gradual increase in monetary intervention rates helps to temper loan portfolio growth. In doing so, it also reduces risks to the financial system. However, on this front, it is important to establish prudent regulations of an anticyclical nature, particularly along the lines of those being developed by the Superintendent of Financial Institutions.

... exerting inflationary pressure that could undermine confidence and eventually affect economic growth.

Monetary policy can be used to prevent these risks and to help preserve growth in an economically stable environment. Nevertheless, its capacity should not be overestimated. For this reason, a policy of fiscal restraint that is consistent with the prevailing monetary policy and contributes to economic stability and sustained growth is indispensable. In this respect, efforts to control government spending help to avoid excess aggregate demand in the economy, which is accompanied by inflationary pressure, currency appreciation and current account deficit.

This report is organized into chapters. The outcome of inflation in 2006 and the outlook for 2007 are presented in Chapter I. Chapter II contains an account of economic activity in 2006 and projections for 2007. The recent trends in the labor market and the possible reasons why unemployment has not declined are examined in Chapter III. The monetary policy and exchange intervention strategy are reviewed in Chapter IV. The changes in financial markets, interest rates and monetary aggregates are analyzed in Chapter V, which also contains an evaluation of the quality and risk indicators for financial institutions. The balance of payments is outlined in Chapter VI and the fiscal policy, in Chapter VII. International reserves and the external vulnerability indicators are discussed in Chapter VIII. Banco de la República's financial situation is described in Chapter IX.

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This report also contains a series of special sections or boxes on topics that are considered important to an analysis of the current economic situation: Box 1: Is the economy heating up?; Box 2: Inflation-targeting Worldwide; Box 3: Interest Rate Pass-through to the Economy; Box 4: Anti-cyclical Provisions; Box 5: Foreign Direct Investment during 2006; Box 6: Fiscal Policy and the Economic Cycle; and Box 7: The Public Debt and Macroeconomic Stability.

I. Inflation: 2006 and the Outlook

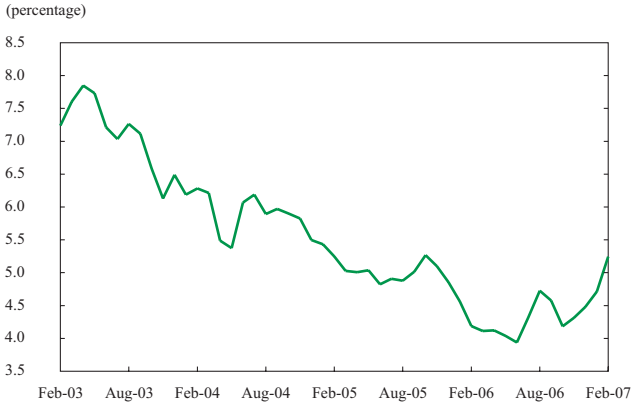
Consumer inflation ended the year at 4.5%, which is at the center of the target range defined by the Board of Directors and less than inflation in December 2005 (4.9%).

A. Inflation during 2006

Consumer inflation ended the year at 4.5%, which is at the center of the target range defined by the Board of Directors and less than inflation in December 2005 (4.9%). This rounds out three consecutive years of compliance with the inflation targets set by the Bank (Graph 1). Consumer inflation during 2006 was marked by two trends. One was a significant decline during the first half of the year, which reduced the rate from 4.9% in December 2005 to historically low levels in June (3.9%). The other was an increase during the second half of the year, marked by several interruptions. Core or underlying inflation followed a similar pattern. The average of the three most commonly used indicators of core inflation (non-food CPI, CPI excluding staple foods, fuel and utilities, and nucleus 20) exhibited a downward trend until April, but rose as of May, ending the year at 4.5% (Graph 2).

Graph 1

Total Consumer Inflation (Annual Variation)

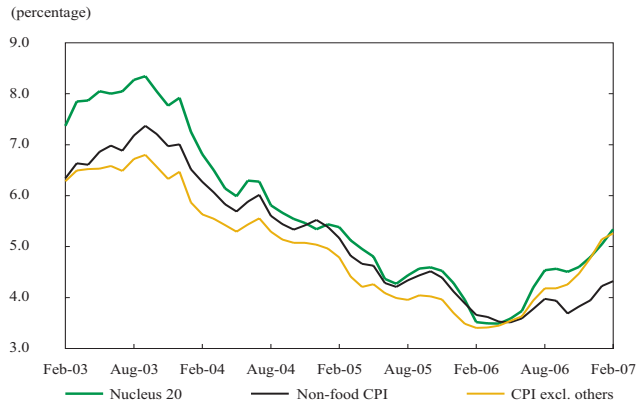


Source: DANE. Banco de la República's calculations.

The initial decline and subsequent increase in consumer inflation during 2006 was linked to changes in the price of food and regulated items; annual inflation in both these baskets fell during the first half of the year and increased during the second. Food inflation went from 6.6% in December 2005 to 4.7% in June and 5.8% in December (Graph 3). Inflation in regulated items dropped from 6.6% in December 2005 to 3.8% in June 2006, but increased to 6.0% in December.

GRAPH 2

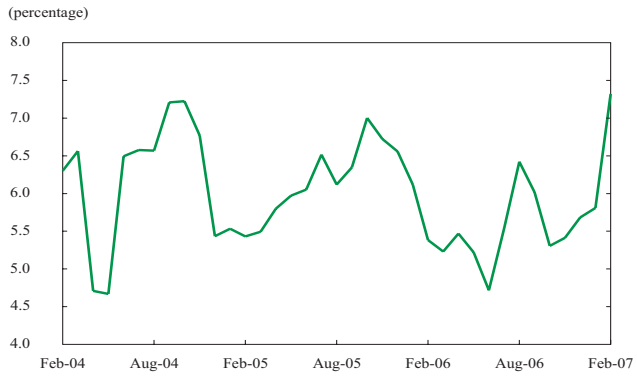
CORE INFLATION INDECATORS
(ANNUAL VARIATION)



Source: DANE. Banco de la República's calculations.

GRAPH 3

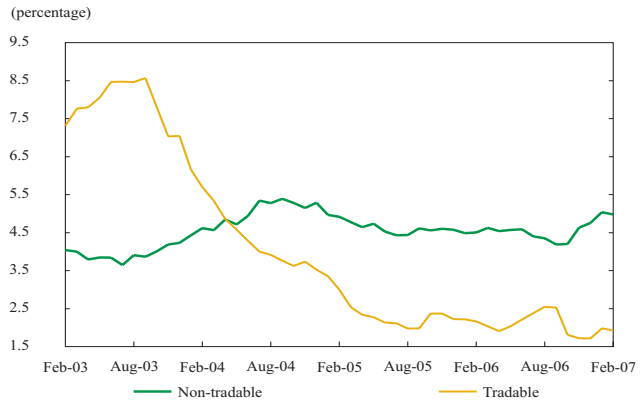
FOOD INFLATION
(ANNUAL VARIATION)



Source: DANE. Banco de la República's calculations.

GRAPH 4

TRADABLE AND NON-TRADABLE INFLATION
EXCLUDING FOOD AND REGULATED ITEMS
(ANNUAL VARIATION)



Source: DANE. Banco de la República's calculations.

Inflation in tradables, excluding food and regulated items, stayed at around 2% during 2006, despite a temporary rise in the exchange rate during the second half of the year. The impact of exchange-rate increases on prices was slight and disappeared by the fourth quarter (Graph 4). Inflation in non-tradable goods and services, excluding food and regulated items, remained near 4.5% throughout the year. The only exception was a slight dip in the third quarter, which began to turn around in October (Graph 4). The stability of inflation in this basket of goods and services, despite the acceleration in aggregate demand, might be related to inflationary expectations, which have fallen since the beginning of the year and remained consistent with the target, in spite of higher inflation during the second half of 2006.

International oil prices were an important source of price hikes during 2006. Higher oil prices were passed on to consumer prices through various channels. One was the domestic price of gasoline, which was up by nearly 10% during the year. This prompted increases in public transportation rates that were above average inflation. Another was the price of food. High oil prices have encouraged substitution with bio-fuels, raising domestic and international prices for a number of farm products such as corn, other cereals and sugar cane. This has pushed up food prices. Annual food inflation stayed above 4.5% as a result, and was on the rise at the end of the year (Graph 3).

B. OUTLOOK FOR 2007

The upward trend in consumer inflation, evident as of the fourth quarter of 2006, became more pronounced in early 2007. As a result, total inflation was 5.25% by February and the average for the three core inflation indicators was 5.0%. Banco de a República anticipated some of these increases, particularly those related to prices for food and regulated goods and services. Yet, the

increase in non-tradable inflation, excluding food and regulated items, has been more than expected. It was 5% in February, having been 4.8% in December and 4.2% in September 2006.

The inflation forecasts for 2007 point to inflationary pressure on three of the four groups in the consumer price index (CPI)…

The inflation forecasts for 2007 point to inflationary pressure on three of the four groups in the consumer price index (CPI): food, regulated items, and non-tradables excluding food and regulated items. The rise in food prices is likely to be temporary, because of El Niño weather, and should slip back during the second half of the year. In the case of regulated items, the forecast points to a one-time hike for a number of public utilities with prices backed up since 2006; these increases would be concentrated in the first half of the year. For both food and regulated items, the upward effect on annual inflation is expected to occur during the first half of the year, before reducing gradually during the second.

…food, regulated items, and non-tradables excluding food and regulated items.

The upward pressure on non-tradable goods and services (excluding food and regulated items) would continue a bit longer, in connection with the sharp growth in aggregate demand during the second half of 2006, which is expected to continue into early 2007. Growth last year was far and above the historical average for Colombia. Despite heavy investment throughout 2006 and in previous years, plus the gains in productivity, it reduced the surplus productive capacity the economy had accumulated.

Of all the upward factors being predicted, this one poses the biggest challenges in terms of monetary policy. To curb price pressures, the Board of Directors has adjusted the stance of its monetary policy by raising intervention interest rates since late April 2006 (200 basis points (bp) had been added by February). One of the main objectives of this measure is to prevent inflationary expectations from reaching levels that are incompatible with the target for 2007 and with long-term inflation at around 3%.

As to forecasts, the Bank expects total inflation to exceed the 2007 target range (3.5% to 4.5%) during the first half of the year; however, it should fall within that range during the second. For the most part, the temporary hikes in food inflation would be concentrated in perishables and would be due to rain and frost associated with El Niño weather. Meteorological agencies predict moderate El Niño weather from the end of 2006 to March 2007. Similar circumstances in the past caused temporary increases in perishable food inflation. For example, several major hikes were evident by February and are likely to continue during the second quarter, after which prices are expected to fall.

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The upward pressure on prices is likely to continue, because of higher international prices for food and raw materials, as well as domestic fuel prices. In the case of food, the international price of a product such as corn exceeded its historical average during the final weeks of 2006 and at the beginning of 2007. This trend is likely to continue, given worldwide demand, and could

The Bank does not expect the exchange rate to exert inflationary pressures in 2007.

keep exerting pressure on a large segment of the processed food basket in Colombia, even during the second half of the year.

The Bank's statistical models estimate increases of 100 bp to 300 bp in food inflation until mid-year; some are expect to fall back during third and fourth quarters. However, it is important to point out that food price forecasts are highly uncertain due to the volatile nature of the series and the complexity of the factors involved.

Although 2007 is expected to see international fuel prices slightly below those in 2006, the continuing gap with respect to domestic prices would require hikes above the targets for inflation. This would apply not only to gas and gasoline, but also to public transportation fares. Even so, these increases would be less than in 2006.

The Bank does not expect the exchange rate to exert inflationary pressure in 2007. The relative stability anticipated for this variable would help to keep tradable inflation, excluding food and regulated items, in the 2% range. As a result, and because the interest rates hikes should curb some of the pressure on the price of non-tradable goods and keep inflationary expectations in check, the target for 2007 is likely to be met.

II. Economic Activity: 2006 and the Outlook

At 6.68%, economic growth in 2006 surpassed all projections, even those of Banco de la República.

At 6.68%, economic growth in 2006 surpassed all projections, even those of Banco de la República. Table 1 contains the latest GDP growth estimates on the supply side.[1]

Table 1

Real Annual GDP Growth, by Expense Item (Percentage)

	2004	2005 a/	2006 b/
End Consumption	**4.8**	**4.8**	**5.0**
Household	6.0	4.7	6.0
Government	1.1	4.8	1.9
Gross Capital Formation	**15.6**	**25.7**	**28.0**
Gross Fixed Capital Formation (GFCF)	15.0	18.8	19.3
GFCF excl. Civil Works	22.0	16.7	19.5
Civil Works	(7.9)	28.2	18.3
Variation in stock	28.0	158.3	105.1
Domestic Demand	**6.6**	**8.5**	**9.9**
Total Exports	**10.0**	**5.6**	**8.0**
Total Imports	**19.8**	**21.7**	**21.1**
GDP	**4.9**	**5.3**	**6.8**

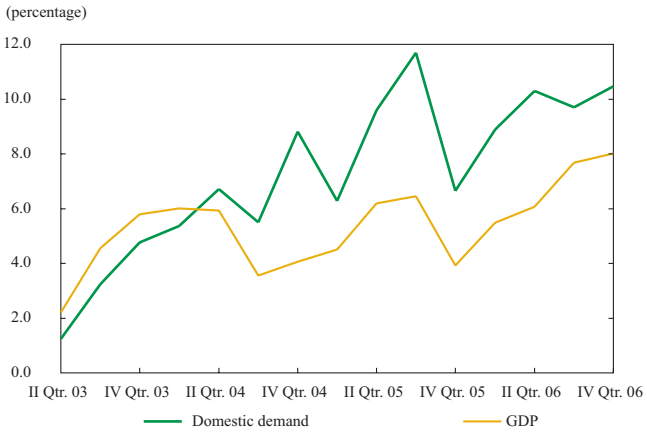
a/ Preliminary.
b/ Projection.
Source: DANE. Banco de la República's calculations.

[1] DANE released the figure for economic growth in 2006 (6.8%) at the time this report was published, and announced a change in the 2005 rate from 5.3% to 4.7%. However, the information needed to modify Table 1 and Table 2 was not available when this report was written; accordingly, those tables include DANE figures for 2005 and Banco de la República's estimates for 2006.

This is a surge compared to the past two years (4.9% in 2004 and 4.7% in 2005) and was evident with publication of the figure for the second quarter of 2006, when the economy grew by 6.0% despite several adverse supply shocks. Figures on final quarter of 2006 and the year to date indicate domestic demand continues to gain strength as the basic driving force of Colombian economic growth. The increase in household consumption propelled by more earnings, ample credit and liquidity, coupled with an atmosphere of confidence, seems to indicate the acceleration in growth will continue during the coming months.

GRAPH 5

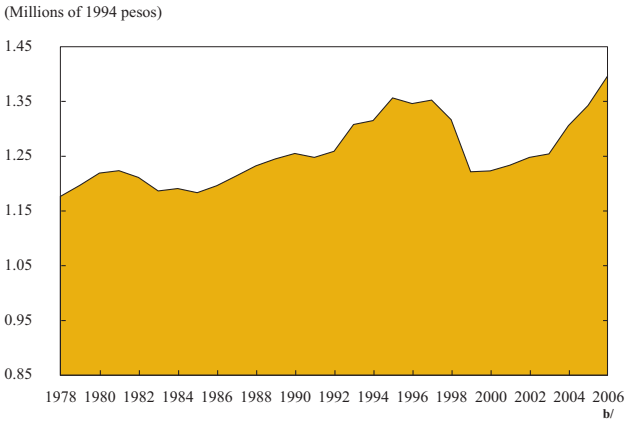
REAL ANNUAL GROWTH IN GDP AND DOMESTIC DEMAND



Source: DANE. Banco de la República's calculations.

GRAPH 6

PER CAPITA HOUSEHOLD CONSUMPTION a/



a/ Population estimates calculated by Banco de la República between censuses, with data from DANE.
b/ Projected.
Source: DANE, DNP and Banco de la República.

A. DOMESTIC DEMAND IN 2006

Real growth in domestic demand was around al 10% during 2006 (8% without the variation in stock), rounding out eleven quarters of growth above the increase in gross domestic product (GDP) (Graph 5). Household consumption and investment in machinery, equipment and construction were the most dynamic elements of the growth in domestic demand. Household non-durable goods consumption increased substantially, overcoming the lag in growth last year compared to the other consumer items, which had already begun to increase at high rates.

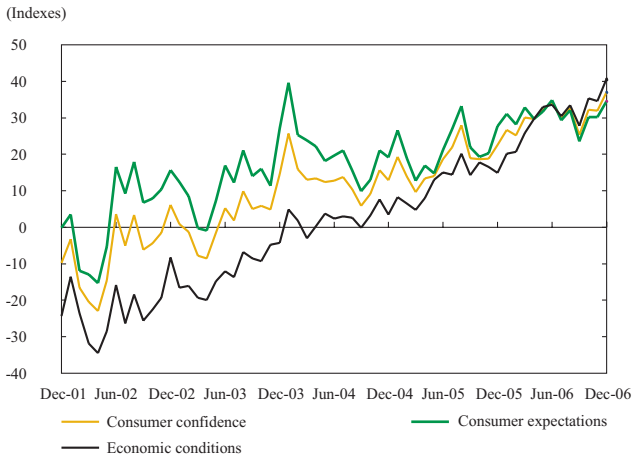
During the crisis at the end of the nineties, household consumption was hit hard in per capita terms and almost pushed back to the 1987 levels (Graph 6). It began to recover in 2003 and, by mid-2005, had surpassed the highs witnessed in the early nineties.

Figures released by the National Revenue and Customs Bureau (DIAN) and DANE on imports of these goods confirm the positive development in household consumption. Official foreign trade data show an increase in consumer goods, as a share of total imports, from 18% in 2005 to 21% in 2006. The strong growth in consumer credit, coupled with the Fenalco reports on commercial sales and the DANE Monthly Retail Sample

(MRS), also confirms the expansion in household consumption. Consumer confidence remains historically high, as do indicators of expectations for consumption and economic conditions (according to the Fedesarrollo Consumption Survey). The foregoing suggests that consumption will continue to increase in the coming quarters (Graph 7).

GRAPH 7

FEDESARROLLO CONSUMER SURVEY INDEXES



Source: Fedesarrollo.

The investment in machinery and equipment continues to explain much of the rise in domestic demand. 2006 marked four years of real average annual growth at 22.5%. This has added to the potential for economic growth at a time when the rate of installed company capacity utilization is high.

Investment items associated with construction also propelled the rise in domestic demand. Home and building construction were up by nearly 20% in 2006, marking the start of a period when investments of this type contributed heavily to growth.

Unlike the expansionary phase in the mid-nineties, when investment was concentrated on home and building construction, it has been fueled in recent years primarily by gross fixed capital formation (GFCF) in machinery and equipment, directly contributing to the increase in productive capacity and productivity. Moreover, construction of civil engineering works continued to add to the increase in domestic demand and GDP in general. Macro-projects for highway pavement, mass transit, mining exploration and investment associated with telecommunications allowed for a real increase of more than 15% in investment in civil works throughout 2006.

Confirmation of these results would round out five years of growth in total investment above the increase in GDP (19.4% average growth in investment compared to an increase of 4.6% in GDP), and would account for approximately 26% of GDP in 2006 (Graph 8).

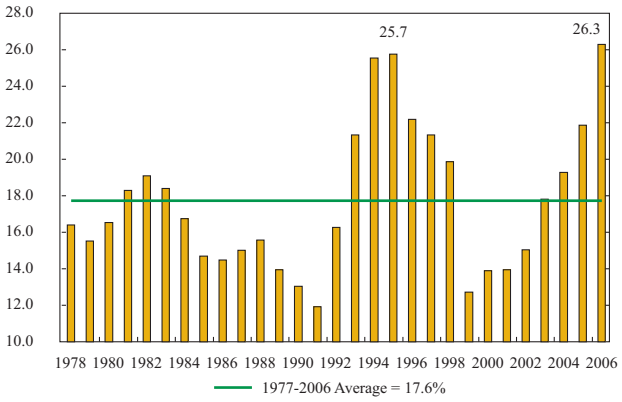
The increase in public-sector consumption throughout 2006 was relative limited (approximately 2.5%). This appears to be consistent with the government's fiscal goals and performance. The sharp reduction in public-sector management of social security would have offset the increase in consumption by the central and local governments.

Construction of civil engineering works continued to add to the increase in domestic demand and GDP in general

Thanks to moderate growth in public consumption during 2006, its share of GDP continued to decline, adding another year to the trend observed

Graph 8

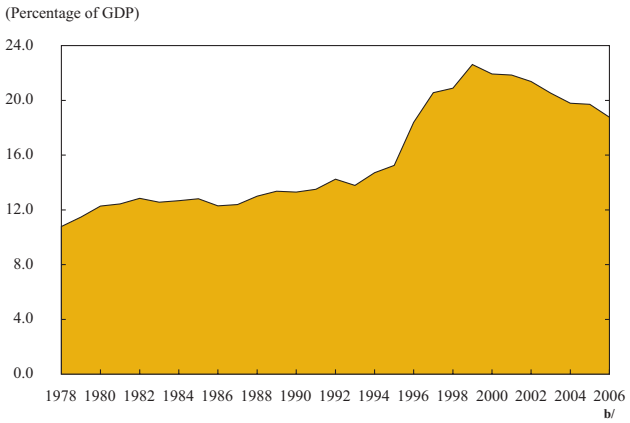
Total Investment as a Percentage of GDP



Source: DNP and DANE. Banco de la República's calculations.

Graph 9

Government Consumption a/



a/ Includes government services and social security.
b/ Projected by Banco de la República.
Source: DANE, DNP and Banco de la República.

since 1999. The proportion is close to 18%, which is comparable to the levels witnessed in 1996 (Graph 9).

B. External Demand

The fourth quarter was positive for exports. According to the forecasts, traditional exports at constant prices would have increased by about 14%, thanks to sales of coffee and coal, despite the real reduction in exports of oil and petroleum derivatives. Non-traditional exports remained a driving force of economic growth, with a 12% calculated real increase in pesos. If the fourth-quarter forecasts were borne out, total exports in 2006 would have increased by almost 8% in real pesos, which is slightly more than in 2005 (5.6%).

Despite good export performance, real net external demand might be negative due to the momentum in imports, particularly consumer and capital goods imports. The real growth in aggregate imports is expected to exceed 20% during the fourth quarter of 2006; the real rate for the entire year is forecast at 21%.

A look at foreign trade figures in dollars during 2006 shows a positive panorama. Total exports were up by 15.1%, traditional exports, by 13.9% and non-traditional exports, by 19.3%. Ferronickel and coal were the traditional exports that increased the most (50% and 12%, respectively); in contrast, foreign sales of coffee were down by 0.6% due to a poor coffee crop in 2005/2006.

In general, growth in non-traditional exports was vigorous, particularly base metal industrial products (42.6%), machinery and equipment (23.6%), non-metallic minerals (22.8%), plastic and rubber products (21.6%) and

wood and manufactured wood products (19.7%). Non-traditional agricultural export performance was more moderate. Sales of bananas and flowers, for example, experienced annual increases of 3.4% and 6.7%.

Venezuela took the lead as the most dynamic export destination for non-traditional products (largely industrial) (28.2% during the year).

Venezuela took the lead as the most dynamic export destination for non-traditional products (largely industrial) (28.2% during the year). Exports to the United States (5.0%) and Ecuador (7.7%) showed less momentum towards the end of 2006, possibly because of the limited economic growth in those countries and partly because of the exchange rate

The slim growth in non-traditional exports to the United States shows that 11 of the 14 major sectors that sell to the US reduced their sales even more. In that group, the chemical industry, the base metal industry, leather and leather products and wearing apparel were the sectors where the most growth was lost (see Chapter VI for more information on Colombian foreign trade).

C. Supply-side Growth

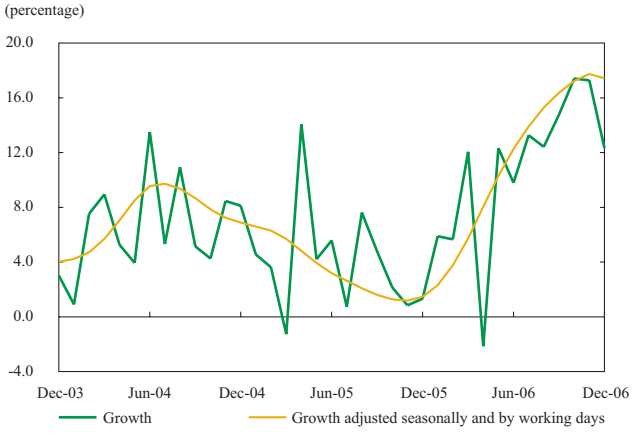
On the supply side, good industrial production continued to propel economic growth in Colombia during 2006. According to the DANE Monthly Manufacturing Sample (MMS), industrial production would have increased at a real rate of 11.1% (Graph 10). The data available on industry show that only two of the 47 sectors monitored registered a real drop in production during 2006; namely, printing and graphic materials, and oil refining.

Construction was another activity that bolstered economic growth in 2006, thanks to heavy investment in the sector. The almost 18% increase is explained by building construction and civil works. Besides generating direct employment, this sector contributed to the growth in activities related to industrial manufacturing, such as the production of non-metallic minerals (38% annual growth), basic iron and steel industries (20.8%), and other sectors associated with building occupancy (electrical appliances, machinery and electrical devices, furniture manufacturing, etc.) (Table 2).

The agricultural sector is expected to increase by nearly 3.0%, with more than 4.0% real growth

Graph 10

Annual Increase in the Industrial Production Index a/



a/ DANE real MMS index
Source: DANE. Banco de la República's calculations.

TABLE 2

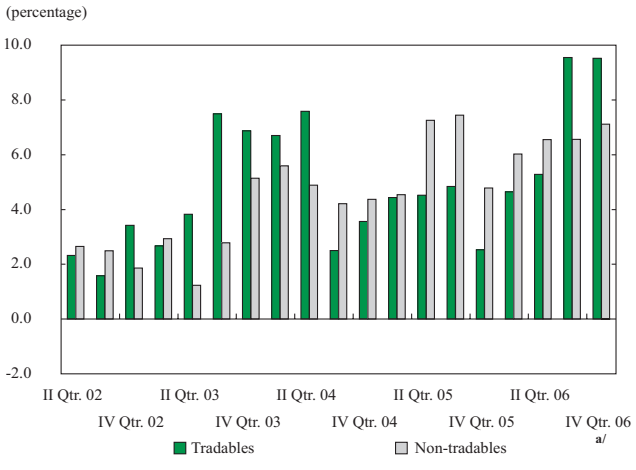
REAL ANNUAL SECTORAL GDP GROWTH (PERCENTAGE)

	2004	2005 a/	2006 b/
Agriculture, forestry, hunting and fishing	2.0	3.0	2.6
Mining and quarries	2.7	3.0	0.7
Electricity, gas and water	2.8	3.2	3.0
Industrial manufacturing	7.2	3.9	10.9
Construction	12.4	12.1	16.6
Buildings	29.4	3.6	15.4
Civil Works	(10.0)	28.2	18.4
Commerce, repairs, restaurants and hotels	7.6	9.4	10.7
Transport, storage and communication	6.2	5.1	9.2
Financial estabs., insurance, real estate and company services	4.8	3.6	1.6
Social, community and personal services	1.4	4.0	1.9
Financial brokerage measured indirectly	10.3	8.4	(6.0)
Subtotal: Aggregate value	4.5	4.7	6.4
GDP	4.9	5.3	6.8
Taxes minus subsidies	10.6	12.8	12.5
Net FBSMI financial services c/	3.1	2.0	4.6
Tradables d/	5.0	4.1	7.3
Non-tradables	4.8	6.0	6.6

a/ Preliminary.
b/ Projection.
c/ FBSMI: Financial brokerage services measured indirectly.
d/ The tradable sectors include agriculture, mining and manufacturing; air, water, complementary and auxiliary transport, and some private services for companies.
Source: DANE. Banco de la República's calculations.

GRAPH 11

ANNUAL TRADABLE AND NON-TRADABLE GDP GROWTH



a/ Projected.
Source: DANE. Banco de la República's calculations.

in the fourth quarter, thanks to a larger coffee crop. The tradable sectors, for the most part, could have expanded by 7.3% during 2006, consolidating four years with growth above 5.0%

The non-tradable sectors might have grown by more than 6.5% in the aggregate for 2006. Commerce and home construction were probably the most dynamic sectors in the group. This is confirmed by the increase in the DANE monthly retail trade sample and in building permits (17% and 34%, respectively, during October-December).

These figures suggest real peso appreciation did not cause a slowdown in the tradable sectors. Their growth was backed primarily by the trend in world demand and by the increase in investment (Graph 11).

D. GDP Forecast for 2007

The GDP simulation exercises for 2007, which were conducted with a multi-sector general equilibrium model and depend largely on balance-of-payments scenarios, show probable growth between 4.5% and 6.5%, which is a bit less than in 2006.

The GDP simulation exercises for 2007, which were conducted with a multi-sector general equilibrium model and depend largely on balance-of-payments scenarios, show probable growth between 4.5% and 6.5%. This is a bit less than in 2006.

