Inflation at September and the Outlook

- Consumer inflation went from 3.9% in June to 4.6% by September, and the average for core inflation indicators during the same period rose from 3.7% to 4.2%. These increases do not jeopardize the possibility of compliance with the target for 2006, which is between 4% and 5%.

- The rise in inflation was due primarily to the supply factors that influenced the price of food and regulated goods and services. Tradable inflation also was up slightly, due to second-quarter depreciation.

- Second-quarter growth in the Colombian economy far surpassed expectations. Indicators of productive activity suggest the increase continued during the third quarter with good growth in private demand, investment and consumption. These tendencies were motivated by the sharp increase and acceleration in credit.

- The growth in exports and national income continue to benefit from external demand and terms of trade, while survey results show household and business confidence remains high. This being the case, domestic and external factors are still favorable for growth in aggregate demand. The situation is expected to continue as such during the coming year, but with less growth in world demand and probably a decline in terms of trade, which is expected to be gradual.

- Real interest rates in the financial system remain low for deposit and borrowing, while the loan portfolio continues to grow at a high rate. The performance of these variables is partly due to the fact that financial institutions have shifted their portfolios shift towards loans as opposed to TES and other investments, which has given them an important source of resources for credit.

- Expectations for inflation in 2006 and 2007 are up in response to the third-quarter increases in inflation. There is the possibility of additional inflationary pressures in the coming months and at the start of 2007 due to El Niño, higher prices for regulated goods and services, and possible changes in the value added tax (VAT). Although these factors are likely to have only a temporary impact on inflation, they could lead to higher expectations of inflation. However, the country's monetary authority will try to prevent this and to explain the temporary nature of these price changes to agents in the market.

- Increased productivity continues to curb unit labor costs, although some of that increase might be cyclical rather than permanent. Raw material prices have elevated the cost of doing business, although the recent trend in the exchange rate might slow at push. Nevertheless, if the force of aggregate demand continues, pressure on costs could begin to be more evident. In fact, surveys show the business community expects the cost of raw materials increase.

- In short, real interest rates remain low, economic growth continues, and the credit channel has intensified. Surplus productive capacity would be expected to decline under these conditions. However, not to be ignored is the impact the sharp rise in private investment in machinery and equipment could have on potential output and productivity, which could reduce that risk. In any case, although the exchange rate is not a source of inflationary pressure at the moment, neither does it allow for a sustained reduction in future inflation, as no major appreciation in the central macroeconomic scenario is anticipated for 2007 and thereafter. On the other hand, the hikes in the intervention interest rate have had only a limited impact so far, due to the shift in bank assets from domestic government bonds to loans. If this process does not continue, the effect of these hikes would be expected to begin to exert more of an impact on the pattern of aggregate demand.

- Given these factors as a whole, the Banco de la República Board of Directors (BRBD) raised intervention rates by 25 basis points at its meeting on October 27, setting the base rate for expansion auctions at 7.25%. This measure is coherent with the increases ruled in August and September, and is part of the monetary policy standardization strategy announced by BRBD to ensure stable economic growth and the gradual convergence of inflation towards 2% to 4% in the long term.

Board of Directors
Banco de la República