The external context in 2007 will be one of relative stability compared to 2006. The US Federal Reserve Bank (the Fed) is expected to leave interest rates unchanged throughout most of the year; moderate increases are expected in the euro zone and Japan. Consequently, no major outflows of capital from the emerging economies are anticipated, and both the public and private sectors should have easy access to financing outside the country.

The external context will continue to contribute to growth through high external demand, although a slight slowdown in demand on the part pf our major trading partners is expected compared to the increase in 2006. Terms of trade should remain high, near the levels observed in past years (2005 and 2006). A moderate reduction in international coal and oil prices is expected, as are increases in the price of coffee, ferronickel and gold.

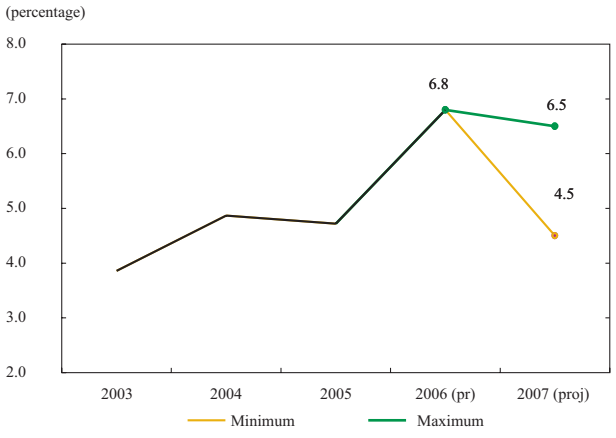
Workers' remittances should expand in line with economic growth in the countries of origin (mainly the United States and Spain), while real production of oil and petroleum derivatives would decline somewhat. The exportable coffee supply would increase somewhat compared to 2006, as would all other mining production, led by coal mining.

At the domestic level, besides an increase in the stock of physical capital, total factor productivity should continue to grow by about 1.0%, within a context of job recovery and high use of installed capacity in the tradable and non-tradable sectors. Consumer and investor confidence would continue, as would the monetary policy normalization process.

Based on the foregoing, the GDP forecasts point to growth in the 4.5%-to-6.5% range during (Graph 12). This would spell a slowdown compared to the outcome anticipated for 2006, reflected in investment that increases less and is oriented more towards home construction.

Graph 12

Real Annual GDP Growth



(pr) Preliminary.
(proj) Projected.
Source: DANE. Banco de la República's calculations.

Household consumption would be up by nearly 6.5%, and government consumption, by 3.0%, while the real growth in exports would be between 4.0% and 6.0%.

Accordingly, there would be somewhat of a slowdown in imports (particularly intermediate and capital goods). Household consumption would be up by nearly 6.5%, and government consumption, by 3.0%, while the real growth in exports would be between 4.0% and 6.0%.

As to the different sectors, the center of the forecast range shows a manufacturing sector that would expand by nearly 7.0% in annual terms: construction and commerce would increase by 9.0%. Economic growth would be balanced between the tradable and non-tradable sectors (5.6% and 5.4%, respectively, at the center of the forecast range).

Is the Economy Overheated?

The Colombian economy has grown by 5.2%, on average, during the last 14 quarters. The same period saw a 7.1% rise in domestic demand, primarily because of an important surge in investment. Inflation declined from 6.5% in 2003 to 4.5% in 2006, and the current account deficit went from 0.4% to 2.3%.

In its research, the Economic Studies Division (SGEE) at Banco de la República has mentioned the gradual reduction in surplus productive capacity in the Colombian economy. This raises the question as to whether the Colombian economy is "overheated" or could overheat any time soon. Being "overheated" means having surplus spending in the economy, according to the following criteria:

a) Domestic spending exceeds the economy's productive capacity (determined by existing surplus capacity and potential growth). In an overheated economy, this would exert upward pressure on prices, especially for internationally non-tradable goods, causing higher inflation (in the absence of large-scale nominal appreciation).

b) Part of the growth in domestic spending is reflected in more demand for imports, adding to the trade deficit and to the current account deficit in the balance of payments. In this case, "overheating" occurs when the current account deficit becomes unsustainable.

The foregoing suggests that excess spending in the economy does not necessarily mean higher inflation. In effect, excess spending can be generated, for example, by a sharp increase in terms of trade or in capital flows, which would lower the price of tradable goods in such a way that overall inflation would not increase, even with higher prices for non-tradables.

For instance, between 1991 and 1997, aggregate demand rose by 5.5%, while inflation declined from 26.8% to 17.7%, largely because of the sharp drop in tradable inflation associated with 20% real appreciation between 1990 and 1997. However, the current account balance went from +1.1% to -5.3%. This increase in the current account deficit was unsustainable and ultimately led to an abrupt correction in 1999, when international markets closed and domestic demand fell by 10%.

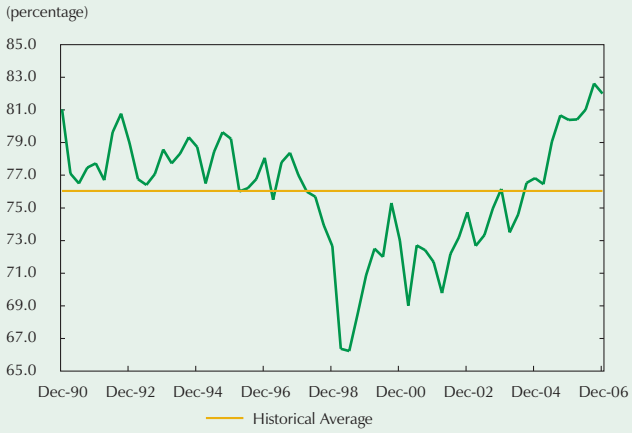
Productive Capacity Restrictions

Evidence of restrictions on productive capacity is mixed. Although the inDecators of capacity utilization in industry and other sectors are at historically high levels (Graph B1.1), the findings of a company survey conducted by Banco de la República in different productive sectors suggests that, up until the first of the year, the difficulty in satisfying unexpected increases in demand had not increased.

However, inflation in non-tradable goods and services has accelerated since the end of 2006, accompanying the increase in household consumption (Graph B1.2). Even if companies

Graph B1.1
Use of Installed Capacity

A. ANDI



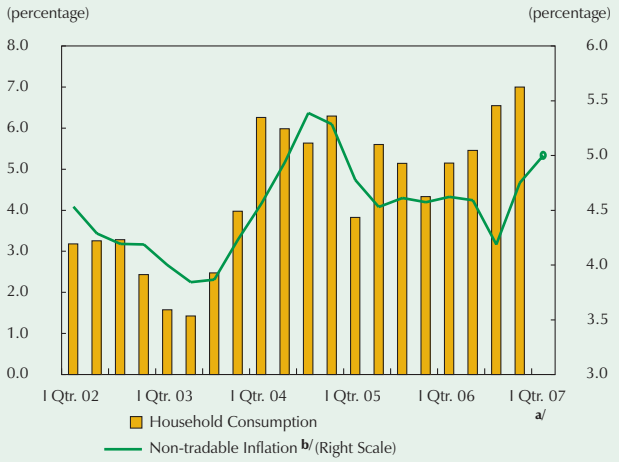
B. Fedesarrollo

Source: ANDI and FEDESARROLLO.

have the surplus capacity to respond to an increase in demand, high inflation is possible if, for example, they take advantage of good conditions to raise their profit margins. This could have been the case in 2004, after several years of recession, when profit margins likely declined.

A number of business opinion surveys corroborate evidence of pressure being exerted by the cost of input and raw materials. In the ANDI survey, the percentage of replies that inDecate this is a major problem in industry has been historically high since mid-2006 (Graph B1.3).

Graph B1.2
Household Consumption and Non-tradable Inflation



a/ Projected figure.
b/ Excluding food and regulated items.
Source: Banco de la República.

Graph B1.3
Cost and Supply of Raw Materials as the Main Problem in Industry

Source: ANDI

As yet, there appear to be no generalized inflationary pressures with respect to the labor market. Despite real wage hikes that were quite high in some sectors, such as commerce, the increases in other sectors were less pronounced or were offset by gains in productivity (adjusted due to the economic cycle). Industry is a case in point.

So, inflationary pressures would be associated mainly with the cost of input and possibly with the shift in profit margins in certain sectors, thanks to the positive situation with demand. Given the growth forecast for this variable, 2007 could see demand pressures rise sharply.

Potential for Economic Growth in Colombia

Economic growth has averaged 4.2% since 1960. The average rate of investment is 16.9% and total factor productivity has increased by 0.7% per year, although it has been much less since 1980 (0.08%). The Colombian economy has not managed to maintain an investment rate above 20% of GDP for more than three years.

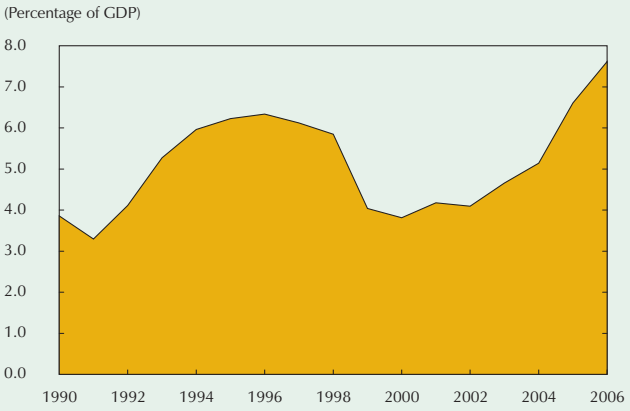
The potential for economic growth in Colombia during the next few years depends largely on whether or not the recovery in investment and productivity can be sustained. For example, if the growth in productivity returns to annual rates of 0.8% and the increase in investment stays at 18% of GDP, the potential for economic growth would be around 4.7%. However, if the investment rate stays above 20%, which probably would contribute to more of an increase in productivity, the potential for growth could be between 5% and 6%.

Several factors suggest it might be easier to sustain the current rate of investment (around 23% excluding the variation in inventory) than was the case on previous occasions. The current boom in investment is concentrated more on machinery and equipment, and probably is oriented more towards exports than in the nineties. (Graphs B1.4 and B1.5). The latter is explained by more of a focus on FDI exports and by the two-fold increase in the rate of industrial exports since the end of the nineties. Furthermore, healthy macroeconomic policies have helped to reduce inflationary expectations and the country-risk premium. This, in turn, has lowered the real long-term interest rate in the economy. If monetary policies remain consistent and committed to economic stabilization, real long-term interest rates will remain low, thereby encouraging investment.

Surplus Spending and the Current Account Balance

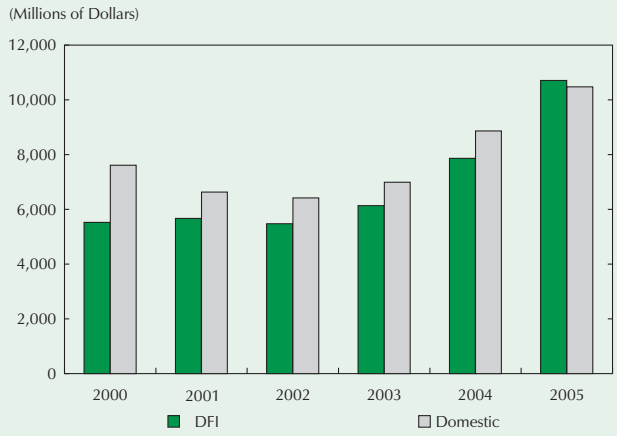
One of the main differences with the nineties is how the growth in investment in the economy has been financed. The period between 2003 and 2006 saw a rise in investment similar to the

Graph B1.4
Investment in Machinery and Equipment



Source: DANE.

Graph B1.5
Exports by Stock Composition



Source: ANDI.

one in1992 -1995 (5.9% and 5.2% of GDP in each period, Table B1). Nonetheless, the increase in the nineties was accompanied by a reduction in the savings rate equal to 1.5% of GDP; the current surge in investment has been accompanied by an increase in savings equal to 5% of GDP. Consequently, while the current account deficit rose to 6.7% of GDP in the first half of the nineties, in the last three years, it has grown by only 0.9%.

Interestingly, between |1996 and 1997, the rate of investment declined by almost the same proportion as it had increased in earlier years, while domestic investment dropped sharply (by 5.4% of GDP) due to the 19% real rise in government spending. This means the current surge in investment is clearly more sustainable than the one in the nineties.

Table B1
Changes in the Macroeconomic Balance
(Percentage Points)

	1992-1995	1996-1997	2003-2006	2006-2007
Saving - Investment = Current Account Balance	**(6.7)**	**(0.5)**	**(0.9)**	**(1.5)**
Domestic Savings	**(1.5)**	**(5.4)**	**5.0**	**0.2**
Total Investment	**5.2**	**(4.9)**	**5.9**	**1.6**
Public Sector	(0.3)	(2.6)	1.9	(0.1)
Public Savings	0.5	(5.7)	3.8	3.0
Public Investment	0.8	(3.1)	1.9	2.6
Private Sector	(6.4)	2.1	(2.8)	(3.0)
Private Savings	(2.0)	0.3	1.2	(0.1)
Private Investment	4.4	(1.8)	4.0	2.9

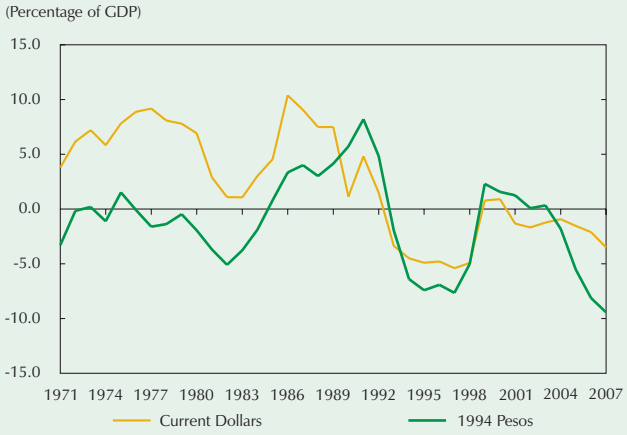
Source: Banco de la República. MHCP and DNP.

However, there are risks to consider, and failure to act in time could threaten economic stability.

1. The current account deficit in dollars is moderate (around 2.3% for 2006). This is partly because of good international prices, which have benefited the Colombian economy. One way to isolate price effects is to calculate the deficit in real terms. Doing so shows it has grown considerably in recent years (Graph B1.6).

2. The trend in the current account up to 2006 is consistent with the various measurements of external sustainability. The central forecast developed by Banco de la República for

Graph B1.6
Current Account Deficit



Source: Banco de la República.

the trade balance in 2007-2011 also allows for stabilization of the external debt at 30% of GDP. However, a less favorable scenario (in terms of international prices, world demand, transfers or FDI) would mean an increase in the external debt as a share of GDP.

3. The sustainability of the current account also would be affected by acceleration in household consumption, which would mean a sizeable drop in savings, or by an increase in the fiscal deficit.

Conclusion

There now is evidence of cost pressure on input, raw materials and non-tradable inflation. As yet, it does not appear to be linked to pressure in the labor market and may be due to the change in profit margins as a result of rising demand. This is not to say that inflationary pressure on wages might not emerge if the economy continues to grow as it did in the second half of 2006.

Historically speaking, the Colombian economy has never managed to keep investment rates above 20%; however, better macroeconomic conditions and increased investment in export activity might make this possible. Approval of the Free Trade Agreement with the United States would be fundamental in this respect. Even so, growth in domestic demand to the extent forecast for 2007 is likely to exceed potential GDP growth and aggravate inflationary pressures. Although the performance of the current account is consistent with different measurements of external sustainability, a decline in external conditions would imply more of an external debt as a portion of GDP.

While these findings are not conclusive proof that the economy is overheated, they do inDecate it will overheat if domestic demand continues to grow as it did in 2006, particularly during the last six months of the year. This would generalize the inflationary pressures brought to bear by demand and/or by the excessive current account deficit. Maintaining macroeconomic stability and sustaining growth requires policies that help to increase the rate of public and private savings. Gradually reducing the monetary stimulus is one of the most important measures to this end, and is precisely what the Board of Directors has been doing since April of last year by raising intervention interest rates. However, it must be supplemented by a fiscal policy that is conducive to an increase in public savings, at least while external conditions remain favorable.

III. Recent Labor Market Trends

Although the growth in output during 2006 was the highest it has been in the last thirty years, the labor market inDecators based on the DANE Household Survey were less favorable during the second half of the year.

Although the growth in output during 2006 was the highest it has been in the last thirty years, the labor market indicators based on the DANE Household Survey were less favorable during the second half of 2006. Other sources of information, some originating with DANE, suggest a different pattern in the labor market, at least in industry and commerce. This chapter offers an analysis of the recent trend in employment and how it relates to economic growth.

The relevant segment of the population for analyzing the labor market is known as the working-age population (WAP). It is comprised of persons above 12 years of age in main cities and above 10 years of age in rural areas. The working-age population can be divided into two groups: i) those who are actively involved in the labor market; that is, the economically active population (EAP), and. ii) persons who decide not to participate; that is, the economically inactive population (EIP). The EAP is comprised of persons who are working at present (employed population) and those who are unemployed (persons who are available to work and are looking for employment, but do not have a job).

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The Household Survey (HS) is designed to estimate rates concerning the WAP or the EAP. The global participation rate (GPR) is defined as the ratio of EAP to WAP. Therefore, it is an indicator of willingness to be employed. The employment rate (ER) is the percentage of working-age people who have jobs and can be interpreted as an indicator of demand for work.[2]

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[2] The working-age population is a point of reference for both the GPR and the ER, and its relative fluctuations will be reflected in the unemployment rate:

$$UR = 1 - \frac{ER}{TPR} = 1 - \frac{Employed/WAP}{EAP/WAP} = 1 - \frac{Employed}{EAP} = \frac{Unemployed}{EAP}$$

The unemployment rate (UR) is the ratio of currently unemployed persons[3] to the EAP. Consequently, an increase in the unemployment rate can be explained by an increase in the total number of persons without work in relation to the EAP, or by a decline in the EAP that is not offset by a decline in the total number of persons without work.

Table 3 shows the pattern of these indicators for the period between 2003 and 2006. Up until the first half of 2006, the labor market showed a general increase in the employment rate and a sustained reduction in the unemployment rate. However, in the second half of the year, this trend changed and unemployment increased on the whole (ceased to decline for the thirteen cities). This turn of events was accompanied by a sharp drop in the labor supply, which was reflected in a lower GPR and a decline in ER. The latter meant a sharp decline in the number of people with jobs (particularly in the rural areas). It is as if a significant percentage of people who were actively involved in the labor market (many with jobs) suddenly decided to abandon the labor market for other activities, such as domestic chores or schooling.

[3] Persons are regarded as unemployed if, at the time of the survey, they are without a job but *have done all possible* to find a job within the last twelve months and are available to go to work if given an opportunity to do so.

TABLE 3

LABOR MARKET INDECATORS

	I Six Months				II Six Months			
	2003	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**
National Total Participation Rate	**61.63**	**61.05**	**59.41**	**59.51**	**62.59**	**60.55**	**60.45**	**57.19**
Rural area	59.42	59.06	56.69	56.51	59.75	57.41	56.96	52.33
Major towns	62.44	61.77	60.39	60.57	63.62	61.69	61.70	58.90
Thirteen cities	63.78	62.77	62.22	62.27	65.24	63.06	63.23	59.96
National Employment Rate	**52.63**	**52.05**	**51.87**	**52.36**	**54.02**	**53.01**	**53.91**	**50.29**
Rural area	53.72	52.99	52.24	52.25	54.39	52.85	53.23	47.58
Major towns	52.23	51.71	51.73	52.40	53.88	53.06	54.15	51.24
Thirteen cities	52.61	52.43	52.92	53.90	54.88	54.02	55.05	52.43
National Unemployment Rate	**14.61**	**14.74**	**12.70**	**12.01**	**13.70**	**12.46**	**10.82**	**12.07**
Rural area	9.59	10.28	7.86	7.54	8.98	7.93	6.55	9.09
Major towns	16.36	16.28	14.33	13.49	15.31	13.98	12.23	13.01
Thirteen cities	17.51	16.49	14.95	13.45	15.88	14.33	12.94	12.56

Source: DANE.

The primary explanation for the higher unemployment rate is the drop in the economically active population and not an increase the number of unemployed.

The 3.0 percentage point (pp) decline in the employment rate for the major towns is associated with a decline of 431,000 employed persons between the second half of 2006 and the same period in 2005, and with an additional 952,000 persons considered inactive during the same period. In the case of the rural area, the total number of employed was down by 463,000 persons, and the total number of inactive persons increased by 465,000. Moreover, the 0.8 pp rise in the unemployment rate for the major towns and 2.5 pp for the rural area is associated with an increase in the number of unemployed persons: 76,000 and 97,000 respectively. In short, the higher unemployment rate is explained primarily by the decline in the economically active population, rather than an increase the number of unemployed. The lower EAP, compared to the second half of 2005, is due to the fact that a substantial number of people who were employed left the labor market (in the rural areas the ratio appears to be one to one).

This means the Colombia economy would have experienced a sudden productivity shock of major proportions as of the second half of 2006, given the acceleration in output growth (7.9% during the last six months of the year, consistent with 6.8% growth for the entire year) at a time when fewer people were working. It should be noted that international literature contains no evidence of a shock of that magnitude in another country.

The results of the HS are difficult to interpret, given the changes DANE introduced in July 2006 to make the information in the survey more precise. They involve gathering practices, electronic data collection and broader coverage. Consequently, it is impossible to know if the changes observed are due to economic events or can be explained by the modifications to the survey. As a matter of fact, in a press bulletin, DANE stated that "[…] field experiments are now underway to determine the extent to which the series from surveys prior to July 2006 are comparable."[4]

Other available indicators show that employment continues to grow. Sector information released by DANE shows that employment in industry and commerce increased at respective rates of 5.0% and 6.0% between July and December compared to the first half of 2006 (1.4% and 4.6%, respectively) and to past years (the increase in workers employed in the manufacturing industry was 1.7% in 2004 and 0.8% in 2005; in commerce, total employment saw respective increases of 2.9% and 3.8%).

Sector information released by DANE shows that employment in industry and commerce increased at respective rates of 5.0% and 6.0% between July and December.

Information on the social security system operated by the Ministry for Social Protection shows a major increase in affiliates (Table 4). The number of active affiliates with individual pension funds was up by more than 400,000; the total number of persons covered for professional risks increased by

[4] DANE press bulletin, February 2007.

Social Security System Affiliates

Description	2005	2006	Variation (percentage)
In health			
Subsidized system [a/]	18,581,410	20,028,055	7.79
Total subsidies	16,513,662	17,936,938	8.62
Partial subsidies	2,067,748	2,091,117	1.13
Contributive system [b/]	15,533,582	15,971,078	2.82
In pensions			
Pensions- Active ISS affiliates [c/]	2,447,981	2,303,947	(5.88)
Pensions - active affiliates -Individual savings pensions [d/]	3,217,576	3,637,760	13.06
In professional risks			
PRM affiliates [e/]	5,104,050	5,637,676	10.45
Others			
Affiliates - Family subsidy funds [f/]	4,390,160	4,858,857	10.68
Companies affiliated to family subsidy funds [f/]	214,473	229,324	6.92

a/ Source: DGGDS.
b/ At September 2006. Compensated.
c/ At December 2006 (Source: ISS).
d/ At December 2006 (Source: Superintendent of Financial Institutions).
e/ At December 2006 (Source: DGRP).
f/ At December 2006 (Source: SSF) Preliminary.
Source: Ministry for Social Protection.

more than 500,000. There was a similar increase in the number of affiliates to family subsidy funds. This point to the creation of new jobs during 2006; it also indicates they are quality jobs in the formal sector.

IV. Monetary and Exchange Policy

The monetary policy strategy known as inflation targeting (IT) has been used in Colombia (IT) since 1999. First popularized in the nineties, its aim is to stabilize prices and to soften the economic cycle.

A. Monetary Policy

1. Inflation-targeting as a Monetary Policy

The monetary policy strategy known as inflation targeting (IT) has been applied in Colombia since 1999. First popularized in the nineties (Box 2), its aim is to stabilize prices and to soften the economic cycle.

a. How has inflation targeting been used in Colombia and what are its features?

The inflation target is decided on the basis of the CPI calculated by DANE. The BDBR defines the range and target for the current year, and the range within which the mid-point for next year's target will be set. A range of 3% +/- 1% is the long-term target towards which inflation must converge.

Because there is a lag in the effect of monetary policy, it can be six to eight quarters before any action in this respect has an impact on prices (Box 3). For this reason, Banco de la República has an operational procedure oriented towards the future by projecting inflation for the coming quarters (including the effect of policy actions) and comparing that forecast to the target.

Monetary policy can stabilize the economic cycle and keep inflation near the target.

To keep inflation near or on target, monetary policy should be restrictive during a boom period and loose during a recession. It also should try to stabilize inflation around the target; this anticyclical management will soften fluctuations in the economy.

The cost of economic fluctuations, especially those of the magnitude witnessed in emerging countries like Colombia, can be high. Recessions lead to soaring unemployment and lost earnings. Accordingly, if expansion is not sustainable, serious weaknesses and imbalances can accumulate in the economy and eventually nourish recession. Monetary policy can help to stabilize the economic cycle and to keep inflation on or near the target. During a recession, macroeconomic stability can help to temper unemployment and maintain production, income, wealth and social well being.

During a recession, macroeconomic stability can help to temper unemployment and maintain production, income, wealth and well being.

b. What is the most appropriate monetary policy stance when the economy is booming and during a recession?

As noted earlier, interest rates are an important factor in determining investment, aggregate demand and the economic cycle. Low interest rates tend to stimulate aggregate demand and lead the economy into an upper phase of the cycle; relatively high interest rates tend to take the cycle to a lower phase.

If economic activity is on the rise, because of low interest rates or for reasons that have nothing to do with the monetary policy stance, inflation will tend to increase and the central bank will be obliged to raise rates to curb inflationary pressures. However, if the economy is in recession, the central bank might reduce interest rates to help it emerge from the standstill and to prevent inflation from falling below target.

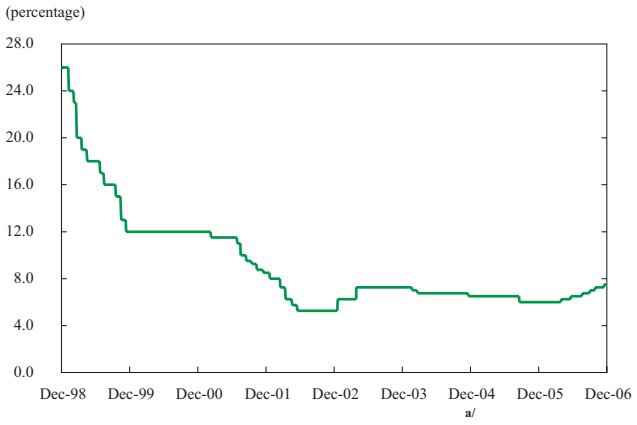
2. Monetary Policy Decisions in 2006 and 2007

The BDBR has raised intervention interest rates on several occasions since April 2006 (Graph 13). These hikes followed a period when the Bank lowered rates by 675 bp (from 12% in 2000 to 5.25% at mid-2002). This was done to help the economy recover, after being hard hit by the crisis at the end of the nineties. In 2003, the BDBR raised its policy rates by 200 bp in the midst of high exchange depreciation. Core inflation accelerated as a result of this depreciation and expectations of inflation increased.

Surplus capacity at the start of the decade made it possible to accommodate the acceleration in economic growth as of the second half of 2003, and even to reduce the new intervention interest rates by 125 bp, given the trend towards

GRAPH 13

EXPANSION AUCTION INTEREST RATE



a/ Banco de la República closed the contraction window (auction and Lombard) on December 22, 2004.
Source: Banco de la República and the National Office of the Superintendent of Financial Institutions.

GDP growth has averaged 5.4% a year since the second half of 2003 and the increase in demand was even higher (7.5%).

appreciation during 2004 and 2005, which placed the expansion interest rate at 6.0% by the end of 2005.

However, by early 2006, it was obvious this stance had to be changed if growth was to be sustainable and the appearance of inflationary pressures in the economy was to be avoided, so as not to jeopardize the inflation targets. The figures clearly reflect the strength of the Colombian economy in the last few years:

- GDP growth has averaged 5.4% a year since the second half of 2003, and the increase in demand was even higher (7.5%).

- This growth is supported by a substantial rise in investment, which went from 15% of GDP in 2003 to 26.3% in 2006. However, since early 2006, household consumption has been quick to recover and increased by about 6.0% during the year.

- Economic growth in recent years has been fueled largely by the force and confidence of the private sector. Private GDP (defined as total GDP, excluding state-run mining, government services and civil works) has been up by 5.6% a year since 2003.

The foregoing shows a high growth rate for the Colombian economy. It also indicates that no special monetary stimulus would be required for growth to continue. Moreover, the presence of an excessive monetary stimulus, reflected in historically low real interest rates, could cause imbalances that would result in inflationary pressures, macroeconomic imbalances and unsustainable growth. Recessions are costly; they tend to persist for several years and focus disproportionately on the most vulnerable segment of the population. The experience of Latin America, and particularly Colombia at the end of the nineties,[5] shows this to be true. Hence, macroeconomic policies must act in time and with enough strength to avoid these recessions or to cushion their possible impact in the future. Given these considerations, the BDBR raised its intervention interest rates by 150 bp between April and December 2006.

Statistics available at the start of 2007 show a quick increase in aggregate demand. The estimate for growth in 2006 and the forecast for 2007 were raised accordingly. The upward trend in non-tradable inflation and core inflation indicators continued.

In recent years, economic growth in has been fueled largely by the force and confidence of the private sector.

In this context, the BDBR felt it was best to continue to reduce the monetary stimulus by raising intervention interest rates. It did so in January and February

[5] The recovery in economic growth has reduced the portion of the population living in poverty from 60% in 2000 to 49% in 2005.

of this year, by 25 bp on each occasion. The last of these hikes placed the base rate for expansionary auctions at 8.0%. The decision to continue monetary normalization ratifies the Board of Directors' commitment to ensuring that inflation converges towards its long-range target. Gradual elimination of the monetary stimulus does not affect the capacity for potential growth of the Colombian economy. Rather, it contributes to its continuity and sustainability.

The decision to continue with monetary normalization ratifies the Board of Directors' to ensuring that inflation converges towards its long-range target.

B. Exchange Intervention and Monetary Policy

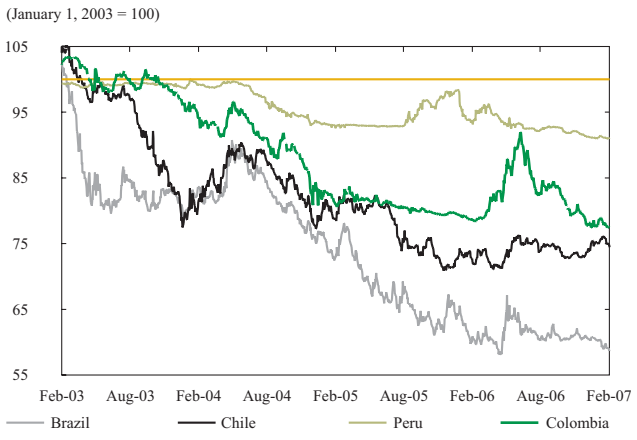
1. Changes in Nominal and Real Exchange Rates

The exchange rate in Colombia during 2006 was characterized by a great deal of market volatility, given the uncertainty reigning among international investors about anticipated changes in international interest rates. The other Latin American economies experienced a similar situation. Their currencies were even more volatile than the Colombian peso (Graph 14).

Having appreciated in 2005, the Colombian peso continued to gain strength during the first two months of 2006. A variety of factors helped to sustain that trend; namely, i) the vigorous increase in demand worldwide and in terms of trade that favored export growth; ii) the influx of resources for foreign direct investment, mainly in mining and energy, which added to expectations of further appreciation based on news of the sale of private and state-owned Colombian companies; and iii) continued surplus liquidity on international markets, which kept alive foreign investors' appetite for debt securities in emerging markets, such as Colombia (Graph 15). All of these factors helped to reduce the spread on Colombia's sovereign debt and that of various countries (Graph 16). As explained in the following section, Banco de la República continued its policy of discretional intervention in the exchange market during this lapse.

Graph 14

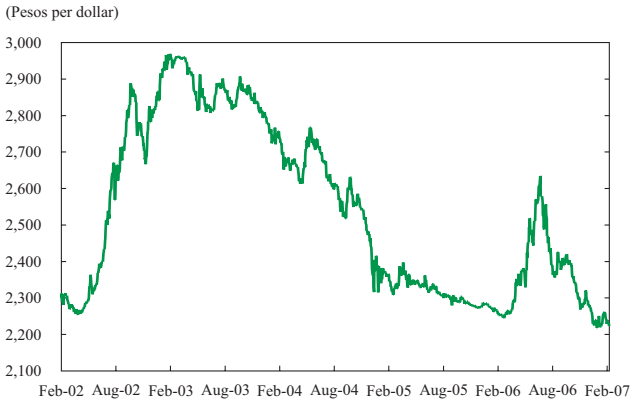
Nominal Exchange Rate Index



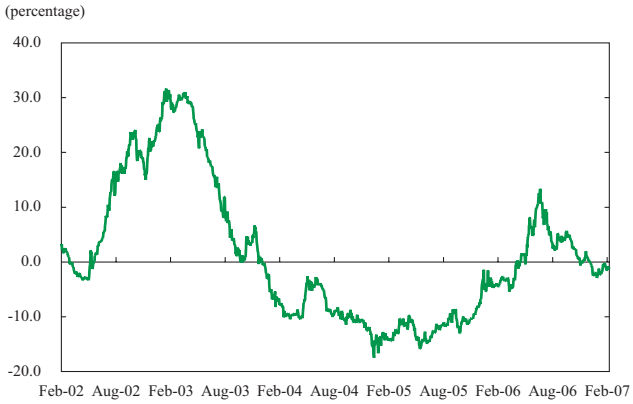
Source: Datastream.

GRAPH 15

A. REPRESENTATIVE MARKET EXCHANGE RATE a/
(FEBRUARY 2002- FEBRUARY 2007)



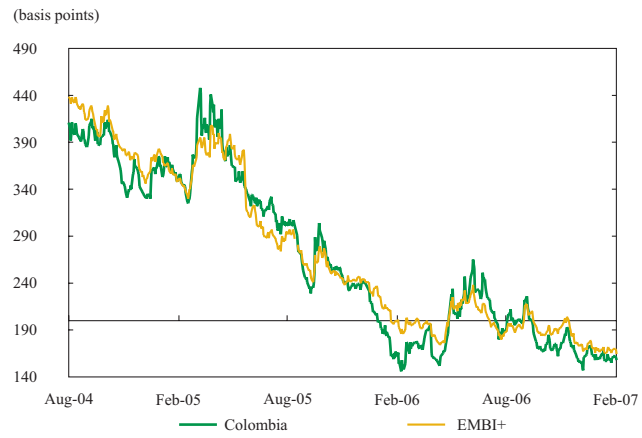
B. ANNUAL NOMINAL DEPRECIATION a/



a/ Data at February 14, 2007.
Source: Banco de la República.

GRAPH 16

COUNTRY-RISK PREMIUM:
EMBI+ LATIN AMERICAN COUNTRIES



Source: Datastream.

International investors began to alter their expectations at the end of March, when the likelihood of external interest rate hikes increased due to obvious inflationary pressures in the United States. Interest in risky investments declined, prompting an outflow of capital from emerging economies. This had an impact on local stock markets and local debt, which translated into a generalized increase in the country-risk premium in the region. Nowhere in the region was the currency weakened more than in Colombia. In June, the dollar hit an all-time high for the year (Col$2,633). This amounts to 15% devaluation between March and June (Table 5).

The threat of additional rate hikes by the Fed diminished in July. Added to news of good economic conditions worldwide, particularly in the emerging economies (which continued to perform well, thanks to positive terms of trade and more demand worldwide), this helped to lower the risk perception on international markets. The result was an increase in demand for bonds from emerging markets, as reflected in a generalized decline in EMBI.

Meanwhile, in Colombia, news about consolidation of the sale of several state-owned companies continued, and the influx of foreign exchange from foreign investment and workers' remittances increased (Box 3 and Chapter VI). The sum of these factors caused the peso to appreciate again, particularly during the last quarter of the year. The exchange rate dropped by Col$494 between July and December, ending the year at Col$2,239 per dollar.

The average rate of exchange in 2006 was Col$2,358 per dollar, with 1.6% average nominal devaluation. In real terms, there were no significant variations in the exchange rate indicator at the close of the year. According to the real exchange rate index, deflated by the CPI, real annual devaluation at the end of 2006 would have been 0.5%; the indicator that uses the PPI shows a slight amount of real appreciation (0.1%) (Table 6, Graph 17).

So far in 2007, the Colombian peso has continued to appreciate, bolstered by the supply of foreign exchange in the local market due to the purchase of Bancafé and Ecogás. Both were sold last year. The government's decision to request payment of those proceeds in pesos, to reduce the outstanding balance on the domestic debt, led to a surplus supply of foreign exchange during the first two months of the year. This prompted Banco de la República to intervene in the exchange market, as will be explained in the following section. Foreign investment capital, both direct and portfolio, continued to enter the country during that period. By the end of February, nominal and real appreciation in the exchange rate was 1.0%, in both cases.

TABLE 5

Nominal Exchange Rate

	Nominal Exchange Rate		
	Average for the Period	End of Period	% Annual Variation, End of Period
2004	2,626.22	2,389.75	(13.98)
2005	2,320.77	2,284.22	(4.42)
2006	**2,357.98**	**2,238.79**	**(1.99)**
January-March	2,264.09	2,289.98	(3.64)
April-June	2,431.51	2,633.12	12.92
July-September	2,433.42	2,394.31	4.57
October-December	2,305.36	2,238.79	(1.99)
2007			
January	2,237.06	2,259.72	(0.26)
February	2,227.63	2,224.12	(1.03)

Source: Banco de la República.

TABLE 6

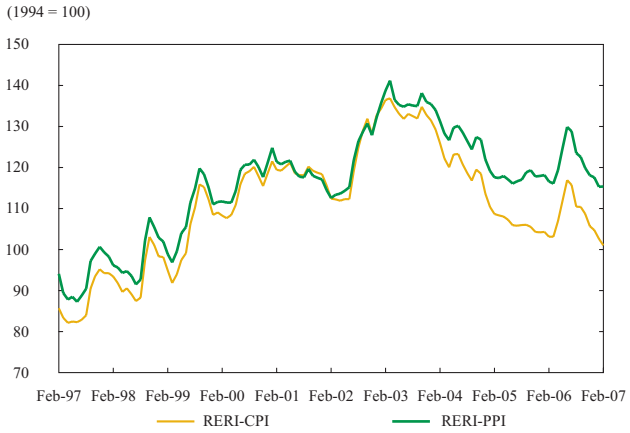
Real Exchange Rate Indexes

	Real Exchange Rate (Average)				Real Exchange Rate			
	CPI Index	Annual Variation (%)	PPI Index	Annual Variation (%)	CPI Index	Annual Variation (%)	PPI Index	Annual Variation (%)
2004	120.4	(9.0)	128.3	(5.7)	113.5	(13.3)	122.7	(9.7)
2005	106.7	(11.3)	118.5	(7.7)	104.5	(8.0)	118.8	(3.1)
2006	108.6	1.8	122.3	3.2	105.1	0.5	118.7	(0.1)
January-March	103.8	(4.8)	118.0	(0.6)	103.4	(4.3)	117.2	(0.5)
April-June	111.9	4.6	125.5	6.6	116.9	10.2	130.9	11.9
July-September	112.3	5.9	126.0	6.4	110.6	4.2	123.7	3.4
October-December	106.7	1.7	119.7	0.5	105.1	0.5	118.7	(0.1)
2007								
January	103.0	(1.4)	116.6	(2.1)	103.0	(1.4)	116.6	(2.1)
February	101.9	(1.5)	116.7	(0.9)	101.9	(1.5)	116.7	(0.9)

Source: Banco de la República.

GRAPH 17

REAL EXCHANGE RATE INDEX



Source: Banco de la República.

2. Exchange Intervention and Policy Decisions

As mentioned in the previous section, the change in the direction of capital flows during 2006 caused the exchange rate to fluctuate sharply. In response, Banco de la República conducted several sterilized interventions in the exchange market, through purchase and sale operations using the various instruments at its disposal. It sold US$164 m in international reserves (net) (Table 7) and, to temper peso appreciation, it exercised its faculty for discretional intervention, purchasing a total of US$1,196,7 m in foreign exchange during the first quarter of 2006. These transactions were concentrated in January and February. However, this type of discretional invention was suspended in view of the trend in peso depreciation that began in April.

TABLE 7

FOREIGN CURRENCY PURCHASED AND SOLD BY BANCO DE LA REPÚBLICA
(MILLIONS OF DOLLARS)

	2005	2006					2007		
		I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Acum. Jan-Dec	Jan.	Feb.	Acum. Jan-Feb
Purchases	4,658.4	1,196.7	0.0	393.8	190.0	1,780.5	1,001.6	1,022.9	2,024.5
Put options	0.0	0.0	0.0	393.8	190.0	583.8	0.0	0.0	0.0
To accumulate international reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
To control volatility	0.0	0.0	0.0	393.8	190.0	583.8	0.0	0.0	0.0
Discretional intervention	4,658.4	1,196.7	0.0	0.0	0.0	1,196.7	1,001.6	1,022.9	2,024.5
Sales	3,250.0	1,000.0	944.3	0.0	0.0	1,944.3	0.0	0.0	0.0
Call options	0.0	0.0	944.3	0.0	0.0	944.3	0.0	0.0	0.0
To control volatility	0.0	0.0	944.3	0.0	0.0	944.3	0.0	0.0	0.0
National government	3,250.0	1,000.0	0.0	0.0	0.0	1,000.0	0.0	0.0	0.0
Net purchases	1,408.4	196.7	(944.3)	393.8	190.0	(163.8)	1,001.6	1,022.9	2,024.5

Source: Banco de la República.

Nonetheless, the possibility of intervention through options to control volatility was left open. These are activated automatically. For example, when the exchange rate is 2% below (or above) the average representative market rate (RMR) for the last 20 days, US$180 m in put (or call) options are auctioned. Market agents who purchase these options may exercise them the same day, or during the course of one month, provided another 2% deviation in the exchange rate occurs compared to the average RMR for the last 20 days.

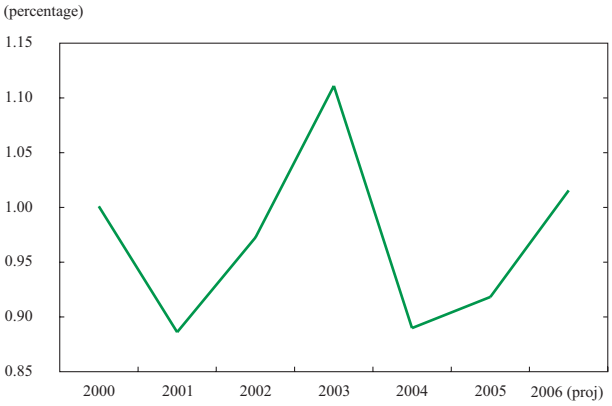
The conditions for activating call options (foreign exchange sales) to control volatility occurred on various occasions during the second quarter of 2006, and US$944 m were exercised during that period. As of July, when the peso began to appreciate once again, several put options were activated to control volatility and US$583.8 m were exercised between July and December. For its part, discretional intervention continued uninterrupted until the end of 2006.

The trend in appreciation became far more pronounced as of January 2007, mainly due to the large influx of foreign currency to pay the government for important state-owned companies such as Bancafé and Ecogás, which were sold in late 2006. Banco de la República regarded this as a temporary phenomenon and decided to intervene, at its discretion, to help curb appreciation by purchasing US$1,001,6 m in foreign exchange in January and US$1,022,9 m in February.

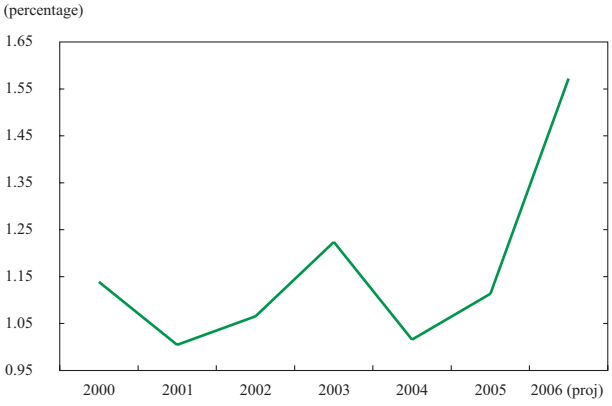
Exchange market intervention has been an effective tool. On the one hand, it has been used to accumulate international reserves, thereby reinforcing the country's international liquidity position (Graph 18). Colombia now has more than US$17 b in international reserves, which are crucial to preserving economic stability in the event of a negative external shock. On the other hand, exchange market intervention has not hindered continuation of the disinflationary process. This is demonstrated by the fact that inflation has been very much on target for the last three years, which means the exchange intervention policy has been consistent with the inflation-targeting approach. In other words, there is no conflict between the monetary policy and the exchange policy.

GRAPH 18

A. [NET INTERNATIONAL RESERVES / (EXTERNAL DEBT PAYMENTS IN (T + 1) + CURRENT ACCOUNT DEFICIT IN (T + 1))]



B. [NET INTERNATIONAL RESERVES / (EXTERNAL DEBT PAYMENTS IN (T + 1))]



(proj) Projected.
Source: Banco de la República.

There are various instruments that allow for this coherence between monetary and exchange policies, making it possible to sterilize the monetary expansion created when Banco de la República purchases foreign currency on the exchange market. Consequently, monetary authorities have been able to keep the interest rate at the level considered necessary to comply with the target for inflation.

Coordination with the government is a primary means of sterilization. As part of that coordination, the National Treasury maintains large sums on deposit with the Bank: currently more than Col$5 trillion (t). This removes a significant amount of pesos from circulation, offsetting part of the expansion provoked by the purchase of foreign exchange. In addition, to pay part of its external debt in advance and to substitute sources of financing, the government purchased US$3,550 m in foreign exchange from Banco de la República en 2005 and US$1,000 m in 2006.

Having been paid by the country in pesos, this foreign exchange sale created monetary space that was used by the Bank in 2005 to purchase TES on the secondary market. These bonds are still part of its portfolio. They can be sold when necessary and, therefore, used as a means of sterilization.

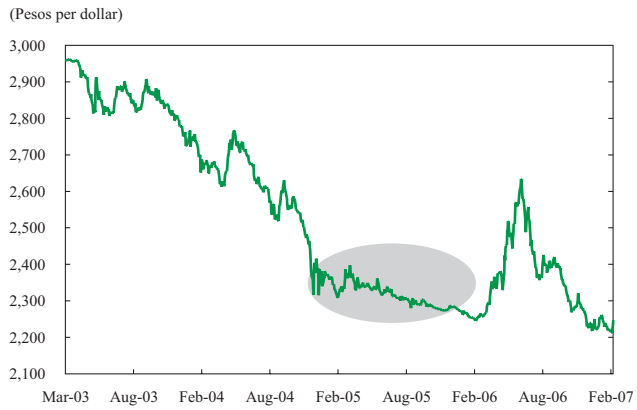
Another instrument to this end involves reducing the repo quotas, which are a way to furnish the banking system with temporary liquidity. In fact, insofar as the purchase of foreign exchange provides permanent liquidity to the economy, the amount of temporary liquidity supplied through repo operations has declined.

The Bank has other sterilization mechanisms at its disposal that have not been used lately. One is the market sale of securities in the monetary control portfolio. Operations of this type extract liquidity permanently from the economy. Contractionary auctions and the window for contractionary operations (closed since 2004) are ways to extract liquidity temporarily from the economy through repo operations. There also is the monetary contraction deposit, which operates through financial system deposit accounts with the Bank that earn interest and do not constitute a reserve.

It is extremely difficult to gauge the effectiveness of intervention to curb appreciation, given the impossibility of knowing how the exchange rate would have behaved without intervention. Nonetheless, as suggested by performance of the exchange rate in 2005, exchange intervention has helped to temper the sharp trend in appreciation observed since the last quarter of 2004 (Graph 19).

GRAPH 19

REPRESENTATIVE MARKET RATE OF EXCHANGE
(MARCH 2003 TO FEBRUARY 2007)



Source: Banco de la República.

The current situation is similar. Were it not for exchange intervention, a number of factors would have caused the peso to appreciate even more. These include the large amount of dollars entering the economy to pay for the sale of public assets, continued high export growth, sizeable foreign investment and workers' remittances, and other sources of currency such as external public financing.

The broad range of sterilization mechanisms described in this section enables Banco de la República to continue its intervention in the exchange market without jeopardizing the inflation target for 2007 and convergence towards the long-range target (between 2% and 4%).

Box 2

Inflation-Targeting Worldwide

Inflation targeting (IT) is a monetary policy framework that emerged as an alternative in the nineties, based on experience with various monetary policy strategies in past decades and on the consolidation of independent central banks. One of the most important lessons learned was the impossibility of permanently reducing medium and long-term unemployment by accepting higher levels of inflation. Any attempt to raise output above the level consistent with stable inflation eventually results in a permanently higher rate of inflation: sooner or later, the agents in the economy include a higher level of inflation in their expectations. The outcome, in the long term, will be higher inflation without an increase in employment.

More than a policy, inflation targeting is an institutional framework in and of itself. Technically speaking, it does not give central banks a set of simple and mechanical operating instructions. On the contrary, it implies an analytical and institutional framework that affords "limited discretionary power" that allows for a flexible monetary policy. In a general framework restricted by medium and long-term inflation targets, this strategy gives central banks considerable leeway to respond to conditions associated with unemployment, the exchange rate and other short-term developments that are important factors in the economy.

Today, approximately 30 countries have adopted the IT approach, which was pioneered in the early nineties by Canada, New Zealand and the United Kingdom. Later, it was adopted by developing countries such as Chile, Mexico and Israel, and by transition countries such as the Czech Republic and Poland.

Although the institutional framework for inflation targeting is not the same everywhere, it essentially has the following components:

- The central bank's objective is to comply with an openly announced quantitative target for inflation.

- The interest rate is the primary monetary policy instrument and the central bank is free to manage it at will. Some countries, including Colombia, also use exchange intervention.

The central bank regularly publishes reports that describe the economic situation and prospects for compliance with the inflation target. Transparency makes the policy more predictable and effective. Accountability gives it legitimacy.

In most countries with IT, the announced target refers to a target range for inflation, more than a specific figure. The target range for long-term inflation usually is between 1% and 3% and generally is based on the CPI.

To guarantee transparency, monetary authorities must offer an explanation of the elements on which decisions about the stance of monetary policy are founded. Central banks provide for transparency and accountability in different ways, the most common being the publication of an inflation report.

Box 3

How are changes in Banco de la República's intervention interest rate passed through to the economy until inflation is affected?

Intervention interest rates, the primary monetary policy instrument, convey policy decisions to the economy through so-called *monetary policy transmission mechanisms*. Essentially, there are three: the aggregate demand channel, the exchange rate channel and the expectations channel.

- *The aggregate demand channel* involves the effect of a change in interest rates on demand and the effect of aggregate demand on inflation. For example, a reduction in interest rates increases aggregate demand, which adds to inflation.

- *The credit channel* does not take into account the presence of financial intermediaries. Their existence makes the source of financing an important point in decisions on corporate and household investment. Basically, economic agents have two sources of financing: bank loans and their own funds. In this context, the relative cost of financing with a loan, as opposed to financing with own resources, becomes relevant. Thus, a decline in the policy interest rate directly and quickly affects financial prices, such as rates on deposits with the financial system and the more long-term rates on household and corporate borrowing.

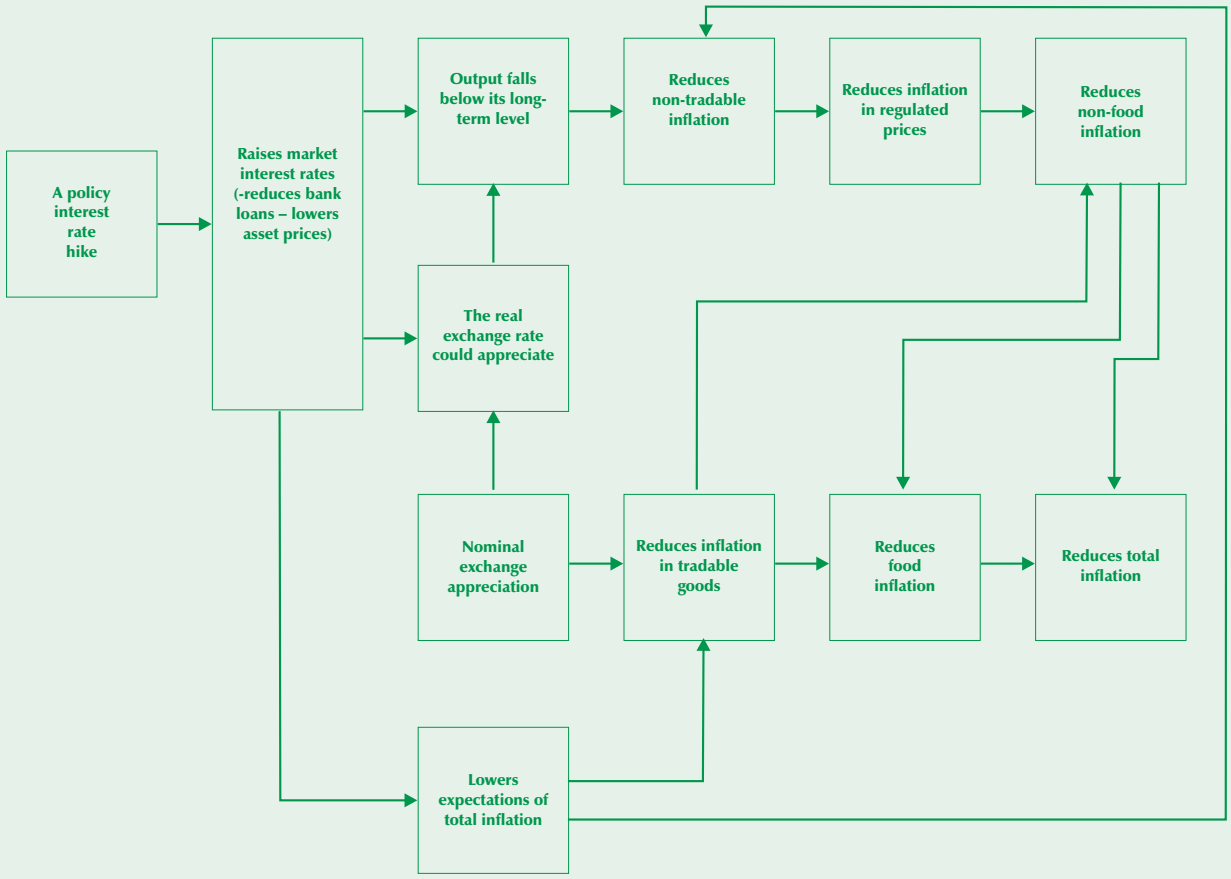
- *The exchange rate channel* feels the effect of policy interest rates on the exchange rate. In the direct exchange rate channel, a reduction in the policy rate leads to nominal depreciation, implying an increase in tradable inflation. The indirect channel operates through the

impact of the real exchange rate on the level of economic output. With an increase in the real exchange rate, output moves beyond its long-term potential level and inflation in non-tradables rises. Increases in tradable and non-tradable inflation add to total inflation (Diagram 1).

- With the *expectations channel,* a cut in the interest rate bolsters inflationary expectations (a drop in intervention interest rates heightens these expectations, since a reduction in interest rates, through the monetary policy transmission channels, lowers future inflation), and an increase in inflation expectations tends to raise inflation.

The monetary policy transmission mechanisms described in this section operate with a lag, as many of the decisions agents make with regard to spending take time. In the Colombian case, the estimated lag in monetary policy pass-through to inflation is four to eight quarters.

DIAGRAM 1
MONETARY POLICY TRANSMISSION MECHANISMS



V. Financial Markets

Profitability ratios are historically high and the system's capital soundness far exceeds the mandatory minimum.

A. Interest Rates and Sources of Credit Financing

1. Market Interest and TES Rates

a. Banco de la República Intervention Rates

As mentioned earlier, the BDBR has raised expansion rates nine times since April 2006, adding 25 bp on each occasion. As a result, the expansionary auction rates were up to 8.25% by March 2007 (Table 8).

b. Market Interest Rates

The interbank rate (IBR) was 7.53% at the end of the year. This is 182 bp more than during the same month in 2005 (Graph 20), implying a real increase of 210 bp. As noted on previous occasions, IBR movement is closely linked to Banco de la República's minimum rate for expansionary auctions, which saw an increase of 150 bp during the same period.

For its part, the DTF [6] was relatively stable throughout the first half of 2006 and began to increase only in the second. Although this rate has risen substantially in recent months, the increase does not fully reflect the policy rate hikes (Graph 21).

The DTF was relatively stable during the first half of 2006, and began to increase only as of the second.

[6] The weighted monthly average rate on 90-day certificates of deposit reported to the Superintendent of Financial Institutions by banks, finance corporations and commercial lending companies throughout the country.

Table 8

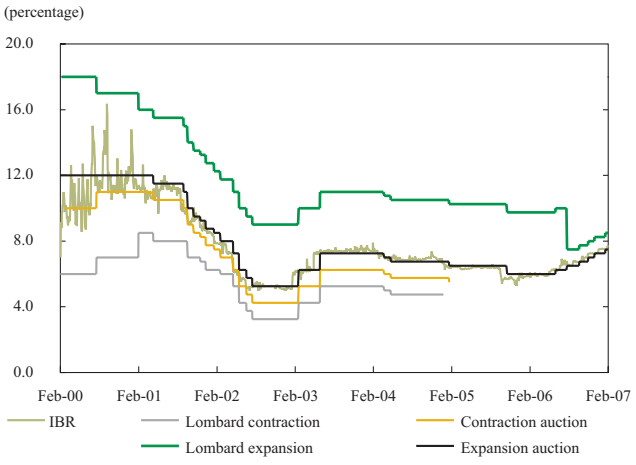
Banco de la República Intervention Rates and the Interbank Rate (IBR) (Percentage)

Effective as of:	Minimum for Expansion Auction	Average IBR for the Period	Maximum expansion rate (Lombard)
Dec-17-01	8.50	12.25	8.43
Jan-21-02	8.00	11.75	7.82
Mar-18-02	7.25	11.00	7.29
Apr-15-02	6.25	10.00	6.15
May-20-02	5.75	9.50	5.69
Jun-17-02	5.25	9.00	5.22
Jan-20-03	6.25	10.00	6.15
Apr-29-03	7.25	11.00	7.41
Feb-23-04	7.00	10.75	7.16
Mar-23-04	6.75	10.50	6.93
Dec-20-04	6.50	10.25	6.62
Dec-22-04 a/	6.50	10.25	6.39
Sep-19-05	6.00	9.75	5.81
May-02-06	6.25	10.00	6.23
Jun-21-06	6.50	7.50	6.59
Aug-22-06	6.75	7.75	6.75
Oct-02-06	7.00	8.00	7.01
Oct-30-06	7.25	8.25	7.25
18-Dec-06	7.50	8.50	7.52
29-Jan-07	7.75	8.75	7.74
26-Feb-07	8.00	9.00	7.99
26-Mar-07	8.25	9.25	-

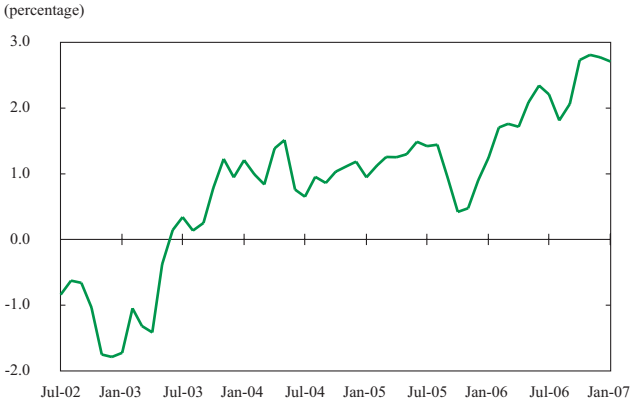
a/ Banco de la República's contraction window (auction and Lombard) has been closed since December 22, 2004.
Source: Banco de la Republic and the Office of the National Superintendent of Financial Institutions (interbank rate).

Graph 20

Banco de la República's Nominal Interbank and Intervention Rates a/



Real Interbank Rate



a/ Banco de la República closed the contraction window (auction and Lombard) on December 22, 2004. It has not reopened.
Source: Banco de la Republic and the Office of the National Superintendent of Financial Institutions (interbank rate).

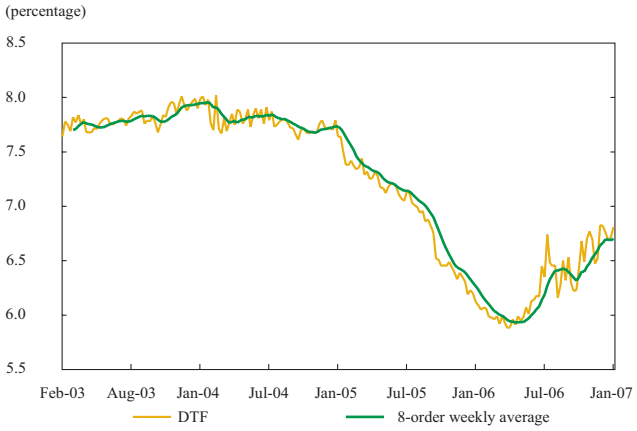
Nevertheless, a look at interest rates on all certificates of deposit (CDs) between April 2006 and February 2007, regardless of maturity, shows more of an increase compared to the rate on a 90-day CD. This would suggest that pass-through from the policy interest rate to deposit rates has been higher than what is reflected in the DTF.

As to lending rates, depending on economic use, the nominal levels dropped sharply in 2006. The largest reductions were in rates on consumer and ordinary loans: the former dropped 361 bp in 2006 from 24.2% in 2005, on average, to 20.5% in 2006; the latter went from 16.8% in 2005 to 15.2% in 2006, which is 157 bp less. Although prime and treasury loans declined, on average, during 2006, their levels rose by nearly 165 bp and 162 bp between June and December of that year (Table 9, Graph 22). This may reflect an increase in the marginal cost of deposits, since the spreads on these loans are extremely narrow.

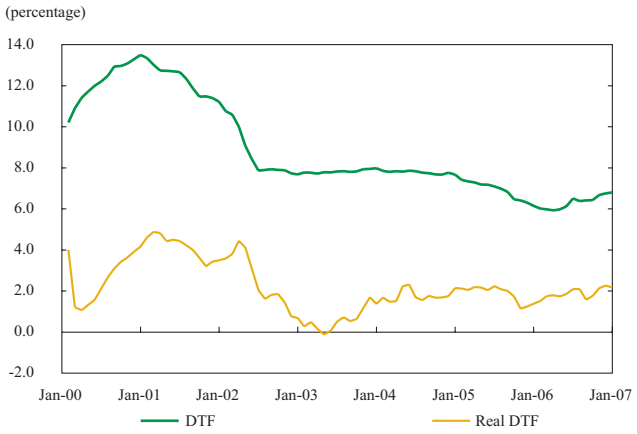
GRAPH 21

INTEREST RATES

NOMINAL DTF



NOMINAL AND REAL DTF a/



a/ CPI deflated.
Source: Banco de la República.

c. Developments on the Domestic Public Debt Market in 2006

The domestic debt market in 2006 reflects two changes compared to its development in years past. On the one hand, market interest rates concluded the adjustment process that began when the market was created in 1997. On the other, the market strengthened its correlation with the market for US Treasury bonds and perceptions of risk and global liquidity.

The TES market was created in 1997 and the rates on these bonds have declined ever since, adjusting to the course of inflation. This process was brought to a close in March 2006, when TES rates were at historically low levels. For example, one-year bonds were around 6.5% and ten-year bonds, 7.20%. Good first-quarter earnings, evident in valuation of the domestic stock market index (IGBC), were motivated by the confidence on international markets about US economic

TABLE 9

LENDING RATES a/

	Consumer Loans		Ordinary Loans		Preferential Loans		Treasury Loans	
Year	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
2000	33.5	22.7	20.4	10.7	18.6	9.1	16.0	6.6
2001	31.3	22.0	19.4	10.9	14.1	6.0	13.9	5.8
2002	27.0	18.7	17.1	9.5	10.9	3.7	9.0	1.9
2003	26.7	19.0	16.8	9.7	11.4	4.6	10.2	3.5
2004	24.9	18.4	16.7	10.6	11.3	5.5	9.5	3.8
2005	22.7	17.0	15.6	10.2	9.7	4.6	8.4	3.4
2006								
January	22.7	17.3	16.3	11.2	9.3	4.6	8.3	3.6
February	22.5	17.6	15.3	10.6	9.1	4.8	8.1	3.8
March	22.3	17.4	15.6	11.1	8.9	4.6	8.1	3.8
April	21.1	16.3	15.4	10.8	8.7	4.4	7.7	3.4
May	20.5	15.8	15.3	10.8	8.6	4.4	8.0	3.8
June	20.1	15.5	14.5	10.1	8.9	4.7	8.0	3.9
July	19.6	14.7	15.4	10.6	9.2	4.7	8.4	3.9
August	19.4	14.0	15.6	10.4	9.4	4.5	8.7	3.8
September	19.4	14.2	15.5	10.4	9.6	4.8	8.7	4.0
October	19.7	14.9	14.9	10.2	9.5	5.1	8.9	4.5
November	19.7	14.8	14.3	9.6	10.0	5.5	9.2	4.7
December	19.6	14.4	14.2	9.3	10.2	5.5	9.6	4.9
2007								
January	19.2	13.8	14.5	9.3	10.4	5.4	9.8	4.9

a/ Monthly average weighted by amount. The annual figures for 2000 to 2005 pertain to December.
Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

performance, the trend in international prices for raw materials and their impact of the earnings in emerging economies, the perception of wealth in global liquidity, and the entry of new investors into local markets, plus more leveraging and speculation.

Between March and June, the international markets changed their optimistic outlook on economic performance and global liquidity. This sentiment was reflected on local markets. During that period, the IGBC devaluated by 31.5% and, at the end of June, the rates on 10-year TES were up to 12.16%, the highest in 2006 (Graphs 23 and 24). The US Federal Reserve Bank continued to raise its reference rate during this period; consequently, expectations of less global liquidity made the international markets nervous.

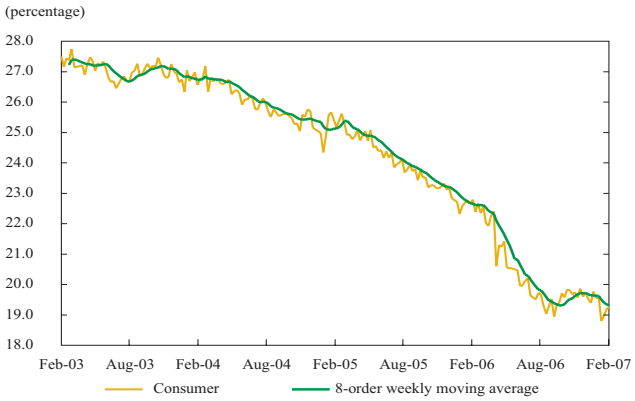
The second half of 2006 was characterized by a reduction in, and stabilization of, TES rates, which ended the year at around 7.70% for one-year bonds and 8.80% for 10-year bonds.

This perception was reinforced when the Central Bank of Japan announced an increase in its interest rates and a reduction in liquidity. The European Central Bank was expected to do the same. Investors reduced exposure to global risk by selling off their investments in risky assets, particularly in the emerging markets, making them volatile.

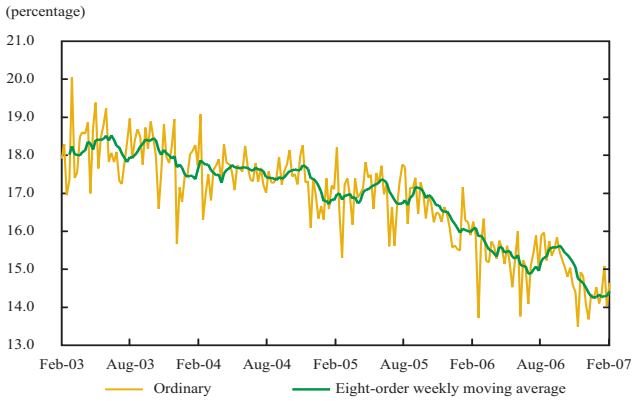
GRAPH 22

LENDING RATES, BY ECONOMIC ACTIVITY

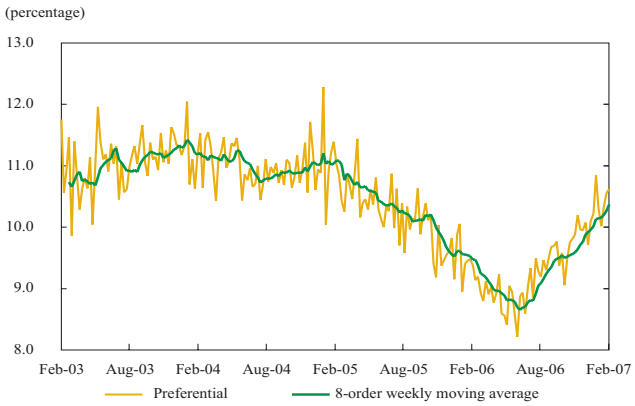
CONSUMER



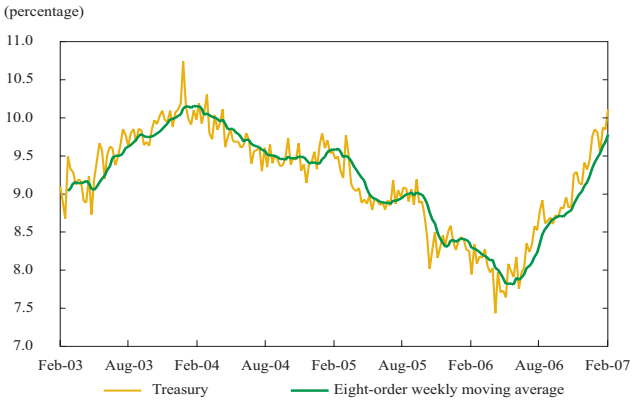
ORDINARY



PREFERENTIAL



TREASURY

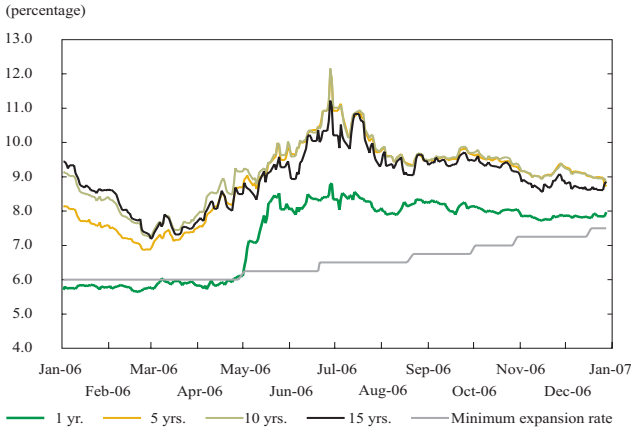


Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.,

The second half of 2006 was characterized by a reduction in, and stabilization of, TES rates, which ended the year at around 7.70% for one-year bonds and 8.80% for 10-year bonds. Rate stabilization during this period was consistent with the extent to which Banco de la República raised its intervention rate, which is why TES rates did not fall to the minimum levels observed in the first quarter of 2006. The adjustment in TES rates continued to reflect international market expectations about developments in the US economy and the actions of the central banks in Japan and Europe. The slowdown in the US economy was a signal to the market that the Fed would cease its gradual rate hikes, and global risk perception declined as a result, encouraging investors to return to the emerging markets. This process was

GRAPH 23

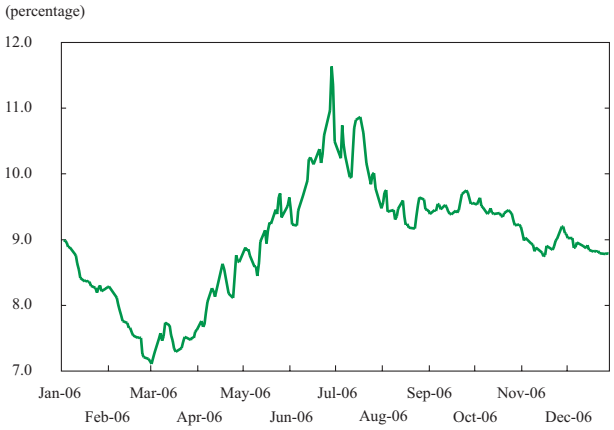
ZERO-COUPON CURVE FOR PESO TES AT 1, 5, 10 AND 15 YEARS JANUARY 2, 2006 TO DECEMBER 28, 2006



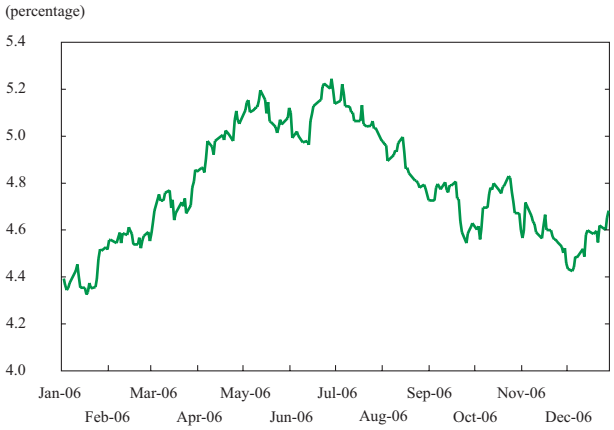
Source: Colombian Stock Exchange (BVC).

GRAPH 24

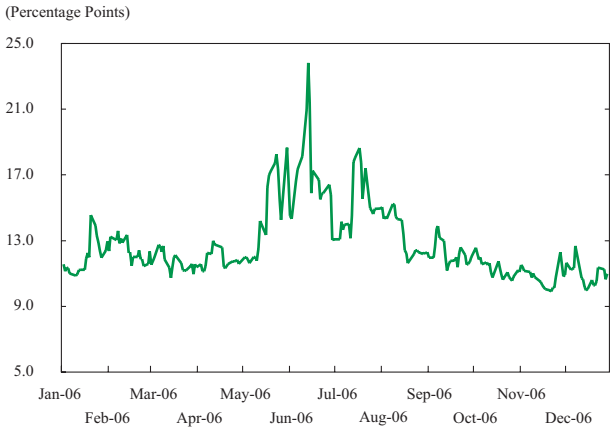
MOVEMENT IN THE RATE ON TES MATURING IN 2020



MOVEMENT IN THE RATE ON 10-YEAR US TREASURY BONDS



MOVEMENT IN VIX



Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

interrupted briefly by regional political events in Latin America at the end of the year.

2. Base Money, Credit and Financing Sources in the Financial System

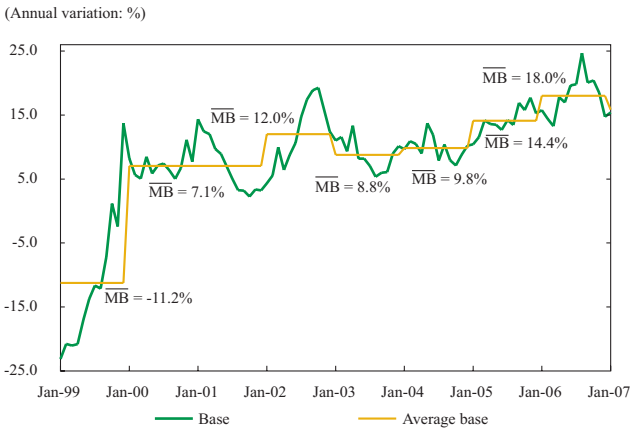
a. Base Money

The average variation in base money during 2006 was 23.1%.. This is a real increase of 18% (Graph 25) and is the highest in the last eight years, thanks to more demand for cash. In fact, the average annual increase in cash during 2006 was 25.1% (19.9% in real terms), while the average increase in bank reserves was 18.3% (13.5% in real terms). This is not as much as in 2005, given the shift in the composition of deposits with the financial system towards longer-term deposits, which have less of a reserve requirement. Another contributing factor was the decision by financial institutions to manage fewer excess reserves (Graph 26).

Table 10 shows base-money growth during 2006 was due largely to expansionary repo operations

GRAPH 25

REAL BASE MONEY

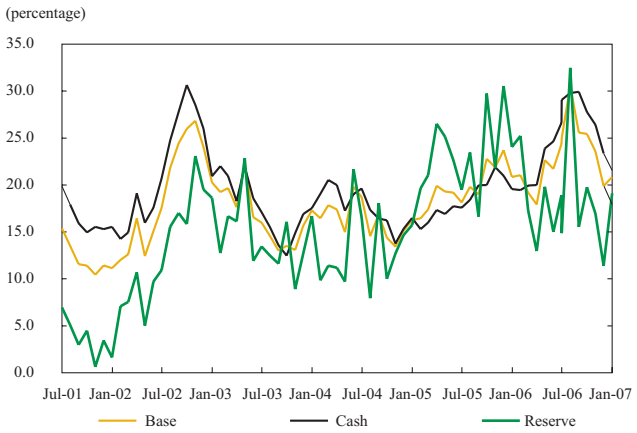


Source: Banco de la República.

($2,586 b) and the reduction in government deposits ($1,968 b), not to exchange intervention by Banco de la República. This is contrary to the beliefs of economic analysts. Intervention in the exchange market reduced base money by $483 b in 2006. However, by February 2007, the strategy for mass exchange intervention, announced by the BDBR on January 26, was reflected in base money. This prompted the Bank to adopt a sterilization policy for the remainder of the year, in coordination with the government. Among other mechanisms, that policy includes deposits by the National Treasury and the sale of TES.

GRAPH 26

BASE MONEY AND ITS USES (ANNUAL RATE OF GROWTH IN THE MONTHLY AVERAGE)



Source: Banco de la República.

TABLE 10

BASE MONEY SOURCES (IN BILLIONS OF PESOS)

		Annual Variation			
		Dec-05	Dec-06	Jan-07	Feb-07
I.	**Government**	**(2,637)**	**1,968**	**277**	**116**
	Transfer of profits [a/]	0	793	793	0
	Pesos	0	793	793	0
	Deposits with Banco de la República	(2,637)	1,175	(516)	116
II.	**Regulation TES**	**897**	**(327)**	**(482)**	**(485)**
	Definite purchases	5,230	463	633	633
	Definite sales	(4,000)	(261)	(434)	(434)
	Matured	(334)	(529)	(681)	(684)
III.	**Repos**	**1,539**	**2,586**	**2,339**	**2,170**
	Expansion [b/]	1,539	2,586	2,339	2,170
	Contraction	0	0	0	0
IV.	**Foreign exchange**	**3,239**	**(483)**	**2,080**	**3,785**
	Put options (accumulation)	0	1,397	1,398	1,398
	Call options (decrease accumulation)	0	(2,315)	(2,315)	(2,315)
	Discretional intervention	10,758	2,702	3,902	4,702
	Foreign exchange sold to government	(7,519)	(2,268)	(905)	0
V.	**Others** [c/]	**506**	**483**	**587**	**616**
	Total variation in base money	**3,543**	**4,227**	**4,801**	**6,203**
	Base money balance	**22,805**	**27,032**	**25,544**	**26,493**

a/ All profits turned over to the government in 2005 and 2007 were in dollars: Col$454 b (US$195.9 m) and Col $1,186 b (US$533 m), respectively.
b/ Includes one-day, overnight and medium-term repos.
c/ Includes, among other items, the monetary effect of Banco de la República's income statement, its loan recovery and investments.
Source: Banco de la República.

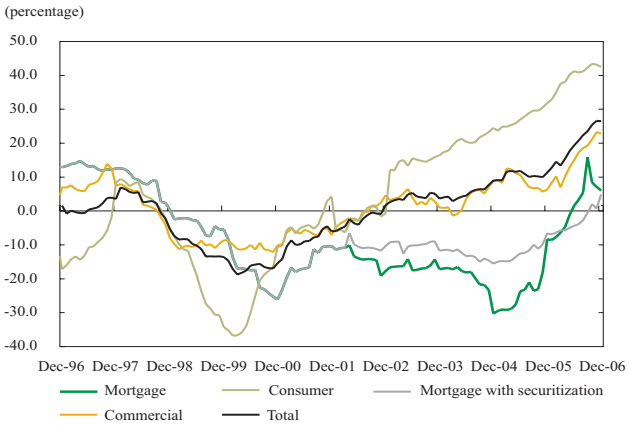
b. Loan Portfolio

As indicated in several studies, bank funds are the main source of household financing and a very important source of financing for companies. In fact, bank loans accounted for approximately 50% of all third-party corporate liabilities in 2005.[7] This is confirmed by a Fedesarrollo survey on the structure of corporate financing and the current situation of domestic credit. Those interviewed said that 41.0% of their company's financing comes from bank loans; the other 59.0% comes from other sources, such as withheld profits and suppliers.

As of late 2005, growth in the financial system's loan portfolio has been more pronounced. By December 2006, the gross loan portfolio reported by credit institutions as a whole was up by a real annual rate of 26.5%, largely because of the trend in consumer and commercial lending (Graph 27). The loan portfolio in the financial system has two important aspects: i) the increase in brokerage activities was partly due to the sell-off of securities by credit institutions in response to market volatility; and ii) the context surrounding vigorous loan portfolio growth is one of better loan portfolio quality indicators, except for consumer loans, and high coverage levels. Each of these aspects is analyzed below.

GRAPH 27

REAL ANNUAL GROWTH IN THE GROSS LOAN PORTFOLIO: CREDIT INSTITUTIONS



Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

Credit institutions sold off nearly $6.2 t in tradable assets during the course of 2006, releasing a large amount of funds that were used for traditional brokerage activities. By December 2006, the real annual increase in the gross loan portfolio was 26.5%, thanks to strong annual growth in consumer and commercial loans (42.5% and 22.9%, respectively) (Graph 27). The real annual increase in the mortgage loan portfolio was 6.1%, which

[7] Jalil, M. "Algunos comentarios sobre la transmisión de la política monetaria y el canal de Crédito," R*eportes del Emisor*, No. 77, October 2005; Zamudio, N. and Martínez J. "Estructura financiera de las empresas y los hogares. 2004-2005," (mimeograph) *Banco de la República*. 2006.

is the lowest since August 2006. However, the impact of securitization[8] must be considered when analyzing portfolios of this type; it is one of the reasons for the slowdown in the fourth quarter, since disbursements increased by a real average annual rate of 113.1% during 2006.

c. Sources of Financing Used by the Financial System

When analyzing loan portfolio performance, it is important to consider other aggregates in the financial system to help understand the changes in bank loan portfolios. A look at the main balance sheet accounts of credit institutions shows an important change in financing sources during 2006. Loan portfolio growth was backed by fewer investments and more liabilities subject to reserve requirements (LSR) (Tables 11 and 12). Credit institutions reduced their investments by Col$6.2 t during 2006. One of the reasons was the loss in market value of those investments and the

[8] There were two securitization processes in 2006: one in October for Col$796.6 b and another in December for Col $620.4 b.

TABLE 11

CREDIT INSTITUTIONS - AMOUNT OUTSTANDING ON IN MAIN BALANCE SHEET ACCOUNTS

	Billions of Pesos			
	Mar-06	**Jun-06**	**Sep-06**	**Dec-06**
Assets				
Own cash position [a/]	834	1,351	915	495
Bank reserve	5,669	5,345	6,404	6,955
Net loan portfolio (m/n)	62,043	70,084	77,013	82,221
Investments	45,121	40,340	36,088	36,890
Leasing portfolio (m/n)	5,869	6,369	7,064	7,857
Other net assets	(17,853)	(14,625)	(16,163)	(16,367)
Total	**101,683**	**108,864**	**111,322**	**118,050**
Liabilities				
Active opens market operations (OMAS)	5,935	6,909	6,745	6,636
LSR	95,748	101,955	104,577	111,414
Total	**101,683**	**108,864**	**111,322**	**118,050**
Memorandum Item				
Nominal value Tes B financial system	21,734	20,250	17,063	17,449
Nominal value Tes B financial system + portfolio	89,646	96,703	101,141	107,526
Investments + Loan portfolio	113,033	116,794	120,165	126,967

a/Exchange market agents' own cash position. Therefore, it includes stockbrokers who are considered exchange market agents.
Source: Banco de la República.

TABLE 12

PERCENTAGE OF ANNUAL VARIATION IN CREDIT INSTITUTIONS[1]
MAIN BALANCE SHEET ACCOUNTS

	Mar-06	Jun-06	Sep-06	Dec-06
Assets				
Own cash position [a/]	(39.7)	(32.5)	(44.4)	(68.3)
Bank reserve	14.1	(2.7)	37.5	7.1
Net loan portfolio (m/n)	15.6	23.6	35.0	36.7
Investments	26.5	5.1	(8.8)	(14.4)
Leasing portfolio (m/n)	41.8	42.5	48.6	45.7
Other net assets	36.0	(3.6)	9.8	0.1
Total	17.2	18.6	19.9	17.7
Liabilities				
Active open market accounts (OMAS)	525.9	89.8	270.0	63.8
LSR	11.6	15.6	14.9	15.8
Total	17.2	18.6	19.9	17.7
Memorandum Item				
Nominal value Tes B financial system	27.1	9.0	(14.0)	(16.7)
Nominal value Tes B financial system + portfolio	19.7	21.3	23.9	24.4
Investments + loan portfolio	20.9	17.3	18.6	16.9

a/ Exchange market agents' own cash position. It, therefore, includes stockbrokers who are considered exchange market agents.
Source: Banco de la República.

amount of TES liquidated and cashed in at maturity by the financial system (approximately Col$3.5 t during the year). Liabilities subject to reserve requirements (LSR) were up by nearly Col$15.2 t during the same period. In average annual terms, this is 15.2% less than in 2005 (18.2% annual).

This loan financing strategy, based on the sale investments in TES, may explain the heterogeneous way interest rates have behaved lately,[9] and might have allowed banks to fund their credit and reserve needs without having to adjust their deposit rates in proportion to the increase in the intervention rate. The supply of certain types of loans increased when banks shifted the composition of their portfolios away from TES, causing some lending rates to decline (consumer, commercial and credit card). This trend in market rates might reflect the hypothesis that pass-through from the policy rate to bank interest rates is not one to one. Betancourt,

[9] Between April and December 2006, the reaction in deposit rates was less than the policy rate adjustment. Lending rates exhibited a more complex reaction. Treasure and preferential rates increased as much or more than the policy rate, while those on consumer and credit card loans declined.

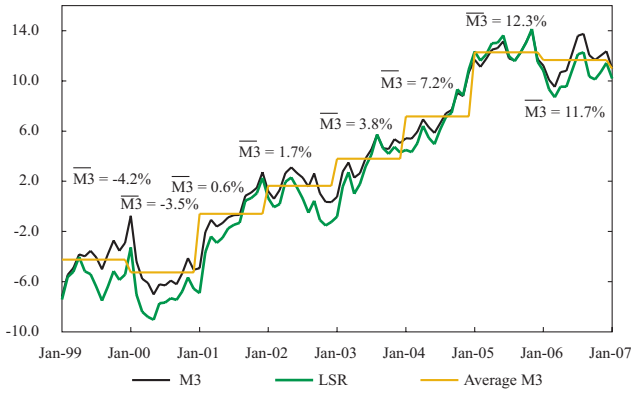
Vargas and Rodríguez (2006)[10] say it depends on how banks perform and on conditions in the loan and deposit markets, which are affected by a number of macroeconomic factors.

The average increase in M3 during 2006 (16.7%), (11.7% in real terms) (Graph 28) was similar to what it was in 2005 (16.9%) and reflects the rise in LSR, coupled with the trend in cash. The average annual increase in savings, which accounted for almost 45% of LSR, declined from 30.0% in 2005 to 22.3% in 2006 (Table 13). Certificates of deposit account for approximately 30% of LSR; they also experienced annual variations of around 10%, on average, during the year.

GRAPH 28

REAL BROAD MONEY (M3)

(% annual variation)



Source: Banco de la República.

[10] Betancourt, R., Vargas. H. and N. Rodríguez, "Interest Rate Pass-Through in Colombia: A Micro-Banking Perspective," Borradores de Economía, No. 407, Banco de la República. October 2006.

TABLE 13

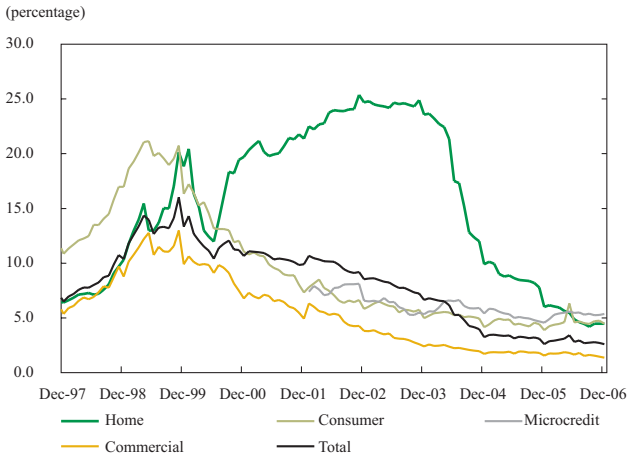
M3 COMPOSITION
(BILLIONS OF PESOS)

	Balance at December			Average growth in 2006
	2005	2006	Var, anual (%)	(%)
Private M3	91,598	109,168	19.2	18.8
Cash	16,397	20,136	22.8	25.2
LSR	75,200	89,032	18.4	17.6
Checking accounts	12,474	14,823	18.8	23.1
CDs	26,855	31,018	15.5	10.0
Savings [a/]	30,861	37,940	22.9	25.8
Others	5,011	5,251	4.8	2.5
M3 público	20,998	22,408	6.7	8.3
Checking accounts	5,510	5,779	4.9	5.4
CDs	2,179	1,728	(20.7)	6.8
Savings	9,834	10,823	10.1	13.2
TGN Repos	-	-		
Others	3,475	4,079	17.4	23.2
Public M3 without Repos	20,998	22,408	6.7	12.1
M3 total	112,596	131,576	16.9	16.7
Cash	16,397	20,136	22.8	25.2
LSR	96,198	111,441	15.8	15.4
Checking accounts	17,984	20,602	14.6	17.5
CDs	29,034	32,746	12.8	9.7
Savings	40,694	48,763	19.8	22.3
TGN Repos	-	-		
Others	8,486	9,330	9.9	10.3

a/ Does not include deposits with the Military Housing Fund, which was created in July 2006.
Source: Banco de la República.

GRAPH 29

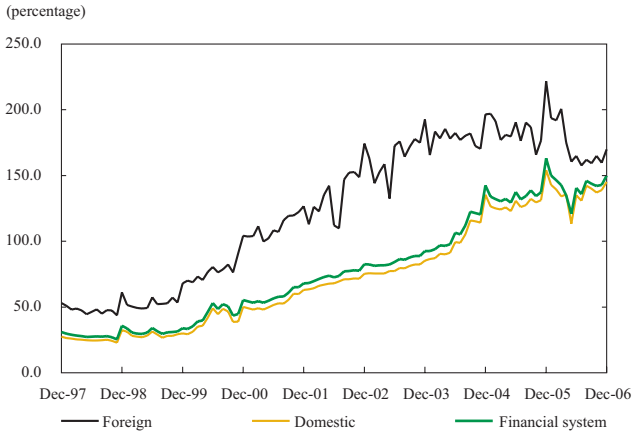
PORTFOLIO QUALITY BY TYPE OF LOAN a/



a/ The quality indicator is calculated as the ratio of non-performing loans to the gross loan portfolio.
Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

GRAPH 30

COVERAGE: PROVISIONING/NON-PERFORMING LOANS



Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

B. QUALITY OF ASSETS IN THE FINANCIAL SYSTEM

Indicators of loan portfolio quality and coverage are analyzed in this section, as is the profitability of the financial system. Also included are the general results of several exercises on credit, liquidity and market risk.

1. Loan Portfolio Quality and Coverage Indicators

The increase in the gross loan portfolio during 2006 was accompanied by good indicators of portfolio quality (QI), which is measured as the ratio of non-performing loans to the gross portfolio. This ratio stabilized at around 3.0%; however, the QI for the consumer loan portfolio showed some deterioration at mid-year, going from 3.9% in December 2005 to 4.5% at the end of 2006 (Graph 29).

The loan portfolio coverage indicator (provisions/non-performing portfolio) was down from 163% in December 2005 to 149.9% in December 2006, but remains at levels that are historically high and even surpasses the average for the last five years (109.3%) (Graph 30).

In short, loan portfolio performance in the financial system has been determined primarily by the increase in consumer and commercial lending. As noted later in this report, the expansion has occurred in a context of good portfolio quality indicators, compared to the historical average, and a high degree of coverage, which helps to make the system less vulnerable. However, these trends must continue to be monitored, given the current decline in the quality of the consumer loan portfolio.

The performance of the loan portfolio in the financial system has been determined primarily by the increase in consumer and commercial lending.

Typically, during periods of broad portfolio growth and momentum, quality indicators improve insofar as bank agents can roll over non-performing loans easily, which delays the appearance of delinquent loans. Consequently, a better indicator of loan portfolio coverage is one that gauges loan-loss provisioning for the entire portfolio, not just the non-performing portion. There always will be a minimum amount of provisioning, regardless of the

existence of non-performing loans. This suggestion is implicit in the logic behind the resolution being drafted by the National Superintendent of Financial Institutions on anticyclical provisions (Box 4).

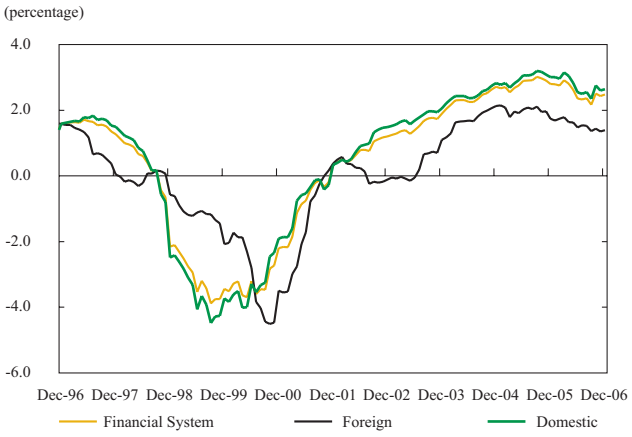
2. Profitability Indicators

The profitability indicator for the financial system dipped slightly at the end of 2006, from 2.8% in December 2005 to 2.5%. This was due to fewer earnings because of investment devaluation and reduced rates on loans (Graph 31). Investments accounted for 16.4% of all financial income reported by the system. This is 8.7 pp less compared to the same month the year before. However, the system's profitability is at historically high levels.

The capital adequacy ratio for the financial system[11] as a whole was used to analyze the capital soundness of credit institutions. The indicator was 12.8% at December 2006, some 70 bp less than in December 2005, due to the increase in risk-weighted assets resulting from loan portfolio growth. However, this is still more than 3 pp above the mandatory minimum (9%). In other words, capital levels posed no restriction to the increase in financial brokerage activities. This is normal when the economy is booming, but does not rule out the need to monitor this indicator carefully (Graph 32).

GRAPH 31

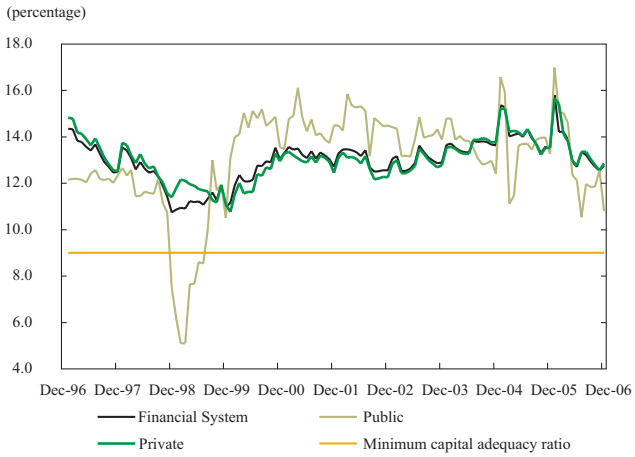
RETURN ON ASSETS (ROA)



Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

GRAPH 32

CAPITAL ADEQUACY RATIO BY TYPE OF INTERMEDIARY



Source: Office of the National Superintendent of Financial Institutions. Banco de la República's calculations.

3. Analysis of the Principal Risk Indicators

Exercises conducted recently by the Monetary and Reserves Section[12] show that market risk is still the main threat to stability in the financial system, since liquidity and credit risk remain low. However, credit institutions were

Market risk is still the main threat to stability in the financial system, since liquidity and credit risk remain low.

[11] The capital adequacy ratio is the proportion of technical equity to risk-weighted assets (including market risk).

[12] Financial Stability Department, Banco de la República.

Despite favorable levels, credit and liquidity risk rose slightly during the final months of the year due to the rapid growth in consumer loans.

less exposed during the second half of 2006; as a result, their potential losses declined.

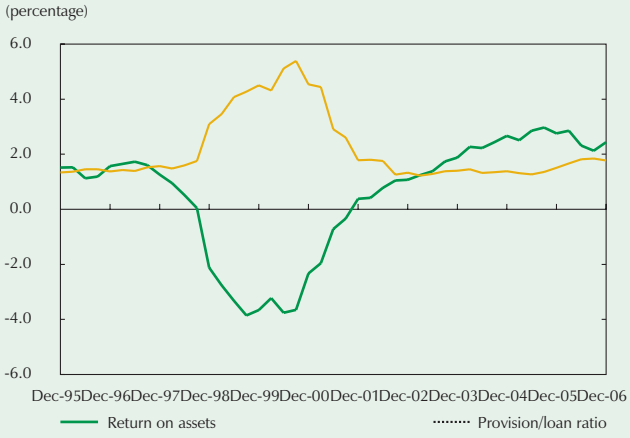
Despite favorable levels, credit and liquidity risk rose slightly during the final months of the year due to the rapid growth in consumer loans. This further exposes institutions to credit risk, given the increase in borrowers who are potentially less creditworthy. Moreover, the fact that institutions have fewer liquid assets to cover eventual deposit withdrawals has raised their exposure to liquidity risk.

Anticyclical Provisions for the Colombian Financial System

The close connection between performance of the financial system and that of the productive sector is manifest in procyclicity of the loan market.[1] When the economy is growing, this is reflected in high loan portfolio growth and an optimistic environment, particularly one where asset prices tend to be high and lending policies are more relaxed. As portfolio indicators and borrowers' creditworthiness decline, the risks acquired during the growth phase begin to materialize. In Colombia, the history of loan-loss provisioning by financial institutions shows cycles with low provisioning, consistent with favorable economic performance, followed by heavy provisioning when the economic cycle reverses, weakening the earnings statement (P&L) and undermining corporate equity (Graph B4). The purpose of anticyclical provisions is to keep loan P&L provisions stable throughout the credit cycle, avoiding a high ratio during the recessive phase and a low one during the growth phase.

The National Superintendent of Financial Institutions in Colombia wants to apply a set of anticyclical provisions along the lines of those instituted by Spain in 2000.[2] The anticyclical provision is calculated as the different between the specific provisions during a particular

Graph B4
Procyclicity in the Colombian Credit Market



Source: Banco de la República.

[1] See Martínez. Pineda and Salamanca (2005) for a further explanation of the procyclical nature of credit and the application of anticyclical provisions.

[2] The Office of the National Superintendent of Financial Institutions has posted a proposal to this effect on its website, in the form of a regulatory circular.

period and the long-term provisions.[3] Accordingly, when specific portfolio provisions fall below the historical average (which usually happens during a growth phase or economic surge), the anticyclical position will be positive and will accumulate in a fund that is itemized on the corporate balance sheet. When specific provisions surpass historical levels, the balance (negative, anticyclical provisions) is removed from the fund listed on the balance sheet.

Anticyclical provisions are an indirect deterrent to loan portfolio growth. However, loan growth stabilization may be included in the model as a specific objective, which is a good idea when downturns in the loan cycle are preceded by atypical increases in loans (Borio and Lowe, 2002). Early reduction in high loan growth prevents subsequent deterioration in loan quality, profitability and the stability of the financial system. With this arrangement, institutions accumulate anticyclical provisions in proportion to the difference between actual growth in the loan portfolio and the average rate of historical growth. Including a direct disincentive to loan growth in the anticyclical provisions model accelerates the level of provisions required of institutions with fast-growing portfolios. They should fill the anticyclical fund faster than the others. This proposal combines the advantages of the system of anticyclical provisions with loan-growth stabilization: two objectives that are consistent with financial system stability.

The proposed model for anticyclical provisions withholds profits during the growth phase of the cycle and lets them be used in the recessive phase. Ultimately, the net value of these anticyclical provisions would be zero and the expenditure on specific provisions as a percentage of the portfolio would remain stable throughout the cycle. By including a component that acts as a deterrent to rapid growth in the loan portfolio, institutions with an accelerated increase in loans will be quicker to establish the anticyclical fund. Reducing procyclicity in earnings and stabilizing the growth of an institution's loan portfolio results in more stability for the financial system (which is desirable from a regulator's standpoint) and less uncertainty about dividends and future profitability (which is good for shareholders).

[3] Unless stated otherwise, specific provisions are understood as the specific net provisions for recovery, not the voluntary P&L provisions.

VI. Balance of Payments in 2006 and the Outlook for 2007

Preliminary figures show the 2006 current account deficit in the balance of payments was US$2,850 m. This is 2.1% of GDP and exceeds the deficit in 2005 (1.5% of GDP).

A. 2006 Balance of Payments

Preliminary figures show the 2006 current account deficit in the balance of payments was US$2,850 m. This is 2.1% of GDP and exceeds the deficit in 2005 (1.5% of GDP[13]) (Table 14), primarily because the trade surplus declined by nearly 1.0 pp of GDP compared to the year before. Another current account item that contributed to the deficit, but less so, was the growing net payment of factor income associated with profits remitted by companies with foreign direct investment in petroleum and other sectors. As illustrated later, the healthy growth in income from transfers, which has become the second leading source of current income in the balance of payments and accounted for 3.7% of GDP in 2006, was not enough to offset these imbalances. The following is a detailed analysis of the balance of payment components in 2006 and their outlook for 2007.

The smaller trade surplus was the result of a sharp rise in imports equivalent to US$4,722 m (23.5% growth). It was not offset by merchandise export earnings, which were up by US$3,451 m compared to 2005 (15.9% growth).

1. Current Account

According to preliminary figures, the current account deficit in 2006 was US$964 m more than in 2005, despite an increase of US$637 m in net income from current transfers. For the most part, the origin of this decline can be traced to

[13] Definite figures for the balance of payments at the close of 2006 were not available at the time this report was written.

TABLE 14

BALANZA DE PAGOS DE COLOMBIA (RESUMEN)

	Millions of dollars			Percentage of GDP			Difference: 2006-2005 in millions of dollars
	2004	2005 (pr)	2006 (e)	2004	2005 (pr)	2006 (e)	
I. Current account	(908)	(1,886)	(2,850)	(0.9)	(1.5)	(2.1)	(964.0)
Income	24,144	29,811	35,187	24.6	24.2	26.1	5,375.7
Outlays	25,052	31,698	38,038	25.5	25.8	28.2	6,339.7
A. Goods y servicios no factoriales	**(334)**	**(507)**	**(1,717)**	**(0.3)**	**(0.4)**	**(1.3)**	**(1,210.5)**
1. Goods	1,346	1,595	325	1.4	1.3	0.2	(1,270.5)
Exports	17,224	21,729	25,181	17.6	17.7	18.7	3,451.2
Imports	15,878	20,134	24,856	16.2	16.4	18.4	4,721.8
2. Nonfactor services	(1,680)	(2,102)	(2,042)	(1.7)	(1.7)	(1.5)	60.0
Exports	2,255	2,664	3,436	2.3	2.2	2.5	772.2
Imports	3,935	4,766	5,478	4.0	3.9	4.1	712.2
B. Factor income	**(4,299)**	**(5,462)**	**(5,852)**	**(4.4)**	**(4.4)**	**(4.3)**	**(390.1)**
Income	671	1,076	1,534	0.7	0.9	1.1	457.6
Outlays	4,970	6,538	7,385	5.1	5.3	5.5	847.7
C. Current transfers	**3,724**	**4,082**	**4,719**	**3.8**	**3.3**	**3.5**	**636.6**
Income	3,994	4,342	5,037	4.1	3.5	3.7	694.7
Workers' remittances	3,170	3,314	3,885	3.2	2.7	2.9	571.3
Others	824	457	1,152	0.8	0.4	0.9	694.7
Outlays	270	260	318	0.3	0.2	0.2	58.0
II. Capital and financial account	3,204	3,151	2,667	3.3	2.6	2.0	(483.9)
1. Long-term financial flows	2,435	4,276	6,472	2.5	3.5	4.8	2,196.5
i. Net foreign direct investment in Colombia	2,941	5,593	5,198	3.0	4.5	3.9	(395.4)
ii. Loans [a/]	(380)	(1,297)	1,395	(0.4)	(1.1)	1.0	2,691.6
iii. Leasing	(76)	28	(73)	(0.1)	0.0	(0.1)	(100.8)
iv. Other long-term movements	(51)	(48)	(47)	(0.1)	(0.0)	(0.0)	1.1
2. Short-term financial flows	770	(1,125)	(3,805)	0.8	(0.9)	(2.8)	(2,680.4)
III.Net errors and omissions	245	464	204	0.2	0.4	0.2	(260.4)
IV.Variation in gross international reserve [b/]	2,541	1,729	23	2.6	1.4	0.0	(1,706.1)
V. Gross international reserves	13,540	14,957	15,440	13.8	12.2	11.4	
VI.Net international reserves	13,536	14,947	15,435	13.8	12.1	11.4	
Months of merchandise imports	10	9	7				
Months of goods and services imports	8	7	6				
Nominal GDP in millions of dollars	98,059	123,085	134,969				
VI.Variation in net international reserves	2,543	1,723	23				(1,700.7)

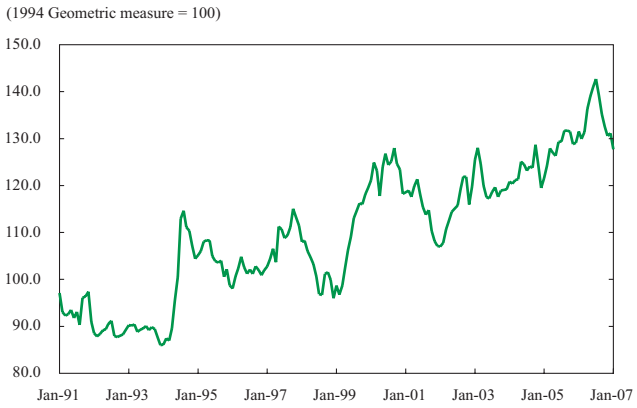
(pr) Preliminary.
(e) Estimate
a/ Includes portfolio investment, direct loans and commercial loans.
b/ Pursuant to the balance of payments methodology.
Source: Banco de la República.

a smaller trade surplus, which went from US$1,595 m in 2005 to US$325 m in 2006), and more net outlays for factor income, which were up by US$390 m.

The smaller trade surplus[14] was the result of a sharp rise in imports equivalent to US$4,722 m (23.5% growth). It was not offset by merchandise export earnings, which were up by US$3,451m compared to 2005 (15.9% growth). In the last few years, Colombian exports have benefited from good international prices for the country's basic export items, coupled with the favorable trend in the world economy and more specialized exports from the industrial sectors. All of these factors helped to generate merchandise account surpluses. Although total exports rose substantially during 2006 (15.1%), they did not increase as much as in 2004 and 2005 (27.1% and 26.6%, respectively). This was due largely to the slight drop in terms of trade (Graph 33) and slower economic growth in the United Status.

GRAPH 33

TERMS OF TRADE



Source: Banco de la República.

As illustrated in Table 15, foreign sales of traditional products were up by an annual rate of 13.9%. Petroleum and petroleum by-products headed the list, followed by ferronickel and coal. On the whole, these items benefited from good international prices. As to quantity, more coal and ferronickel were shipped, while the volume of crude oil was down compared to 2005, as was the case with coffee. The increase in non-traditional exports in 2006 came to 16.2%, fueled largely by industrial products.

As to the destination of total exports, Venezuela, the United States and Ecuador were the country's major trading partners during 2006 (Table 16), as in past years. Nonetheless, 2006 saw a slowdown in non-traditional industrial exports to the United States.

Earnings on non-traditional industrial exports to the United States came to US$1,818 m: the clothing sector accounted for 24.7%; the base metal industry, 15.1%; non-metallic minerals, 12.6%; the chemical industry, 12.1%; and food, beverages and tobacco, 11.2%. (Table 17). By March 2006, the annual increase for each component of non-traditional industrial exports showed positive rates; clothing was the only exception. The result was 11.2% growth in exports of this type; the increase was less in December, making for an annual rate of just 5%. This was a common occurrence in several

[14] Takes into account goods exported and imported through special trade operations.

TABLE 15

EXPORTS ACCORDING TO PRINCIPAL PRODUCTS AND ECONOMIC SECTORS [a/]

	Millions of Dollars		Variation		Contribution to Growth	
	2005	2006 (pr)	Absolute [b/]	Percentage	Percentage Points	Percentage
Traditional exports	10,366	11,809	1,444	13.9	6.8	45.1
Coffee	1,471	1,461	(9)	(0.6)	0.0	(0.3)
Petroleum and petroleum by-products	5,559	6,328	769	13.8	3.6	24.0
Coal	2,598	2,913	315	12.1	1.5	9.8
Ferronickel	738	1,107	369	50.1	**1.7**	11.5
Non-traditional exports [c/]	**10,825**	**12,581**	**1,757**	**16.2**	8.3	**54.9**
Non-monetary gold	**517**	**281**	**(236)**	**(45.6)**	(1.1)	**(7.4)**
Emeralds	**72**	**90**	**18**	**24.7**	0.1	**0.6**
All others	**10,236**	**12,210**	**1,974**	**19.3**	9.3	**61.7**
Agriculture and Livestock Sector	1,970	2,157	187	9.5	**0.9**	5.8
Industrial sector	7,889	9,237	1,348	17.1	6.4	42.1
Mining sector	378	817	440	116.5	2.1	13.7
Total exports	**21,191**	**24,391**	**3,200**	**15.1**	15.1	**100.0**

(pr) Preliminary.
a/ Does not include exports through special trade arrangements.
b/ In millions of dollars.
c/ Excludes temporary exports, re-exports and others; includes balance of payments adjustments
Source: DIAN, DANE and Banco de la República.

Latin American countries, such as Argentina, Peru and Ecuador, and could have originated, among other factors, with the slowdown in GDP in the United States throughout the year. However, countries such as Chile, China, Mexico and Costa Rica managed to maintain the rate of growth in their exports to the United States (Table 18).

As to total imports, 41% of the growth in 2006 is explained by intermediate goods, which were up by 22% with respect to 2005 (Table 19). Imports of raw materials for industry were the outstanding item in this respect, mirroring the vigorous momentum in investment and industrial activity throughout the year. Imports of capital goods for industry also rose significantly (17.1%). Aggregate imports for industry accounted for 52.5% of all import growth. Accordingly, more than 80% of the rise in imports during 2006 is associated with more economic investment and the growing demand for input as a result of more economic activity.

NON-TRADITIONAL COLOMBIAN EXPORTS, BY COUNTRY (PR)
JANUARY - DECEMBER 2006

Annual Percentage Growth in Dollar Value

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	China	Others	Total
Total	12.4	12.1	28.8	(1.3)	16.6	(2.0)	91.2	25.2	15.1
Traditional	20.0	(74.0)	(48.6)	(44.9)	21.7	(7.6)	(42.2)	15.3	13.9
Non-traditional	(0.4)	20.3	29.4	14.3	6.1	27.2	164.6	35.3	16.2
Agriculture and livestock sector	3.9	37.0	37.7	(2.1)	6.8	12.9	(46.1)	2.6	9.5
Industrial sector	5.0	20.7	28.2	14.4	12.8	16.0	n.a.	16.6	17.1
Food, beverages and tobacco	8.0	18.0	22.2	67.0	(12.8)	11.2	(47.5)	8.7	12.2
Yarns and woven fabrics	(30.5)	(0.5)	3.6	23.5	(18.5)	0.0	14.3	26.5	4.5
Garments	(11.3)	36.9	44.9	34.6	20.7	90.6	(100.0)	(3.6)	6.4
Plastic and rubber products	3.7	22.4	39.9	21.3	57.2	0.0	n.a.	25.0	21.6
Leather and leather goods	(3.5)	38.4	56.4	3.7	32.3	34.3	25.7	22.5	19.4
Word and wood products	(7.8)	45.5	55.8	32.3	(8.0)	(12.5)	n.a.	21.9	19.7
Graphic arts and publishing	(3.6)	19.3	31.8	(0.5)	34.9	1.0	(55.9)	27.2	16.0
Chemical industry	8.7	19.9	28.1	(1.2)	28.0	(9.0)	(28.9)	15.2	14.0
Non-metallic minerals	11.4	42.3	55.9	17.7	7.3	66.7	n.a.	31.7	22.8
Base metals industry	21.0	14.3	14.8	55.4	92.0	91.3	n.a.	29.7	42.6
Machinery and equipment	16.6	32.0	39.6	(12.9)	75.5	n.a.	n.a.	17.6	23.6
Transport materials	40.3	15.6	20.5	(76.4)	62.5	n.a.	(57.1)	26.0	15.8
Optical, cinema and other apparatus	68.1	13.8	29.5	21.0	5.1	(44.2)	n.a.	(24.1)	15.9
Other industries	19.3	21.9	28.8	3.3	58.4	96.9	n.a.	15.4	19.3
Mining sector [a/]	(24.2)	(15.4)	6.7	15.6	(39.7)	68.9	n.a.	n.a.	22.9

Value of exports (millions of dollars)

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	China	Others	Total
Total	9,947.7	4,689.4	2,701.7	1,090.2	3,147.8	323.7	452.4	4,739.6	24,390.8
Traditional	6,659.4	94.8	8.8	160.6	2,218.8	255.2	216.3	2,204.5	11,809.5
Non-traditional	3,288.3	4,594.6	2,693.0	929.6	929.0	68.5	236.2	2,535.1	12,581.3
Agriculture & livestock sector	1,037.0	407.2	399.3	3.7	487.4	22.3	0.4	198.5	2,156.5
Industrial sector	1,817.6	4,041.8	2,283.2	924.4	405.9	25.1	235.7	1,786.2	9,236.7
Mining sector [a/]	433.8	145.6	10.5	1.5	35.8	21.1	0.0	550.4	1,188.1

Contribution (%) to growth

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	China	Others	Total
Total	5.2	2.4	2.9	(0.1)	2.1	(0.0)	1.0	4.5	15.1
Traditional	5.2	(1.3)	(0.0)	(0.6)	1.9	(0.1)	0.3	1.4	6.8
Non-traditional	(0.1)	3.7	2.9	0.5	0.3	0.1	0.7	3.1	8.3
Agriculture and livestock sector	0.2	0.5	0.5	(0.0)	0.1	0.0	(0.0)	0.0	0.9
Industrial sector	0.4	3.3	2.4	0.5	0.2	0.0	0.7	1.2	6.4
Mining sector [a/]	(0.7)	(0.1)	0.0	0.0	(0.1)	0.0	0.0	1.9	1.0

(n.a.) Not applicable.
(pr) Preliminary.
a/ Includes gold and emeralds.
Source: DANE and Banco de la República.

TABLE 17

NON-TRADITIONAL INDUSTRIAL EXPORTS TO THE UNITED STATES
(ACCUMULATED 12-MONTH ANNUAL GROWTH)

	Millions of dollars	Share (%)	Percentage		
			Mar-06 (a)	Dec-06 (b)	Change (b - a)
Transport material	63	3.4	108.8	40.2	(68.5)
Optical, cinema and other apparatus	15	0.8	114.5	68.2	(46.3)
Chemical industry	219	12.1	42.8	8.7	(34.1)
Base metals industry	275	15.1	53.7	21.0	(32.7)
Yarn and woven fabrics	13	0.7	(1.4)	(30.4)	(29.0)
Graphic arts and publishing	60	3.3	15.8	(3.6)	(19.4)
Leather and leather goods	52	2.9	14.9	(3.5)	(18.4)
Plastic and rubber products	19	1.1	14.6	3.5	(11.1)
Wood and wood products	28	1.5	(0.2)	(7.7)	(7.6)
Machinery and equipment	146	8.0	19.5	16.6	(2.9)
Non-metallic minerals	230	12.6	13.9	11.4	(2.6)
Food, beverages and tobacco	203	11.2	4.4	8.1	3.6
Garments	450	24.7	(15.0)	(11.3)	3.6
Other industries	45	2.5	9.9	19.3	9.4
Total	**1,818**	**100.0**	**11.2**	**5.0**	**(6.2)**

Source: DANE. Fedesarrollo's calculations.

TABLE 18

RATE OF INCREASE IN EXPORTS TO THE UNITED STATES, BY COUNTRY OF ORIGIN
(PERCENTAGE)

Country	1999	2000	2001	2002	2003	2004	2005	2006
Canada	13.5	15.5	(5.3)	(2.9)	6.4	14.1	12.5	5.4
China	15.1	22.2	2.5	22.3	21.5	29.4	23.7	18.3
Mexico	17.2	23.6	(3.1)	2.8	2.3	12.9	9.2	16.5
Philippines	4.2	12.6	(18.9)	(2.9)	(8.5)	(9.0)	1.0	5.0
Chile	20.6	15.4	0.7	8.5	11.9	25.8	34.7	41.6
Colombia	32.4	13.6	(15.8)	(4.3)	17.9	16.0	19.2	5.4
Ecuador	4.4	22.4	(12.9)	7.1	27.2	55.4	40.4	19.4
Peru	(2.8)	6.1	(9.1)	8.2	23.7	52.5	39.0	15.1
Dominican Republic	(3.8)	2.4	(4.4)	(0.5)	6.9	1.7	1.6	(1.4)
Argentina	14.7	20.4	(4.3)	8.4	(3.6)	21.9	23.2	(15.6)
Costa Rica	44.2	(10.1)	(18.1)	8.0	6.6	(1.7)	2.4	12.9
Honduras	6.6	14.0	1.3	4.2	1.5	9.8	3.3	(0.6)
Total US Imports		18.5	(6.0)	2.0	8.3	16.8	13.8	11.0

Source: DANE. Banco de la República's calculations.

IMPORTS (FOB) BY CUODE CLASSIFICATION (PR) a/

	January-December		Variation		Contribution to Growth	
	2005 b/	2006 b/	Absolute b/	Percentage	Percentage points	Percentage
Consumer goods	**3,674**	**4,921**	**1,247**	**33.9**	**6.3**	**26.3**
Durables	1,716	2,158	443	25.8	2.2	9.3
Non-durables	1,958	2,762	804	41.1	4.1	17.0
Intermediate goods	**8,754**	**10,678**	**1,924**	**22.0**	**9.7**	**40.6**
Fuel & lubricants c/	520	653	133	25.7	0.7	2.8
For agriculture	668	762	94	14.1	0.5	2.0
For industry	7,566	9,262	1,696	22.4	8.6	35.8
Capital goods	**7,361**	**8,923**	**1,562**	**21.2**	**7.9**	**33.0**
Construction materials	397	521	124	31.1	0.6	2.6
For agriculture	59	57	(2)	(3.8)	(0.0)	(0.0)
For industry	4,614	5,403	789	17.1	4.0	16.7
Transport equipment	2,291	2,942	651	28.4	3.3	13.8
Unclassified goods	**10**	**12**	**2**	**24.5**	**0.0**	**0.1**
Total imports	**19,799**	**24,534**	**4,735**	**23.9**	**23.9**	**100.0**

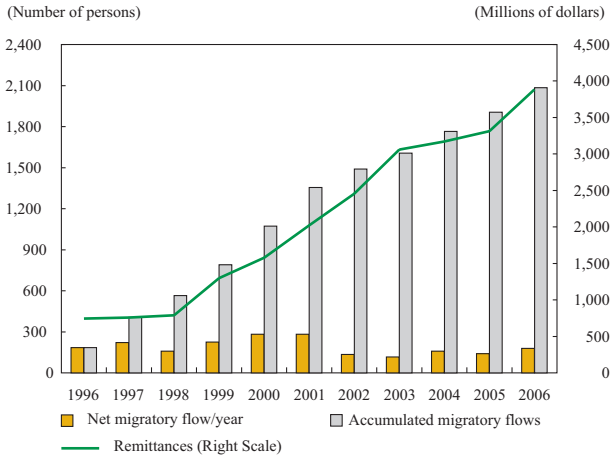
(pr) Preliminary.
a/ Excludes temporary imports, re-imports and others; includes balance of payments adjustments.
b/ In millions of dollars.
c/ Includes petroleum and coal by-products.
Source: DANE and DIAN.

The factor income deficit is estimated at US$5,852 m, which is US$390 m more than in 2005 (-US$5,462 m). The deterioration in this account largely reflects the outflow of profits and dividends to home offices, associated with more foreign direct investment in recent years. As to companies in the petroleum sector, the outlays for this item are calculated at US$2,046 m: those in the other sectors of the economy are estimated at close to US$2,400 m. In short, these items were up by 27% with respect to 2005.

Net transfers increased by US$637 m compared to 2005 (16% annual growth), amounting to an estimated US$4.719 m. Workers' remittances account for US$3,885 m of that sum, having grown by an estimated 17.2% last year. This increase is associated with migratory flows and economic performance in countries that have become a source of income for Colombian workers (mainly Spain and the United States) (Graph 34).

GRAPH 34

COLOMBIA: MIGRATORY FLOWS AND REMITTANCES



Note: The figure for remittances in 2006 is a preliminary estimate subject to revision.
Source: DAS. Banco de la República's calculations.

2. Capital and Financial Account

An estimated US$2,667 m in net resources entered the capital and financial account in 2005, originating with US$5.472 m in long-term financial transactions associated with foreign direct investment and the external debt. Net short-term capital outflows came to US$3,805 m. In addition to private-sector operations, this figure also includes the increase in external accounts belonging to the government and several companies in the public sector.

As to long-term flows, preliminary estimates point to a net influx of US$5,198 m in foreign direct investment (3.9% of GDP). Telecom was privatized in 2006, and companies such as OLA, Superview, TV Cable, DHL, and Propal Monómeros Colombo Venezolanos were sold to international investors. There also was a great deal of income from foreign investment in the mining and petroleum sectors, calculated at close to US$3,400 m (See Box 5 for details).

Part of this income was offset by US$1.163 m. in net payments on the external debt and by the accumulation of external assets in the public sector. The rest of the public sector reported US$2,764 m in net outflows, largely because of external assets accumulated by entities such as Ecopetrol, Fogafin and the Petroleum Stabilization Fund (FAEP). For its part, the national government received US$1,601 m in net resources during 2006 (including US$2,000 m to pre-finance the deficit in 2007 and 2008) (Table 20).

The private sector, excluding FDI, reported US$1,320 m in net capital outflows for external and portfolio borrowing, compared to a net inflow of US$537 m in 2005. Contrary to the year before, agents in the private sector lowered their external exposure during 2006 and settled an estimated US$524 m in long-term obligations outside the country. An outflow of US$797 m was registered for short-term operations that include both debt and portfolio capital flows (Table 20).

Public and Private Capital Flows: 2001-2006 (e)
(Millions of dollars)

	2001	2002	2003	2004	2005	2006 (e)
Capital and Financial Account	**2,446**	**1,304**	**656**	**3,204**	**3,151**	**2,667**
I. Total private sector	**1,012**	**956**	**279**	**3,241**	**6,130**	**3,877**
A. Net foreign investment in Colombia	2,509	1,283	820	2,941	5,593	5,198
B. Rest of private sector without FDI	(1,497)	(327)	(541)	300	537	(1,320)
Long term	(380)	(1,346)	(1,095)	(1,243)	(49)	(524)
Short term	(1,117)	1,019	554	1,543	585	(797)
II. Total public sector	**1,469**	**378**	**407**	**14**	**(2,931)**	**(1,163)**
A. Non-financial	1,940	504	694	433	(2,125)	515
B. Financial	(471)	(126)	(287)	(419)	(806)	(1,679)
III. Other long-term flows	**(35)**	**(30)**	**(30)**	**(51)**	**(48)**	**(47)**
Non-financial public sector	**1,940**	**504**	**694**	**433**	**(2,125)**	**515**
Government	**2,685**	**801**	**1,702**	**916**	**(1,392)**	**1,601**
Long term	3,823	(619)	1,963	1,403	(1,128)	2,194
Outlays	5,485	2,246	4,786	2,750	3,935	5,144
Amortization	1,662	2,864	2,823	1,347	5,063	2,950
Short term (loan portfolio & debt)	(1,138)	1,419	(260)	(488)	(264)	(593)
Other entities	**(745)**	**(297)**	**(1,008)**	**(482)**	**(733)**	**(1,085)**
Long term	(360)	(474)	(506)	(491)	(61)	(95)
Outlays	259	223	130	140	377	725
Amortization	619	697	635	631	438	820
Short term (loan portfolio & debt)	(384)	177	(502)	9	(673)	(991)

(e) Estimate.
Source: Banco de la República.

As a result of these flows, Colombia's total outstanding external debt was US$40,173 m at December 2006 (41.0% of GDP), including US$26,047 m (65%) in public debt and US$14,125 m (35%) in private debt (Table 21). The short-term amount would come to US$5,695 m., with 95% pertaining to the public sector.

3. Variation in International Reserves

According to the balance-of-payments method, Banco de la República accumulated US$23 m[15] in gross international reserves during 2006, for a total of US$15,440 m (11.4% of GDP). This is equivalent to 7.5 months of goods imports, 6.1 months of goods and services imports, and 1.2 times the value of public and private debt amortization payments during the year. As

[15] The change in gross international reserves (US$23 m) refers to a balance-of-payments concept that does not include valuation gains or losses on international reserves due to exchange differentials or interest rates.

TABLE 21

COLOMBIA'S OUTSTANDING EXTERNAL DEBT

	Millions of dollars				Percentage of GDP [a/]			
	2003	2004	2005 (pr)	2006 (e)	2003	2004	2005 (pr)	2006 (e)
Total outstanding	**38,008**	**39,441**	**38,555**	**40,173**	**47.8**	**40.2**	**39.3**	**41.0**
Public sector	24,527	25,779	24,133	26,047	30.9	26.3	24.6	26.6
Private sector	13,480	13,662	14,422	14,125	17.0	13.9	14.7	14.4
1. Medium & Long-term Maturities	**34,689**	**34,530**	**32,918**	**34,478**	**43.7**	**35.2**	**33.6**	**35.2**
a. Public sector by borrower	24,228	25,321	23,677	25,768	30.5	25.8	24.1	26.3
Non-financial public sector	23,634	24,856	23,253	25,598	29.7	25.3	23.7	26.1
Government	20,663	22,320	20,852	23,289	26.0	22.8	21.3	23.7
Decentralized agencies	2,970	2,536	2,401	2,309	3.7	2.6	2.4	2.4
Financial public sector	594	465	424	170	0.7	0.5	0.4	0.2
b. Private sector	8,357	7,180	7,146	6,688	10.5	7.3	7.3	6.8
Financial	166	151	516	372	0.2	0.2	0.5	0.4
Non-financial	8,191	7,030	6,629	6,316	10.3	7.2	6.8	6.4
c. Leasing	2,104	2,029	2,095	2,022	2.6	2.1	2.1	2.1
Public	76	67	56	49	0.1	0.1	0.1	0.0
Private	2,028	1,962	2,039	1,973	2.6	2.0	2.1	2.0
2. Short term	**3,319**	**4,911**	**5,637**	**5,695**	**4.2**	**5.0**	**5.7**	**5.8**
a. Public sector	224	391	399	230	0.3	0.4	0.4	0.2
b. Private sector	3,095	4,520	5,237	5,465	3.9	4.6	5.3	5.6
Memorandum item:								
Total outstanding without leasing	35,904	37,413	36,460	38,151	45.2	38.2	37.2	38.9
Public	24,452	25,712	24,077	25,998	30.8	26.2	24.6	26.5
Private	11,452	11,701	12,383	12,153	14.4	11.9	12.6	12.4

(pr) Preliminary.
(e) Estimated.
a/ Calculation based on the exchange rate at the end of the period.
Source: Banco de la República.

mentioned earlier, Banco de la República made discretional foreign exchange purchases in 2006 (US$1.197 m.), sold US$1,000 m. to the national government, and made net sales with options to control exchange volatility (US$360 m.) (see Chapter VIII for details).

B. BALANCE-OF-PAYMENTS OUTLOOK FOR 2007

The projected current account deficit for 2007 is close to US$5.400 m (3.5% of GDP). Mainly, this is because the country's trade balance is expected to evolve from a surplus of US$325 m (0.2% of GDP) in 2006 to an estimated deficit of US$2,845 m (-1.8% of GDP) in 2007 (Table 22). The added imbalance will depend essentially on whether or not total imports continue to grow and what happens to international prices for crude oil. Banco de la

COLOMBIA'S PROJECTED BALANCE OF PAYMENTS

	Millions of dollars			Percentage of GDP		
	2005	2006 (e)	2007 (proj)	2005	2006 (e)	2007 (proj)
I. Current Account	**(1,886)**	**(2,850)**	**(5,378)**	**(1.5)**	**(2.1)**	**(3.5)**
A. Non-factor goods and services	(507)	(1,717)	(5,148)	(0.4)	(1.3)	(3.3)
1. Goods	1,595	325	(2,846)	1.3	0.2	(1.8)
2. Non-factor services	(2,102)	(2,042)	(2,302)	(1.7)	(1.5)	(1.5)
B. Factor income	(5,462)	(5,852)	(5,284)	(4.4)	(4.3)	(3.4)
C. Transfers	4,082	4,719	5,054	3.3	3.5	3.3
II. Capital and Financial Account and Variation in Gross International Reserves	**5,344**	**2,893**	**9,179**	**4.3**	**2.1**	**5.9**
A. Net direct investment	5,593	5,198	6,482	4.5	3.9	4.2
B. Other capital movement [a/]	(249)	(2,304)	2,697	(0.2)	(1.7)	1.7

(e) Estimated.
(pr) Preliminary.
a/ Includes public and private sector transaction, errors and omissions, and the variation in gross international reserves.
Source: Banco de la República.

República forecasts an increase of nearly 15% in imports and fewer sales of traditional products, particularly oil, as a result of the combined effect of lower international prices and less export volume.[16] The strategy is to use national production to satisfy the domestic market (where demand is growing). Although hydrocarbon production is expected to remain above 500 thousand barrels per day (mbd) for the next five years, this strategy definitely has an impact on how much is available to meet the external demand. Of course, higher international prices for crude oil or more export volume would bring more income into the country, meaning less of a trade deficit.

The factor income deficit is expected to be US$568 m less in 2007 with respect to the calculation for 2006, thanks to the combined effect of more interest earned on international reserves and less interest paid on the external debt, both public and private.

[16] For 2007, the assumed price of West Texas Intermediate (WTI) is US$57.7 per barrel. This is almost US$8 less than in 2006. According to preliminary data, crude export volume is expected to be 20 mbd less than sales in 2006.

If the projections are borne out, net foreign direct investment resources[17] should more than cover the current account deficit. In net terms, they might even surpass the amount registered in 2006. The vigorous momentum in foreign capital focused on sectors such as petroleum, coal, gas, manufactured goods, energy and commerce is expected to continue.

In the medium term, Banco de la República expects the current account deficit in the balance of payments to remain at around 3.0% of GDP, on average, until 2011. This forecast is based on the absence of major negative shocks to the current account and increased sources of external funding. As to the former, income from exports of petroleum and petroleum by-products and coal, as a share of GDP, should remain relatively stable at around 3.8% and 1.9%, respectively. Income from non-traditional exports,[18] as a portion of GDP, is expected to increase from 8.7% in 2006 to almost 10.9% in 2011. According to the forecasts for FDI and external borrowing by the public sector, these flows should increase from an average of US$2.500 m. between 2005 and 2007 to US$2.800 m., on average, between 2008 and 2011.

[17] This takes into account US$2,410 m from the sale of national companies such as Acerías Paz de Río, Promigás, Éxito, Petco, Colpatria and others, which were purchased by foreign investors.

[18] Does not include exports of gold or emeralds.

VII. Fiscal Policy

At the end of 206, the consolidated public sector registered a deficit of Col$2,708 b. Equivalent to 0.9% of GDP, this is less than the deficit target set at mid-year (1.5% of GDP).

A. Fiscal Results: 2006

The consolidated public sector registered a deficit of Col$2,708 b at the end of 2006. Equivalent to 0.9% of GDP, this is less than the deficit target set at mid-year (1.5% of GDP), thanks to an improvement in central government finances. The central government deficit declined from 4.8% to 4.1% of GDP between 2005 and 2006. The decentralized public sector, Banco de la República and Fogafin registered respective surpluses equivalent to 3.1%, 0.5% and 0.2% of GDP. During the year the cost of restructuring the financial system came to Col$1,137 b (Table 23).

Good fiscal performance by the central government (CG) reflects the trend in revenue, which was up by 22.7% due to increased tax collections and the financial surpluses transferred to the government by state-owned companies and public agencies.

Good fiscal performance by the central government (CG) reflects the trend in revenue, which was up by 22.7%, due to increased tax collections and the financial surpluses transferred to the government by state-owned companies and public agencies, particularly Ecopetrol. Income tax, customs duties and external VAT registered the largest increases: 23.1%, 29.3% and 36.0%, respectively. The pace of economic activity and the growth in imports were largely responsible for this positive trend in revenue. Ecopetrol transferred Col$1,298 b in profits during 2005 and Col$2,000 b in 2006, thanks to international prices for crude oil and the policy calling for the gradual elimination of gasoline subsidies (Table 24).

Total CG expenses were up by 16.3%, interest on the debt, 35.2%, operations, 10.3% and investment, 38%. Operating expenses include a 13.7% increase in personal services, 20.1% in general services and 8.8% in transfers. As to the latter, the rise in pension payments came to 12.4%, while the General System of Resource Allocation was up by 7%. The vigorous growth in investments is

TABLE 23

CONSOLIDATED PUBLIC SECTOR: FISCAL BALANCE
2005 AND 2006

Item	Billions of Pesos		Percentage of GDP	
	2005	2006 (pr)	2005	2006 (pr)
A. Total Non-financial Public Sector (NFPS) (1 + 2)	**(988)**	**(3,112)**	**(0.3)**	**(1.0)**
1. National government	**(13,730)**	**(13,027)**	**(4.8)**	**(4.1)**
2. Decentralized sector subtotal	**12,742**	**9,915**	**4.5**	**3.1**
Electrical power	359	483	0.1	0.2
Emcali (Cali Public Utilities Co.)	161	(54)	0.1	(0.0)
EPM (Medellín Public Utilities Co.)	193	150	0.1	0.0
FAEP (Oil Stabilization Fund)	637	1,221	0.2	0.4
Ecopetrol	1,134	2,217	0.4	0.7
Other agencies	2,261	851	0.8	0.3
Social Security	5,844	3,747	2.1	1.2
Regional and local	2,153	1,300	0.8	0.4
B. Banco de la República quasifiscal balance	669	1,440	0.2	0.5
C. Fogafin balance	610	772	0.2	0.2
D. Financial restructuring costs	(1,233)	(1,137)	(0.4)	(0.4)
E. Adjustments	919	(671)	0.3	(0.2)
F. Total consolidated public sector (A + B + C + D + E)	**(23)**	**(2,708)**	**(0.0)**	**(0.9)**

Note: Deficit (-) or surplus (+).
(pr) Preliminary.
Source: Fiscal Policy Board (CONFIS).

associated with highway construction and the development of mass transit systems in the cities of Barranquilla, Cali and Pereira.

Financing the central government deficit in 2006, including the cost of restructuring the financial system, came to C$14.164 b (4.4 % of GDP). The net external debt was Col$5,400 b, given Col$10,090 b. in disbursements and Col$4,690 b. in amortization. The net domestic debt was Col $7,370 b., including Col$22,890 b. in disbursements and Col$15,520 b. in amortization. With Col$22,486 b. in gross placements, TES B is most important instrument for domestic government borrowing; this amount includes Col$8,606 b. placed through auctions. Banco de la República transferred Col$793 b. in profits from its operations.

Financing during the course of 2006 reduced the balance outstanding on the central government's debt from 49.5% of GDP in 2005 to 47.3% of GDP in 2006. This is attributed to the domestic component; its balance outstanding went from 32.8 % of GDP in 2005 to 30.8% in 2006.[19]

Financing the central government deficit in 2006, including the cost of restructuring the financial system, came to C$14.164 b (4.4 % of GDP).

[19] These calculations were made by Banco de la Republica.

NATIONAL GOVERNMENT: FISCAL BALANCE
2005-2006
(BILLIONS OF PESOS)

	2005	2006 (pr)	Annual Growth 2005-2006
I. Total income (A + B + C + D + E)	**45,924**	**56,347**	**22.7**
A. Taxes	42,288	51,221	21.1
Income	17,349	21,354	23.1
Domestic VAT	11,412	12,876	12.8
External VAT	6,016	8,180	36.0
Duty	2,823	3,651	29.3
Gasoline tax	1,143	1,187	3.8
Financial transaction tax	2,401	2,672	11.3
Wealth tax	463	523	13.0
Others	681	778	14.2
B. Non-tax revenue	229	254	10.9
C. Special funds	472	577	22.2
D. Capital resources	2,812	4,232	50.5
Financial returns	593	977	64.8
Financial surplus	1,773	3,066	72.9
Others	446	189	(57.6)
E. Accrued earnings	123	63	(48.8)
II. Total expenditure (A + B + C + D + E)	**59,654**	**69,374**	**16.3**
A. Interest	9,857	13,331	35.2
External	4,268	3,974	(6.9)
Domestic	5,589	9,357	67.4
B. Operational expenses [a/]	44,514	49,097	10.3
Personal services	7,077	8,046	13.7
General expenses	2,880	3,460	20.1
Transfers	34,557	37,591	8.8
C. Investment	4,274	5,898	38.0
D. Net loan	372	412	10.8
E. Accrued payments	637	636	(0.2)
III. Deficit (-) or surplus (+) (I - II) [b/]	**(13,730)**	**(13,027)**	**(5.1)**
Financial restructuring cost	**1,233**	**1,137**	**(7.8)**
IV. Financing (A + B + C + D)	**(14,963)**	**(14,164)**	**(5.3)**
A. Net external credit	(1,079)	5,400	(600.5)
Disbursements	7,059	10,090	42.9
Amortization	8,138	4,690	(42.4)
B. Net domestic credit	17,410	7,370	(57.7)
Disbursements	26,832	22,890	(14.7)
Amortization	9,422	15,520	64.7
C. Banco de la República profits	454	793	74.7
D. Others	(1,822)	601	(133.0)
V. Deficit as a percentage of GDP	**(4.8)**	**(4.1)**	

(pr) Preliminary.
a/ Includes payments and floating debt.
b/ Does not include the cost of restructuring the financial system.
Source: CONFIS.

B. Financial Plan for 2007

Given the increase in national tax revenue during the first two months of the year, the government decided to lower the deficit target to 0.9% of GDP.

The deficit target approved by the Fiscal Policy Board (CONFIS) in February for the consolidated public sector is equivalent to 1.3% of GDP.[20] However, given the increase in national tax revenue during the first two months of the year, the government decided to lower that target to 0.9% of GDP. With the latest adjustments, the projected deficit in central government finances comes to 3.5%, which would be offset in part by a surplus in the decentralized sector equivalent to 2.2% of GDP. The cost of restructuring the financial sector will come to 0.3% of GDP and, according to the latest estimates, the finances of Banco de la República and Fogafin are expected to show respective surpluses equal to 0.5% and 0.2% of GDP. Given financial performance in 2006, no increase in the public deficit as a percentage of GDP is expected, despite a less favorable financial forecast for Ecopetrol, the public sector at regional and local level, and several national agencies and companies (Table 25).

According to official projections, central government finances will include 13.7% more earnings and 9.7% more expenses. The momentum in tax revenue will

[20] The 2007 Financial Plan was presented as part of CONFIS Advisory Document No. 02 dated February 9, 2007.

Table 25

Consolidated Public Sector: Fiscal Balance, 2006-2007

Item	Billions of Pesos		Percentage of GDP	
	2006	2007 (proj)	2006	2007 (proj)
A. Total non-financial public sector (NFPS) (1 + 2)	**(3,112)**	**(4,431)**	**(1.0)**	**(1.3)**
1. National government	**(13,027)**	**(12,026)**	**(4.1)**	**(3.5)**
2. Decentralized sector subtotal	**9,915**	**7,595**	**3.1**	**2.2**
Electrical power	483	360	0.2	0.1
Emcali (Cali Public Utility Co.)	(54)	453	(0.0)	0.1
EPM (Medellín Public Utility Co.)	150	(94)	0.0	(0.0)
FAEP (Oil Stabilization Fund)	1,221	231	0.4	0.1
Ecopetrol	2,217	(1,283)	0.7	(0.4)
Other agencies	851	120	0.3	0.0
Social security	3,747	6,634	1.2	1.9
Regional and local	1,300	1,174	0.4	0.3
B. Banco de la República quasifiscal balance	1,440	1,588	0.5	0.5
C. Fogafin balance	772	781	0.2	0.2
D. Financial restructuring cost	(1,192)	(1,120)	(0.4)	(0.3)
E. Adjustments	(616)	0	(0.2)	0.0
F. Total consolidated public sector (A + B + C + D + E)	**(2,708)**	**(3,182)**	**(0.9)**	**(0.9)**

Note: deficit (-) or surplus (+).
(proj) Projection
Source: Fiscal Policy Board (CONFIS).

be less dynamic than in 2006, particularly in the case of income tax, customs duties and VAT revenue, with respective increases of 9.3%. 11.9% and 10.2%. However, an important increase in revenue is expected from domestic VAT (16.1%), the gasoline tax (12.9%) and particularly the wealth tax (290%). The trend in the wealth tax reflects the legislative adjustments introduced through the 2006 tax reform, which raised the rate from 0.3% a 1.2%. As part of capital resources, financial surpluses will be up by 18.8%, thanks to profits transferred by Ecopetrol, which are expected to increase from Col$2,000 b. in 2006 to Col$3,100 b. 2007.

Transfers from the national treasury for pensions to be paid by the Social Security Institute (ISS, initials in Spanish) will come to slightly more than Col$5,000 b. in 2007.

In terms of expenditure, the central government expects its interest payments increase by 4.9%, operating costs by 9.6% and investment by 20.4%. As to operating costs, personal services will be up by 11.8% and transfers, by 10.1%. Transfers in connection with the General System of Resource Allocation will increase by 7.8% and pension spending, by 11.2%. It is important to point out that transfers from the National Treasury for pensions to be paid by the Social Security Institute (ISS, initials in Spanish) will come to slightly more than Col$5,000 b. in 2007. As to investment, there will be projects for highway facilities, to assist victims of violence, and to expand the capacity of the country's prison system.

The central government's deficit will be financed with resources from domestic and foreign borrowing, privatization and the National Treasury. Net foreign credit will come to Col$4,377 b., because of Col$6,975 b. in disbursements and Col$2,598 b. in amortization. There will be Col$231 b. in net domestic credit, with Col$17,163 b. in disbursements and Col$16,932 b. in amortization.[21] The resources from privatization (estimated at Col$6,592 b.) originate largely with the sale of Granbanco and Ecogas. Banco de la República will transfer an estimated Col$1,186 b. in profits.

As mentioned, official calculations indicate the decentralized public sector will see less of a fiscal surplus in 2007, mainly because of the situation with Ecopetrol, the public sector at regional and local level, and several national companies and institutions. Of particular interest is the change in Ecopetrol's fiscal balance from a surplus equal to 0.7% of GDP in 2006 to a deficit of 0.4% of GDP in 2007. Much of this situation is due to the increase in dividends transferred to the nation and higher payments for gross capital formation in exploration and oil field development projects. As to territorial finances, there is expected to be less of a surplus because of investment payments to be made during the final year of local administrations.

The central government's deficit will be financed with resources from domestic and foreign borrowing, privatization and the National Treasury.

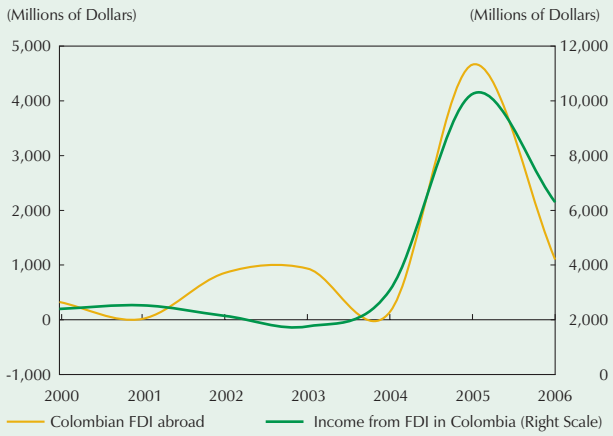
[21] The figures are provisional and consistent with the anticipated reduction in the public sector 's deficit from 1.3% to 0.9% of GDP. The 2007 financial plan to be released in June will contain the definite figures.

Foreign Direct Investment during 2006

Foreign direct investment continued to account for be a sizeable influx of capital into the Colombian economy. These flows totaled US$6,295 m. in 2006, which is more than in past years, with the exception of 2005. That year, foreign direct investment came to US$10,255 m. with the sale of Bavaria, which represented 3.3% of GDP. The outflow of capital for Colombian direct investment in other countries continued to increase compared to the early part of this decade. A total of US$1,100 m. (0.8% of GDP) was invested outside the country in 2006 (Graph B5.1).

In the international context, estimates indicate that Latin America and the Caribbean continued to be major recipients of FDI throughout 2006 (Graph B5.2), owing to the purchase of domestic company assets by foreigners.[1] The entry of foreign investors into the region is motivated by several factors; namely, i) natural resources, ii) growth and development of local markets, and iii) access to third markets. In the case of Colombia, income from FDI is focused on: i) tapping natural resources such as oil, coal, gold and ferronickel, ii) taking advantage of local markets associated with communication and data processing, public utilities, the financial system and manufacturing, and iii) the search for third markets, encouraging international marketing firms and companies that export agricultural and manufactured products.

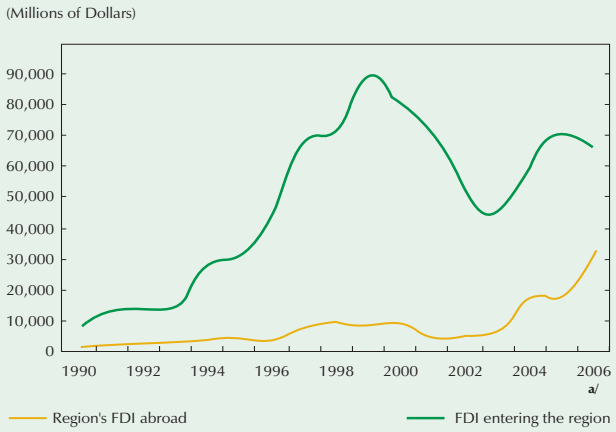
Graph B5.1
Foreign Direct Investment in Colombia



Source: Banco de la República.

[1] Taken from "Preliminary Overview of the Economies of Latin America and the Caribbean," ECLAC, 2006.

Graph B5.2
Foreign Investment in Latin America and the Caribbean



a/ Estimates for 2006.
Source: Graph taken from "Preliminary Overview of the Economies of Latin America and the Caribbean," ECLAC (2006) and edited.

1. Foreign Direct Investment in Colombia during 2006

Foreign direct investments in the Colombian economy came to US$6.295 m. in 2006, or 4.7% of PIB. This far exceeds the average for the last ten years (3.6% of GDP) and even for 2005 (4.2% of GDP), provided the sale of the Bavaria brewery to foreign investors is not included in the calculation. It accounted for 44% of all FDI that year (Table B5).

Table B5
Flow of Foreign Investment in Colombia by Economic Activity
(Millions of dollars)

	2005 (pr)	2006 (pr)	Absolute Variation	Share (%)
1. Direct investment in Colombia, by economic activity	10,255	6,295	(3,960)	100.0
a. Oil sector	1,125	1,770	645	28.1
b. Other sectors	9,130	4,525	(4,605)	71.9
Agriculture, hunting, forestry & fishing	6	33	27	0.5
Mines and quarries	2,157	2,010	(147)	31.9
Manufactured goods	5,532	670	(4,862)	10.6
Electricity, gas & water	(251)	(111)	140	(1.8)
Construction	146	182	36	2.9
Commerce, restaurants & hotels	303	532	229	8.5
Transport, storage & communications	1,011	789	(222)	12.5
Financial institutions	244	404	160	6.4
Community services	(18)	17	35	0.3

(pr) Preliminary.
Source: Banco de la República.

The influx of foreign capital in 2006 was distributed as follows.

- Coal mining absorbed 32% (US$2,010 m.) of all direct investment, which is 6.8% less than a year earlier. For the most part, these investments are being used to expand installed capacity at several coal mining complexes and to purchase the Bogotá-Cienaga railroad concession. As to the type of investment, 59% was in foreign exchange and the other 41% in kind (machinery and equipment).

- International investors sunk US$1,770 m. into the petroleum sector, accounting for 28% of all investments in 2006. This was US$645 m. (57.3%) more in comparison to the amount registered in 2005. Most of these resources entered the country as foreign exchange and were used for new oil field exploration, crude production and export, and to meet local expenses, such as taxes, payrolls and the like.

- Transport, storage and communications received 13% of foreign direct investment (US$789 m), largely through the sale of Telecom and a local mobile telephone company.

- Manufacturing received US$670 m. (11% of all FDI) to finance projects associated with machine tool engineering, food and beverages, and the manufacture of chemical substances and fertilizers.

- Most of the remainder (US$1.056 m. - 16.8%) went to commercial activities (US$532 m), the financial system (US$404 m) and construction (US$182 m). The construction sector received an important influx of capital for housing purchased by non-residents and from several international companies with infrastructure projects in Colombia.

On a country basis, direct foreign investment in 2006 originated largely in the United Status (48%), Spain (19%), Panama (8%), England (6%) and Venezuela (2.5%).

2. Colombian Direct Investment in Other Countries

Colombian direct investment in other countries during 2006 totaled US$1,098 m. (0.8% of GDP) and was used primarily to consolidate business in the industrial sector (cement factories), electricity, commerce and the financial system. Colombian direct investments abroad would have been similar to those in 2005 had the former owners of Barvaria not received stock in companies outside Colombia (valued at nearly US$3.500 m.) in exchange for their interest in Bavaria.

The Fiscal Policy and Economic Cycle in Colombia

Domestic and international evidence shows there is a close relationship between public finances and the economic cycle. When economies grow at a fast pace, tax revenues increase more than spending and governments register positive fiscal accounts. In this sense, economic prosperity, which is reflected in more production and employment, increased business sales and profits, and higher rates of investment and consumption, has a positive impact on the fiscal balance. The opposite usually occurs during periods of economic recession or depression, when the drop in economic activity and tax revenue translates into large government deficits. This being case, a fraction of a country's fiscal balance is due to the economic cycle (known as the cyclical component of the fiscal balance) and, consequently, is beyond the realm of discretional fiscal-policy management.

The evidence also shows that tax authorities are not neutral when it comes to the cycle; they make policy decisions that can accentuate and/or offset it. The possibility of tempering the cycle is a vitally important issue in this regard, since one of the basic functions of fiscal policy is to help stabilize fluctuations in output. This is accomplished through what are known as anticyclical fiscal policies. In other words, during a recession, governments can apply an expansive fiscal policy to stimulate aggregate demand and production. The fiscal deficit resulting from this action could be financed with new borrowing, which hopefully would be reduced as the economy begins to grow. An anticyclical fiscal policy also has advantages during an economic boom, when a restrictive fiscal position helps to keep the economy from overheating and to avoid upward pressure on inflation and interest rates.

One way fiscal variables can temper the economic cycle is through what are known as automatic stabilizers. These are defined as a set of fiscal earnings and expenses that are closely related to the cycle and, because of their nature, react automatically to it by stimulating economic activity during a recession and curbing it during an expansionary phase. The effectiveness of automatic stabilizers depends largely on the structure of public revenue (direct versus indirect taxation) and on certain factors the authorities cannot control, such as openness of the economy. Credit restrictions, the quality of fiscal rules and institutions, corruption and the so-called "voracity effect" also influence the scope of this self-regulatory instrument.

Another way to create an anticyclical policy is through autonomous public spending. With this alternative, a fraction of government spending reflects discretional fiscal policy. Therefore, it can help to expand or offset the cycle. However, evidence shows this is a

more limited mechanism, given the narrow maneuverability margin governments have when it comes to appropriations, especially in countries with a great deal of budget rigidity.

The anticyclicity, acyclicity and procyclicity of fiscal policy have been studied on a number of occasions for the high-income economies (i.e. those of the Organization for Economic Cooperation and Development —OECD—) and for emerging economies as well (middle and low-income countries).[1] The evidence is particularly conclusive for the emerging economies, including Colombia. It shows fiscal policy in those countries has been procyclical in nature, which implies a predominance of restrictive stances in the recession phase and expansive stances in the boom periods, thereby deepening the cycles.

Techniques used in other countries were employed to determine the relationship between public finances and the economic cycle in Colombia. We began by calculating the cyclical component of the fiscal balance reported by the national government in the last few years. The exercise was applied to CG fiscal accounts, given the availability of data and because they are the most representative of the consolidated public sector.[2] Finding that cyclical component, gives us the cyclically adjusted fiscal balance, or the structural component. Secondly, the stance adopted by fiscal authorities with respect to the cycles observed in the economy during recent decades is evaluated to determine if their policy decisions helped to stabilize the fluctuations in output.

1. Impact of the Cycle on the Fiscal Balance

Deviations of GDP from its potential level are used to calculate the cyclical and structural components of the fiscal balance. These deviations are commonly known as the output gap (see the gap in Panel A, Graph B6.1). The procedure is simple. The method suggested by Blanchard and Perotti (1999) is used initially to estimate the elasticity of primary government revenue (income tax, VAT and import duties) to the output gap.[3] This exercise also is applied to the spending items presumed to be most sensitive to the cycle, although payments are usually more rigid in nature. The elasticities are then used to adjust collections and spending according to the cycle. The result is the cyclically adjusted fiscal balance (or the structural component of

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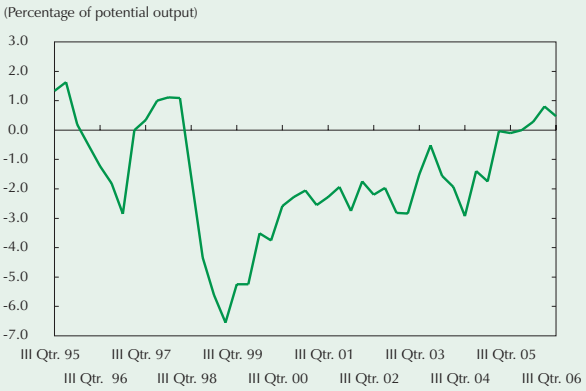
1 See the studies by Manesse (2006); Alesina and Tabellini (2005); Kaminsky, Reinhart and Végh (2004); Braun (2001); Talvi and Végh (2000); Arreza et al.. (1999); Gavin and Perotti (1997), among others.

2 For example, with respect to collections, the tax burden in Colombia (excluding contributions to social security and payroll taxes) was 20% of GDP in 2006. Of this amount, the central government collected 16.5% of GDP (83% of the total); the rest was collected by sub-national administrations. The nation collected 15.1% of GDP through income tax, VAT and import duties.

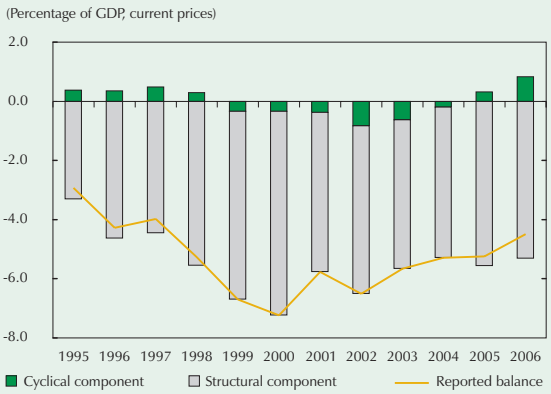
3 According to Blanchard and Perotti, the elasticity of total tax revenue $\eta_{T,Y}$ is given by $\eta_{T,Y} = \sum_{i=1}^{n} \eta_{T_i,B_i} * \eta_{B_i,Y} * \frac{T_i}{T}$; where $\eta_{T_i B_i}$ reflects the elasticity of tax i to its tax base, and $\eta_{B_i Y}$ represents the elasticity of the respective base to GDP; furthermore,

Graph B6.1
Colombia: GDP Gap and Cyclical and Structural Fiscal Balances of the National Government: 1995-2006

A. GDP Gap



B. Total Balance



C. Primary Balance

Source: (A) Banco de la República, (B) and (C) Lozano and Toro (2007).

the fiscal balance). See Lozano and Toro (2007) for details on the application of this method and a description of the results in the study; the principal findings of the present work are found in Graph B6.1, Panels B and C.

The basic conclusion derived from Graph B6.1 is that the cyclical component of the government's deficit during the preceding decade is relatively small, while the structural component is

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$T = \sum_i T_i$. The estimates for Colombia show $\eta_{T,Y}$ = 1.47 (See Lozano and Toro, 2007). This amount of elasticity is within international standards. It is 1.3 for the OECD countries, 1.5 for the countries in the euro area, and 1.1 for the new member countries of the European Union (see Girouard and, 2005).

predominant. As a matter of fact, the average for the sample in question shows that less than 10% of the value of the total deficit can be attributed to the cycle (see the dark areas of the bars in Panel B). Therefore, the government's deficit since the mid-nineties is fundamentally structural. This explains the effort by authorities to secure reforms of this nature (structural) in taxes, transfers to regional governments, pensions, state reforms, etc.

A closer look at the results shows some interesting details. For example, based on the total balance (Panel B), the national government registered an average deficit equivalent to -6.4% of GDP during the crisis phase and recovery (1999-2003); that is, when economic growth was below its potential. A portion of that amount, specifically -0.5% of GDP (or 8% of the value of the deficit), was due to poor economic performance.

In contrast, the rate of economic growth in 2006 was above its potential. This had a positive influence on the central government's fiscal balance. The deficit that year came to -4.5% of GDP; +0.8% pertained to the cyclical component. The sign for the cyclical component is opposite that of the deficit, reflecting the benefits of growth for the fiscal balance. According to these results, if the economy in 2006 had grown at its potential rate, the national government's deficit would have been 5.3% of GDP (not 4.5%) and the primary balance would have been around -1% of GDP (Panel C).

2. How procyclical is fiscal policy in Colombia?

There have been a number of studies done in Colombia to evaluate the government's fiscal stance when faced with a growth cycle. For example, Lozano and Aristizabal (2003) found that fiscal policy was procyclical between 1991 and 2002 (various definitions of fiscal impulses were used as a method of analysis). Cárdenas *et al*. (2006) reached the same conclusion with respect to a longer period (1981-2005). A more recent study by Lozano and Toro (2007) confirms that fiscal policy in Colombia has been clearly cyclical during the last four decades (since 1960). The study by Lozano and Toro uses a different technique than fiscal impulses, which is a technique linked closely to the intertemporal budget constraint.[4] According to their findings, for each percentage point increase in the GDP gap (i.e. increase in actual growth compared to potential growth), the primary surplus in terms of GDP drops by one-fifth (in other words, the fiscal deficit increases). This finding not only corroborates the earlier findings for the Colombian

[4] The results are obtained by estimating the $S_t = a_0 + a_1 Gap_{t-1} + a_2 Debt_{t-1} + a_3 S_{t-1} + u_t$; where S_t is the primary surplus in period t (in percentages of GDP) and Gap_{t-1} is the GDP gap in the preceding period. This regression is controlled by the debt-GDP ratio *(Debt)* and the delayed dependent variable. According to Alesina and Tabellini (2005), Manesse (2006) and other experts, $a1 < 0$ is evidenced of a procyclical fiscal policy. The study cited for Colombia found that $a1 = -0.2$.

case, but also the international consensus on the procyclicity of fiscal policy in emerging countries.

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The Public Debt and Macroeconomic Stability

The level and composition of public spending and the way it is financed, with taxes and/or borrowing, are crucial to economic growth and macroeconomic stability. The latter is affected predominately by the size and sustainability of the public debt, given its impact on investor confidence (some of these aspects are analyzed in this section).

Literature recognizes that government income and spending can affect economic growth through a variety of channels. On the one hand, there are the distortions taxes exert on agents' decisions concerning savings and investment. However, there is no hard international evidence as to the real impact of this channel. On the other hand, the economic growth theory emphasizes the government can boost productive activity by spending on investment in physical and human capital. For example, more spending on education, health, infrastructure, research and development is a long-term growth incentive.[1] In turn, more growth builds the resources the country will have in the future to finance spending on human capital, thereby generating virtuous circles in the economy. Besides their effect on growth, taxes and public spending can have a positive impact on society's development and well being, since the reallocation of resources and social investment make it possible to redistribute wealth more equitably and to reduce poverty.

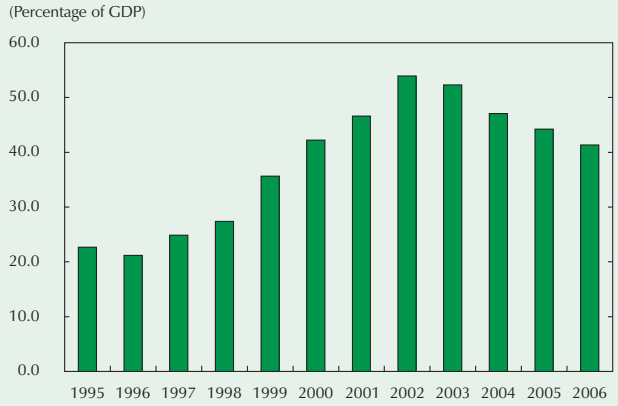
Financing healthy public spending involves more than public finances; it also involves macroeconomic stability. Experts acknowledge that increased public spending can displace private investment, if it is financed largely through borrowing. Government pressure to borrow resources on the domestic market pushes up interest rates. On international markets, the larger loan agreements tend to revaluate the exchange rate. Therefore, to lessen possible market risks and to avoid further harmful effects on the economy, healthy financing for public spending (with taxes) is preferable, as is a low level of indebtedness.

The public sector in Colombia has borrowed less in recent years (Graph B7.1). After exceeding 50% of GDP in 2002 and 2003, the public debt declined to around 40% of GDP in 2006. This is explained by a fiscal adjustment process initiated at the start of the current decade, coupled with the improvement in domestic and external economic conditions, and positive economic performance. There also has been a shift in the source of resources between the external and

[1] See, for example, David E. Bloom, David Canning and Jaypee Sevilla (2001) "The Effect of Health on Economic Growth: Theory and Evidence," Working Document, *NBER*. No. 8587; Steve Dowrick (2003) "Ideas and Education: Level or Growth Effects?," *NBER*, No. 9709; David Canning (1999) "Infrastructure's Contribution to Aggregate Output". *Policy Research*. Working document series, World Bank.

Graph B7.1
The Colombian Public Debt

A. Public Debt Levels a/



B. Composition b/

a/ The non-financial public sector (NFPS) net debt in intrapublic domestic liabilities (bonds and promissory notes).
b/ NFPS gross debt.
Source: Banco de la República.

domestic market. Today, more than one-third of the debt is contracted outside the country and two-thirds, domestically.

Although this shift makes the public sector less vulnerable to external shocks and exchange crisis, it does leave the financial system more exposed to market risks. These occur when an unexpected change in interest rates on public debt securities devalues the equity of financial institutions, making a crisis more likely. Such was the case in Brazil at the end of the nineties, when the hike in external rates, due to the Asian crisis, eliminated the incentive that had attracted foreign capital to the Brazilian market. Coupled with the drop on the major international

stock markets, this prompted foreign investors to cash in what they had earned on domestic market in Brazil. Given the sharp demand for dollars and the immediate reduction in liquidity, the Central Bank of Brazil raised interest rates, increasing the domestic public debt burden on the fiscal accounts. This spelled major losses for many institutional investors.[2]

Expert analysts agree that a low public debt is more sustainable and contributes to an environment of economic stability; it also helps to consolidate the financial system by lowering risk premiums, which means lower interest rates. In contrast, a high debt level increases the perception of risk on the part of investors, thereby stimulating capital flight "towards quality". The departure of capital leads to depreciation in the exchange rate, which eventually is passed through to prices for tradable goods, raising inflation. This creates a vicious circle that affects macroeconomic stability and influences the actions taken by monetary authorities.[3] Therefore, an adequate level of public borrowing and proper debt management are essential to making the nation's finances sustainable and to encouraging development of the domestic financial market, all of which offers low-cost and low-risk benefits in return.

With respect to this point, public finances in Colombia during the last few years undoubtedly have moved in the right direction. Nevertheless, some important challenges remain to be addressed if the medium and long-term sustainability of the country's finances is to be consolidated. According to a recent study conducted by Banco de la República for the central government, the downturn observed in the debt ratio during the last few years could turn around in 2008, requiring an additional effort in terms of the primary balance.[4, 5]

The level of external debt warrants special mention. There is international evidence to the effect that countries obtain benefits for growth and investment up to a certain level of external borrowing. Beyond that threshold, the impact is adverse. A 2003 study on 55 low-income countries[6] shows the external debt begins to have a negative effect on growth and investment when it exceeds 50% of GDP. As shown in Graph B7.2, the Colombian external debt is below that threshold and its trend in recent years has been downward. A good

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2 United Nations (1998) "Impacto de la crisis asiática en América Latina".

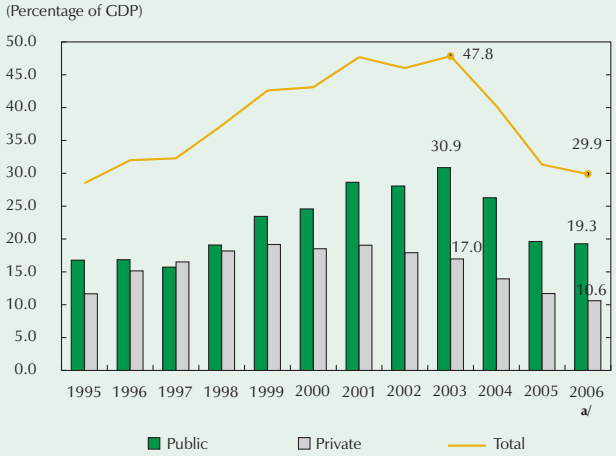
3 Adriana Nieto (2006) "Endeudamiento *vs*. *spreads*: inflación objetivo en Colombia ¿susceptible a la dependencia fiscal?," Master's Dissertation, School of Economics, Universidad de los Andes. Bogotá.

4 Grupo Macroeconomía 2006 (2006) "La economía colombiana: situación actual frente a los noventa y sus perspectivas," *Borradores de Economía*, Banco de la República. No. 429.

5 The central government is not the same as the consolidated public sector, inasmuch as public-sector companies are not included in the fiscal balance.

6 Benedict Clements, Rina Bhattacharya and Toan Quoc Nguyen (2003). "External Debt. Public Investment and Growth in Low-Income Countries," Working Document No. WP/03/249.

Graph B7.2
External Debt Composition



a/ Figures at November 2006.
Source: Banco de la República.

measure of the reduction in foreign borrowing is due to the fact that the national government has replaced some of the external debt with domestic credit, and particularly to revaluation of the exchange rate.

According to the study just mentioned, there is a displacement effect between debt service and public investment, although the relation is not linear. An increase in debt service equal to 1% of GDP lowers public investment by 0.2% of GDP; if debt service declines by 6% of GDP, public investment increases by as much as 0.75% to 1% of GDP. This boosts per capita economic growth by about 0.2%. As noted earlier, public investment is crucial and debt service can have a negative impact on growth.

Analyzed from another perspective, we see that a moderate fiscal deficit reduces vulnerability to external shocks and adds to the possibility of responding with anticyclical policies to soften the fluctuations in output and to deal with unemployment. In crisis situations, fiscal revenue usually declines and there is more pressure to boost spending in an effort to help the economy recover. Countries that are able to maintain healthy public finances under normal conditions can respond with anticyclical policies during a recession, because an increase in their deficit does not necessarily mean a loss of market credibility or an unsustainable debt. However, countries with high deficits will not have as much maneuverability, and will be forced to make larger adjustments, which will aggravate the crisis. The evidence for the developing countries shows they are more affected by external shocks, which eventually jeopardize their public finances. Moreover, the nature of their fiscal policies has been procyclical.

Therefore, healthy fiscal accounts and greater transparency in the use of public resources give the private sector a more stable environment. This, in turn, alleviates uncertainty about the profitability of its investments. It also bolsters the monetary authority's credibility and reinforces the country's image at home and abroad. The resulting benefits include access to credit and incentives to foreign direct investment. Fiscal policy announcements and decisions are decisive to the formation of expectations, which are crucial to the results of a policy. If the market has doubts about the government's ability to generate the primary surpluses required for long-term sustainability of the debt, the risk premium on government bonds increases, making them more difficult to manage. This is why the government must deal with market expectations through coherent announcements and actions that give the market confidence.

VIII. International Reserves

Banco de la República's strategy to accumulate international reserves recognizes the importance of having enough international liquidity to deal with external shocks, which can originate with trade shocks, financial panic and contagion.

A. External Vulnerability Indicators

Our analysis of external vulnerability indicators for the Colombian economy centers on those associated with the level and short-term cash flow of external debt stock. If the economy generates enough income to accommodate debt service and to finance the current account deficit, it will have no solvency problems in the future. This is why the indicators are constructed in terms of the country's international reserves. Depending on a country's characteristics, international markets generally regard an indicator below one as a warning sign of external vulnerability.

Banco de la República's strategy to accumulate international reserves recognizes the importance of having enough international liquidity to deal with external shocks, which can originate with trade shocks, financial panic, contagion or generally any event that causes investors to overreact and leads to a quick turnaround in capital flows. Table 26 shows the various indicators of net international reserves (NIR) for Colombia during 2002-2006. Those in groups A and B improved considerably with respect to amortization and external liquidity in 2006. However, by the end of that year, some were still near 1 (i.e. NIR/current-year debt service; NIR/current year debt amortization + current year current account deficit).

However, some indicators are near 1, which could be a warning sign of external vulnerability.

As illustrated in the third section of Table 26, reserves have stayed above seven months of imports, a level that exceeds international standards for this indicator. However, despite the increase in the balance of international

TABLE 26

INTERNATIONAL RESERVE INDICATORS FOR COLOMBIA

	2002	2003	2004	2005	2006 (e)
Balance					
Net international reserves (US$ millions)	10,841	10,916	13,536	14,947	15,435
Indicators					
A. External Debt Amortization Indicator					
External debt amortization (US$ millions)	10,146	10,173	8,918	13,325	13,426
Net reserves/current year external debt amortization	1.07	1.07	1.52	1.12	1.15
Net reserves /next year external debt amortization	1.07	1.22	1.02	1.11	1.57
B. Adequate External Liquidity Position					
NIR/current year debt service	0.86	0.87	1.19	0.92	0.95
NIR/next year debt service	0.86	0.96	0.83	0.92	1.22
NIR/(current year debt amortization + current year current account deficit)	0.94	0.98	1.38	0.98	0.95
NIR/(next year debt amortization + next year current account deficit)	0.97	1.11	0.89	0.92	1.04
C. Other Indicators of International Reserves					
NIR as months of goods imports	10.77	9.88	10.23	8.91	7.45
NIR/M3 (percentage)	41.85	36.47	33.31	30.33	30.95
NIR/GDP	13.36	13.74	13.80	12.14	11.44

(e) Estimate.
Source: Banco de la República.

reserves, the amount with respect to GDP in dollars has not grown. And, with respect to the amount of deposits in the financial system, the level similar is to what it was in 2005.

B. CURRENT INTERNATIONAL RESERVES AND MANAGEMENT CRITERIA

Colombia had US$15,435.5 b. in net international reserves at December 2006, which is US$488.2 b. more than the balance reported at December 2005. The increase was due to US$817.8 m. in returns on investments.

Colombia had US$15,435.5 b. in net international reserves at December 2006, which is US$488.2 b. more than reported in December 2005.[22] The increase was due to US$817.8 m. in returns on investments. These offset US$163.8 m. in net sales of reserves by the Bank, through intervention in the exchange market, US$129.7 m less in the government's dollar accounts with the Bank, and US$36 m. in other own operations (primarily drafts for imports) As mentioned in Chapter IV, the Bank purchased US$1,196.7 m.

[22] Net reserves equal total international reserves or gross reserves, minus Banco de la República's external short-term liabilities. The latter are comprised of sight liabilities in foreign currency with non-resident agents. Unless stated otherwise, all the figures in this report pertain to the end of December 2006 and are provisional. They have been rounded off and may not coincide.

in reserves during this period, through discretional intervention, and sold US$1,000 m. in foreign exchange to the government. It also purchased US$583.8 m. in foreign exchange and sold US$944.3 m. through options to control volatility.

Most of the country's international reserves are comprised of the so-called investment tranche, which accounts for 92.3% of the total (US$14,249.3 m) (Table 27). The investment tranche includes resources invested in highly liquid financial assets that are tradable on the secondary market. Banco de la República manages a portion (direct portfolio); the rest is administered by specialized firms outside the country (managed portfolio). The direct portfolio has two components: working capital, which is the most liquid portion of the reserves,

TABLE 27

COMPOSITION OF INTERNATIONAL RESERVES

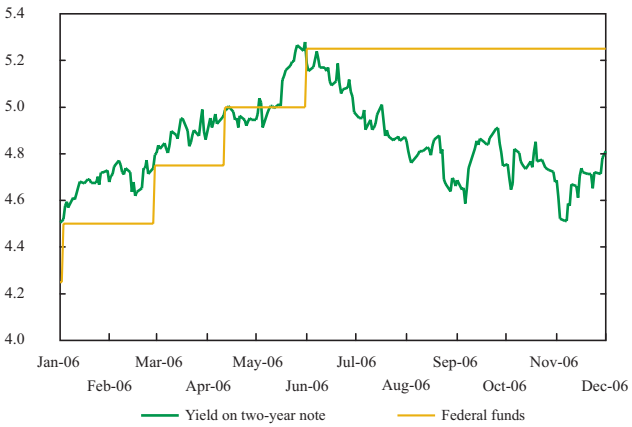
Description	Dec-05		Jun-06		Dec-06	
	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage
Cash	**179.9**	**1.2**	**3.0**	**0.0**	**2.7**	**0.0**
Cash on hand	2.8	0.0	2.5	0.0	2.1	0.0
Demand deposits	177.1	1.2	0.5	0.0	0.6	0.0
Investments	**13,603.9**	**91.0**	**13,345.4**	**92.3**	**14,249.3**	**92.3**
Direct portfolio	6,499.1	43.5	6,088.6	42.1	6,795.0	44.0
Investment portfolio	5,037.3		5,221.6		5,974.6	
Working capital	1,461.9		867.0		820.4	
Portfolio under management	7,104.7	47.5	7,256.9	50.2	7,454.3	48.3
Gold	**167.6**	**1.1**	**133.3**	**0.9**	**141.0**	**0.9**
On hand	0.0	0.0	0.0	0.0	0.0	0.0
Under custody	167.6	1.1	133.3	0.9	141.0	0.9
International Monetary Fund	**583.5**	**3.9**	**609.3**	**4.2**	**626.8**	**4.1**
SDR	175.0	1.2	186.5	1.3	196.8	1.3
Reserve position	408.5	2.7	422.8	2.9	430.0	2.8
Latin American Reserve Fund	**342.2**	**2.3**	**351.2**	**2.4**	**351.2**	**2.3**
Contributions	322.2	2.2	331.2	2.3	331.2	2.1
Andean pesos	20.0	0.1	20.0	0.1	20.0	0.1
International agreements	**79.6**	**0.5**	**22.8**	**0.2**	**69.5**	**0.4**
Total gross reserves	**14,956.6**	**100.1**	**14,465.0**	**100.0**	**15,440.4**	**100.0**
Short-term liabilities	**9.3**	**0.1**	**3.8**	**0.0**	**4.7**	**0.0**
International agreements	0.0	0.0	0.0	0.0	0.0	0.0
Overseas banks	0.0	0.0	0.0	0.0	0.0	0.0
Latin American Reserve Fund	0.0	0.0	0.0	0.0	0.0	0.0
Securities payable, purchase investment	0.0	0.0	0.0	0.0	0.0	0.0
Accrued interest on liabilities	9.3	0.1	3.8	0.0	4.7	0.0
Total net reserves	**14,947.3**	**100.0**	**14,461.2**	**100.0**	**15,435.7**	**100.0**

Source: Banco de la República.

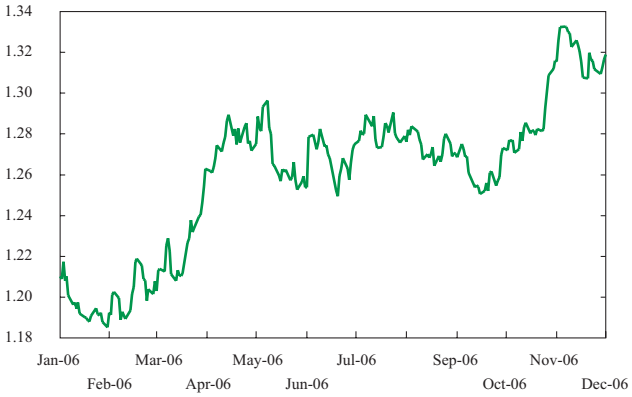
GRAPH 35

CHANGES IN US TREASURY INTEREST AND THE DOLLAR AGAINST THE YEN AND THE EURO

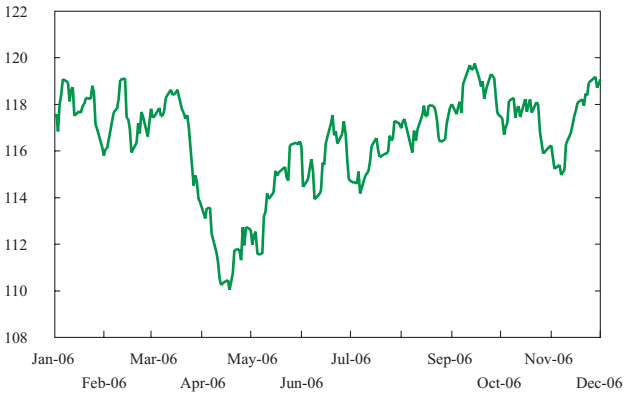
A. CHANGES IN THE RATE OF RETURN ON TWO-YEAR TREASURY NOTES AND US FEDERAL FUNDS. 2006 a/



B. EURO AGAINST THE DOLLAR. 2006 b/



C. YEN AGAINST THE DOLLAR. 2006 c/



a/ The inverse ratio between price and rate of return means the price of a fixed-income asset declines as the coupon rate increases.
b/ The direct euro/dollar quotation means the euro loses value as it approaches zero.
c/ The inverse dollar/yen quotation means the yen loses value as it moves away from zero.
Source: Bloomberg LP.

and the investment portfolio. The remainder includes: i) the reserve position with the International Monetary Fund and the Latin American Reserve Fund (US$761.2 m); ii) special drawing rights (SDR) ($196.8 m.); iii) gold, Andean pesos, and positive balances under international agreements (US$230.5m.) and iv) demand deposits and cash on hand (US$2.7m). Short-term external liabilities stood at US$4.7m.

Security, *liquidity* and *profitability*, in that order of importance, are the criteria Banco de la República applies to the management of international reserves. Accordingly, and to make sure the country meets it external payment obligations, reserves are invested in financial assets that have a broad secondary market. Some of these assets are held as working capital. The latter includes assets with the highest liquidity in dollars, such as one-day term deposits with financial institutions, buy-back agreements with the Fed, US Treasury bills and agency discount notes with under three months maturity (to ensure immediate availability).

In addition, and pursuant to these criteria, overseas fund managers administer part of the investment tranche of the country's international reserves. They are chosen through a rigorous selection process that is designed to evaluate their experience in the business, the size of the funds they administer, and the quality of their process for investment and risk management. As mentioned in previous reports, these firms have improved the yield on Colombia's reserves, thanks to specialized management (Graph 35).

As to the investment tranche, which includes the item entitled "Investment" in Table 27, Banco de la República directly managed US$6,795.0 m. (47.7% of the total tranche), including US$820.4 m. in working capital. The other 52.3% (US$7,454.3 m) was administered by specialized firms; namely, Barclays Global Investors, Goldman Sachs Asset Management, BlackRock Financial, Wellington Management and Pacific Investment Management Company. In 2006, Banco de la República reviewed the performance of the external

management program and, as a result, decided to look for a new manager to replace JP Morgan Investment Management Inc. Its contract was not renewed on October 31, 2006.

The return on the reserve investment tranche was directly associated with the rise in interest rates on the markets in the United States, Germany and Japan.

The investment tranche is concentrated in the sovereign sector, including short- and long-term assets, with 73.5% of portfolio. The remainder is distributed among the other sectors: 11.2% in the banking sector, 11.9% in the corporate sector, 1.2% in the supranational sector and 2.2% in buy-back agreements with the Fed. The distribution of loan quality at December 2006, according to the ratings applied by specialized agencies,[23] was 48.3% P-1,[24] 44.9% AAA, 1.0% AA, 3.6% A and 2.2% in Fed buy-back agreements. Credit risk distribution reflects the strict criterion on security that is applied to the management of international reserves.

Table 28 shows the returns obtained in 2006 by each manager that was responsible a portion of the investment tranche. In addition, the benchmark index, or theoretical portfolio, is included as a basic reference for evaluating portfolio management. It maximizes yield, taking into account the return risk profile of the funds entrusted to each administrator, and the difference between the return obtained by the administrator and the respective index. A positive difference indicates the administrator has gone beyond the desired minimum return. In the case of working capital, with liquidity being the primary objective of these funds, as opposed to profitability, there is no benchmark index to compare their management.

The performance of other currencies in the portfolio against the US dollar also was positive for the international reserve portfolio.

[23] Standard & Poor's, Moody's and Fitch ratings.

[24] "P-1" is the best rating on the short-term scale.

TABLE 28

INTERNATIONAL RESERVE PORTFOLIO RETURNS DECEMBER 31, 2005 TO DECEMBER 31, 2006 (PERCENTAGE)

Manager	Portafolio	Benchmark Index	Difference
Banco de la República [a/]	5.54	5.58	(0.04)
Barclays Global Investors	6.01	5.87	0.13
JPMorgan Investment Management [b/]	4.49	4.78	(0.29)
Goldman Sachs Asset Management	4.32	4.19	0.13
BlackRock Financial	4.43	4.19	0.24
Wellington Management	4.51	4.19	0.32
Pacific Investment Management Co.	5.75	5.87	(0.12)
Working capital	5.03		

a/ Excludes working capital.
b/ Up to October 31, 2006.
Source: Banco de la República.

IX. Banco de la República's Financial Situation

Pursuant to the by-laws, the Board of Directors decided to distribute Col $1.18 t. in profits from the budget year (Col$1,623.9 b).

A. Results at December 2006

Banco de la República reported Col$1,624 b. in profits for 2006, owing to Col$2,730 b. in income and Col$1,106 b. in outlays (Table 29). Compared to 2005, profits were up by Col$1,299 b., largely due to more revenue (Col$1,556 b.). The growth in revenue is explained by the increase in returns on internatio-

Compared to 2005, profits were up by Col$1,299 b., largely due to an increase of Col$1,556 b. in revenue.

The growth in revenue is explained by the increase in returns on international reserves (Col$1,738.1 b.) .

Table 29

Banco de la República Summary Income Statement (Billions of pesos)

	Performance		Absolute Annual Variation: B - A
	Dec. 2005 A	Dec. 2006 B	
Income	**1,174.0**	**2,729.5**	**1,555.4**
Monetary	1,031.9	2,569.9	1,538.0
Corporate	142.1	159.5	17.4
Outlays	**848.8**	**1,105.6**	**256.8**
Monetary	640.6	605.7	(34.9)
Corporate	275.8	312.4	36.6
Pensioners	(67.6)	187.5	255.0
Fiscal year income	**325.2**	**1,623.9**	**1,298.7**

Source: Banco de la República.

nal reserves (Col$1,738.1 b.) and by liquidity operations the Bank used to temporarily inject Col$188.7 b. into the financial system, which offset the decline in income from valuation of the Bank's TES holdings (Col$420.6 b.) (Table 30).

TABLE 30

BANCO DE LA REPÚBLICA
INCOME STATEMENT
DECEMBER 2005 TO DECEMBER 2006

	Performance		Annual variations: B/A	
	Dec. 05 A	Dec. 06 B	Percentage	Absolute
1. Income from P&L	**1,174.0**	**2,729.5**	**132.5**	**1,555.4**
1.1 Monetary income	**1,031.9**	**2,569.9**	**149.0**	**1,538.0**
1.1.1 Interest and returns	912.5	2,419.3	165.1	1,506.8
International reserves	184.1	1,922.2	944.3	1,738.1
Repo-liquidity and temporary support operations	115.4	304.1	163.5	188.7
Valuation gains (losses) on TES through monetary expansion operations	593.0	172.4	(70.9)	(420.6)
Loan portfolio, valuation of other securities [a/]	20.1	20.7	3.0	0.6
1.1.2 Exchange-rate differences	42.9	25.9	(39.7)	(17.0)
1.1.3 Metal currency	54.5	76.2	39.9	21.7
1.1.5 Others [b/]	22.0	48.6	120.6	26.5
1.2 Corporate income	142.1	159.5	12.3	17.4
2. P&L Outlays	**848.8**	**1,105.6**	**30.3**	**256.8**
2.1 Monetary outlays	**640.6**	**605.7**	**(5.4)**	**(34.9)**
2.1.1 Interest and returns	446.4	430.1	(3.6)	(16.2)
Reserve requirement on deposit accounts	110.3	117.0	6.1	6.7
National Treasury deposit accounts	308.0	295.9	(3.9)	(12.1)
International reserve administrative expenses	28.1	17.2	(38.6)	(10.8)
2.1.2 Exchange-rate differences	63.0	37.0	(41.3)	(26.0)
2.1.3 Cost of issuing and distributing bills and coins	124.7	128.4	3.0	3.7
2.1.4 Others [c/]	6.6	10.2	55.4	3.6
2.2. Corporate outlays	**275.8**	**312.4**	**13.3**	**36.6**
2.2.1 Personnel expenses	174.5	184.7	5.8	10.2
2.2.2 General expenses	42.3	44.2	4.4	1.8
2.2.3 Taxes	7.0	8.1	16.5	1.1
2.2.4 Insurance	7.6	7.3	(3.7)	(0.3)
2.2.5 Contributions and membership fees	3.5	5.3	51.6	1.8
2.2.6 Cultural expenses	7.2	8.2	13.7	1.0
2.2.7 Depreciation, provisions, amortization and others [d/]	33.6	54.5	62.2	20.9
2.3 Pension expenses [e/]	**(67.6)**	**187.5**	**377.5**	**255.0**
3. Operational income (loss) (1 - 2)	**325.2**	**1,623.9**	**399.3**	**1,298.7**

a/ External and national government borrowing facilities and non-monetary valuation gain (loss) on gold, return on other operations, TES Law 546 and valuation gain (loss) on other securities.
b/ Other monetary, operational and non-operational income.
c/ Portfolio administration, precious metal refining and other monetary outlays.
d/ Includes other corporate, operational and non-operational outlays.
e/ Return on assets, minus expenses.
Source: Banco de la República.

The return on international reserves in 2006 (Col$1,922.2 b.) is explained by: i) the level of interest rates, ii) portfolio valuation and iii) the exchange differential created by a stronger euro against the dollar. The euro and the yen depreciated against the dollar in 2005 (by 13.2% and 15.2%. respectively); however, in 2006, the euro appreciated by 11.8%, resulting in higher portfolio profitability (5.35%) than in 2005 (0.65%).

The Bank's corporate outlays ($312.4 b.) rose by Col$36.6 b.…..

The growth in income from liquidity operations (Col$188.7 b.) was due to: i) the average increase (Col$2,873 b.) in the temporary purchase of securities from the financial system, and ii) the Bank's intervention interest rate hikes.

Monetary outlays were down by Col$34.9 b. with respect to the year before, primarily because of: i) a change in the formula for remuneration on national government deposits, ii) a reduction in commissions paid to external managers of international reserves, and iii) the exchange difference originating with appreciation of the peso against the dollar, which was 1.99% in 2006 compared to 4.42% in 2005.

Corporate outlays ($312.4 b.) increased by Col$36.6 b.; however, when excluding those over which the Bank has no direct influence (taxes, contributions, insurance and the provision on the restructured debt with Banco Central de Cuba), the increase was 1.2%, thanks to spending controls. The limited increases in personnel expenditure (5.8%) and general expenses (4.4%) are important achievements. In real terms, general expenses were down by 0.1% and personnel expenses were up by 1.3%, despite the increase stipulated in the collective wage agreement. Moreover, the Bank reduced its staff by 23 employees last year. These factors are consistent with a standing policy aimed at streamlining personnel and operating expenses.

At December 2006, net spending on pensioners was Col$187.5 b. due to i) less income (Col$153.8 b.) from the portfolio constituted with pension liability resources, given the drop in TES B prices, and ii) the increase in actuarial provisions to comply with current regulations.

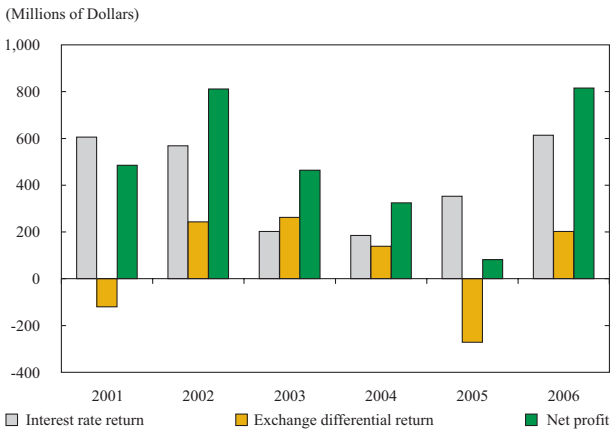
B. Building Up Reserves and Distributing Profits

... however, when excluding outlays over which it has no direct influence, the increase was 1.2%, thanks to controls on spending.

Pursuant to Law 31/1992 and the institution's by-laws, the Board of Directors decided to transfer the equivalent of Col$1,186 b. in dollars (US$533 m) to the national government. It also agreed to add Col$458 b. to the reserve for currency fluctuation and to discount Col$3.7 b. resulting from the investment in goods for cultural activity in 2006 (Table 31).

GRAPH 36

RETURN ON INTERNATIONAL RESERVES
2001-2006



Source: National Office of the Superintendent of Financial Institutions. Banco de la República's calculations.

Compared to 2005, the return on the reserve investment tranche in 2006 was considerably higher. The positive performance of the fixed-income market was directly associated with the rise in interest rates on markets in the United States, Germany and Japan, which is where most of Colombia's reserves are invested. The poor performance of investments in bonds with more than one-year maturity (due to the inverse ratio between the price of these assets and the rate of return) was more than offset by the return on short-term investments in the United States. Being linked to short-term interest rates, they benefited from the successive increases in benchmark interest rates (federal funds) up until June 2006, since short-term securities could be reinvested throughout the year at higher rates.

The performance of other currencies against the US dollar was positive for the international reserve portfolio, and allowed for a recovery from the revaluationist effect of the US dollar in 2005. The euro appreciated by 11.4%, valuating investments denominated in that currency; the Japanese yen was 1.15% weaker, devaluating the respective portion of the portfolio. Colombia's international reserves also benefited from the increase in the price of gold, which appreciated by 23.9% in 2006. The net return on total international reserves at December 31, 2006 was US$815.2 m. Earnings attributed to changes in interest rates and the exchange differential came to US$456.7 m.; the returns from interest accruals came to US$358.5 m. (Graph 36).

TABLE 31

BANCO DE LA REPÚBLICA
2006 PROFIT SHARING AND USE OF RESERVES

	Billions of pesos
I. Distributable funds	**1,648.45**
A. 2006 profits	1,623.88
B. Reserves used	24.56
Asset protection	24.02
Exchange performance	0.54
II. Allocations	**1,648.45**
A. National government	1,186.26
B. Net investment in cultural goods	3.70
C. Reserve for currency fluctuation	458.48

Source: Banco de la República.

Equity reserves include: i) the reserve for currency fluctuation: Col$1,340.8 b.;[25] ii) the asset protection reserve: Col$44.6 b. and iii) the reserve for exchange performance: Col$12.3 b. According to the by-laws, a monetary and exchange stabilization reserve was not created, as no losses are expected in the next two years.

C. BANCO DE LA REPÚBLICA'S FINANCIAL STRUCTURE

1. Assets

Banco de la República reported Col$49,567 b. in total assets at the close of 2006, which is Col$2,949 b. or 6.3% more than in 2005 (Table 32). The following were the main items.

- Repo transactions, which are used to provide temporary liquidity, showed a balance of Col$6,636 b. This is Col$2,586 b. more than on December 31, 2005.

- Gross international reserves valued at market prices were up by Col$403 b.(equivalent to US$484 m.),[26] having gone from Col$34,165 b. at the close of 2005 to Col$34,568 b. at December 2006 (US$14.957 m in 2005 to US$15.440 m in 2006).

[25] Funds used to cover eventual losses due to fluctuation in the dollar exchange rate against the other currencies that make up the country's international reserves.

[26] The variation in pesos is due to the re-expression of international reserves in domestic currency (Col$1,060 b.), minus the exchange difference resulting from peso revaluation (Col$660 b.).

Banco de la República, General Balance, December 2005 to December 2006 (Billions of pesos)

	December 2005		December 2006		Variation	
	Balance	Percentage	Balance	Percentage	Absolute	Percentage
Assets	**46,617.7**	**100.0**	**49,567.2**	**100.0**	**2,949.5**	**6.3**
Gross international reserves	34,164.9	73.3	34,567.9	69.7	403.0	1.2
Contributions with international organizations	2,834.0	6.1	2,802.0	5.7	(32.0)	(1.1)
Investments	2,603.6	5.6	2,472.9	5.0	(130.7)	(5.0)
Public sector: monetary regulation	2,550.5	5.5	2,405.1	4.9	(145.4)	(5.7)
Capitalization bonds public banks and others	53.1	0.1	67.9	0.1	14.8	27.8
Loan portfolio	2.4	0.0	0.7	0.0	(1.7)	(69.7)
Public sector: national government	2.1	0.0	1.8	0.0	(0.3)	(13.9)
Finance corporations	1.4	0.0	0.0	0.0	(1.4)	(100.0)
Provision	(1.1)	(0.0)	(1.1)	(0.0)	0.0	(1.7)
Buy-back agreements-temporary liquidity support	4,050.4	8.7	6,636.3	13.4	2,585.9	63.8
Accounts receivable	36.0	0.1	39.5	0.1	3.5	9.7
Other net assets	2,926.4	6.3	3,047.8	6.1	121.5	4.3
Liabilities and Equity	**46,617.7**	**100.0**	**49,567.2**	**100.0**	**2,949.5**	**6.3**
Liabilities	**30,196.7**	**64.8**	**32,920.6**	**66.4**	**2,723.9**	**9.0**
F/C liabilities that affect international reserves	21.0	0.0	11.1	0.0	(9.9)	(47.2)
Base money	22,804.6	48.9	27,031.8	54.5	4,227.2	18.5
Bills in circulation	19,177.8	41.1	23,925.0	48.3	4,747.2	24.8
Treasury coins	461.2	1.0	537.9	1.1	76.7	16.6
Bank reserve-requirement deposits	2,971.0	6.4	2,380.7	4.8	(590.3)	(19.9)
Rest of financial sector current account deposits	194.6	0.4	188.3	0.4	(6.3)	(3.2)
Other deposits	131.8	0.3	111.2	0.2	(20.6)	(15.6)
National government - National Treasury	3,725.1	8.0	2,547.9	5.1	(1,177.2)	(31.6)
Liabilities with international bodies	2,284.6	4.9	2,243.4	4.5	(41.2)	(1.8)
Monetary and exchange regulation securities	0.3	0.0	0.0	0.0	(0.3)	(100.0)
Accounts payable	58.3	0.1	60.2	0.1	1.9	3.2
Other liabilities	1,171.0	2.5	915.0	1.8	(256.0)	(21.9)
Total Equity	**16,421.0**	**35.2**	**16,646.6**	**33.6**	**225.6**	**1.4**
Capital	12.7	0.0	12.7	0.0	0.0	0.1
Reserves	1,867.7	4.0	1,397.7	2.8	(470.0)	(25.2)
Equity surplus	13,221.4	28.4	12,567.0	25.4	(654.4)	(4.9)
CEC liquidation	453.5	1.0	453.5	0.9	(0.0)	(0.0)
Exchange adjustments from 1993 onward and surplus	12,679.1	27.2	12,022.5	24.3	(656.6)	(5.2)
Others	88.8	0.2	91.0	0.2	2.2	2.5
Property valuation (cultural or artistic objects and real estate)	994.0	2.1	1,045.3	2.1	51.3	5.2
Profits or Loss	325.2	0.7	1,623.9	3.3	1,298.7	399.3
Previous profit and/or loss	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal-year profit and/or loss	325.2	0.7	1,623.9	3.3	1,298.7	399.3

Source: Banco de la República.

The projection for 2007 is Col$1,288.0 b. in profits, which is Col$335.9 b. less than in 2006.

- The variation in reserves during 2006 originated with Col$1,365 b. (US$610 m) in additional income from cash returns and $479 b. (US$214 m) in added accruals and valuations.

- The investment portfolio in domestic currency, valued at market prices, showed a balance of Col$2,473 b. This is $131 b. less than in 2005, primarily due to the maturity of Col$282 b. in TES and TES portfolio depreciation (by Col$52 b.). The effect was offset, in part, by the net purchase of $203 b. in TES.

2. Liabilities

Liabilities came to Col$32,921 b. in 2006, or Col$2,724 b. more (9.0%) than in 2005. The variation is explained by an increase of Col$4.227 b. in base money (18.5%), due to additional cash in circulation (Col$3,768 b.) (23.1%) and to the increase in bank reserve deposits: Col$460 b. (7.1%). As to all other liabilities, the most important was the 31.6% decline in government deposits, which were down by Col$1,177 b.

3. Equity

The equity balance at the end of 2006 was up by Col$226 b. compared to the close of 2005, having gone from Col$16,421 b. to Col$16,647 b. This variation reflects several factors; namely, i) Col$1,297 b. in additional profits (399%); ii) less of an equity surplus because of Col$657 b. (5.2%) in exchange adjustment due to revaluation of the peso against the dollar, and iii) a reduction of Col$470 b. in reserves (25.2%), inasmuch as a portion of the currency fluctuation reserve was used to for profit sharing in 2006.

D. Projected Profits: 2007

The projection for 2007 is Col$1,288.0 b. in profits, which is Col$335.9 b. less than in 2006 (Table 33). This is mainly because of less income from international reserves (Col$254.1 b.), added outlays for interest on reserve-requirement deposits, and remuneration on national government deposits. The latter is associated with the Bank's intervention rate hikes and the larger balance forecast for government deposits. Other factors that had a negative effect on profits include the decline in trust commissions and the increased cost of issuing and distributing bills and coins.

Projected income on international reserves assumes in 2007 a return of 4.54%, which is less than the rate observed in 2006 (5.35%). This change in the profitability of the reserve portfolio is in response to expectations that the Fede-

ral Reserve will lower interest rates in the United States. This would have a positive impact on the price of international reserve assets. However, and more importantly, it would have a negative effect on the flow of interest from new securities.

This projection does not include the possible impact of variations in the exchange rates for the currencies in the reserve portfolio. Accordingly, it is subject to uncertainty about the dollar exchange rate against the euro and yen.

The following are other important items:

- More income from repos is expected, due to a larger estimated demand for base money and the increase in Banco de la República's intervention rate. Less income from commissions on banking services and trust bu-

This projection does not include the possible impact of variations in the exchange rates for the reserve portfolio currencies. Accordingly, projected income is subject to uncertainty about the dollar exchange rate against the euro and yen.

TABLE 33

BANCO DE LA REPÚBLICA, INCOME STATEMENT: 2006-2007
(BILLIONS OF PESOS)

	December 2006 (A)	Projected 2007 (B)	Variation % (B/A)	Variation Absolute (B - A)
I. Total income	**2,729.5**	**2,468.8**	**(9.5)**	**(260.6)**
1. Operational income	2,687.5	2,459.1	(8.5)	(228.3)
Interest and returns	2,419.3	2,207.8	(8.7)	(211.5)
International reserves	1,922.2	1,668.1	(13.2)	(254.1)
Valuation gain(loss) on TES from monetary expansion operations	172.4	166.3	(3.5)	(6.1)
Repo-liquidity operations and temporary support	304.1	368.3	21.1	64.2
Others [a/]	20.7	5.0	(75.6)	(15.6)
Fees	139.4	100.7	(27.7)	(38.7)
Exchange differences	25.9	3.4	(87.0)	(22.5)
Others [b/]	102.9	147.3	43.1	44.4
2. Non-operational income	42.0	9.7	(76.9)	(32.3)
II. Total outlays	**1,105.6**	**1,180.9**	**6.8**	**75.3**
1. Operational outlays	1,102.3	1,175.1	6.6	72.8
Interest and returns	430.1	514.2	19.5	84.0
Reserve-requirement accounts and Nat.Treas.deposits	412.9	493.3	19.5	80.4
International reserve administration expenses	17.2	20.8	20.9	3.6
Exchange differences	37.0	21.6	(41.6)	(15.4)
Bill and coin issue and distribution cost	128.4	183.4	42.9	55.0
Personnel expenses	184.7	199.1	7.8	14.4
Pension expenses	187.5	127.2	(32.2)	(60.3)
General expenses	44.2	46.7	5.7	2.5
Others [c/]	90.4	82.9	(8.3)	(7.5)
2. Non-operational outlays	3.3	5.8	73.9	2.5
III. Fiscal-year profits or losses	**1,623.9**	**1,288.0**	**(20.7)**	**(335.9)**

a/ External and national-government borrowing facilities and non-monetary valuation gain (loss) on gold, return on other operations, TES Law 546 and valuation gain (loss) on other securities.
b/ Metal currency, other monetary and corporate operational income.
c/ Taxes, insurance, contributions and membership fees, cultural expenses, depreciation, provisions, amortization and other monetary and corporate operational outlays.
Source: Banco de la República.

siness is anticipated, given the reduction in TES management rates effective as of July 2006 and less volume negotiated through the electronic trading system (SEN in Spanish).

- Pension spending is expected to decline (by $60.3 mm), due to more returns on the portfolio constituted with pension liabilities (Col$38.6 mm) and less of a provision anticipated for pension liabilities ($33.4 mm).

Because the return on international reserves is the primary determinant of projected profits, the variation in the exchange rate for reserve portfolio currencies against the dollar is an important variable and must be taken into account with respect to profit sharing, particularly because the by-laws say the Bank is required to establish a monetary fluctuation reserve,[27] depending on the variation in the exchange rate.

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[27] Recursos destinados a cubrir eventuales pérdidas por la fluctuación de las tasas de cambio del dólar frente a las otras divisas que componen las reservas internacionales,