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

July 2006

Banco de la República

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Bogotá, D.C., August 1, 2006

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

Dear Sirs,

Pursuant to Law 31 of 1992, Article 5, the Board of Directors of the Banco de la República hereby submit for consideration by Congress a report on the country's macroeconomic results for the year to date. The report also presents the Board's targets for this year and the outlook for the different macroeconomic variables. The final sections describe the composition of the international reserves and discuss projections for the Banco de la República's financial situation in 2006.

Yours truly,

José Darío Uribe Escobar
Governor

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INTRODUCTION

Sustained output growth has made it possible to reduce poverty, expand productive capacity and raise productivity, thereby improving the nation's welfare and laying the foundation for maintaining high future growth.

So far this year Colombia's economy has been growing as strongly as last year. At the end of the first quarter gross domestic product showed an annual growth of 5.2%, the same as in 2005. This good performance has been accompanied by vigorous expansion in household consumption and by a surge in gross fixed capital formation (about 5% and 15% respectively in the first quarter). The fastest growing production sectors were: manufacturing (7.3%), construction (5.7%), commerce (8.4%) and transport (9.7%). The strength of economic activity has kept unemployment on a declining trend, with the national rate standing at 11.9% in May 2006, down from 12.5% a year earlier. Sustained output growth has made it possible to reduce poverty, expand productive capacity and raise productivity, thereby improving the nation's welfare and laying the foundation for maintaining high future growth.

Output growth and declining unemployment have gone hand in hand with falling inflation. At the end of the first quarter inflation was running at an annual rate of 3.9%, considerably lower than last year's 4.9%. This price-level development ensures that the 4.5%-5.5% inflation target range set by the Banco de la República's Board of Directors for 2006 will be comfortably met.

The strength of economic activity has kept unemployment on a declining trend, with the national rate standing at 11.9% in May 2006, down from 12.5% a year earlier.

The above results reflect a positive dynamic on several fronts: i) ever rising consumer and investor confidence has reached record highs; ii) the financial sector has grown stronger in terms of capital, through the good performance of real activity, which has encouraged financial institutions to lend and compete in offering the system's users attractive interest rates; the resulting buoyancy of the system's loan portfolio is evidenced by a 24% annual growth at the end of June; iii) the public sector has benefited from the good behavior of economic activity through a substantial increase in the tax take; and iv) to the foregoing was added a favorable external context, reflected by robust world demand and high terms of trade, which

Review of the figures leads to the conclusion that the conditions for maintaining economic dynamism and assimilating unexpected shocks are better now than they were in the mid-1990s,…

helped to raise the dollar value of Colombian exports by 17.4% in the first quarter of 2006.

The challenge to the Board of Directors is to devise a monetary policy for attaining and keeping a low, stable rate of inflation at the same time as ensuring favorable future conditions for maximizing the output growth compatible with price stability. This being, as often stated, the monetary authority's fundamental aim, the Board decided to raise the intervention interest rate by 50 basis points (bp) in the course of the first quarter. This timely rate rise, within a range that has left monetary policy still expansionary, helps to ensure that the economy will continue to grow at the maximum possible rate without compromising price stability. The present Report treats this subject in depth, discussing in particular each of the transmission channels through which monetary policy operates on the economy. Since this is a lagged effect, the monetary authority has to anticipate events by taking decisions in advance to ensure future economic stability.

To preserve macroeconomic stability requires deep knowledge of the economy, with its strengths and weaknesses. In this respect, the high volatility recently exhibited by external and domestic financial markets raises the question: how vulnerable might the Colombian economy be today? Such a reflection is particularly relevant when we recall that in the nineties the economy went from buoyancy to crisis and needed several years to recover. The present Report discusses this issue methodically by analyzing the vulnerability indicators of the external, real, fiscal and financial sectors and comparing them with their nineties' levels. Review of the figures leads to the conclusion that the conditions for maintaining economic dynamism and assimilating unexpected shocks are better now than they were in the mid-1990s, when the economy was growing by more than 5%, much as it is today. Emphasis is laid particularly on the greater openness and dynamism of exports, low inflation, higher exchange-rate flexibility, high level of international reserves, and the strength of financial-system indicators. Yet, it is never possible to be free of risks, and it is the job of the economic authorities to be always alert to them. It is especially important to deepen fiscal adjustment and avoid excessive imbalances in the balance of payments' current account and increases in spending not compatible with expansion in production capacity.

…when the economy was growing by more than 5%, much as it is today.

This Report consists of ten chapters. The first three discuss the inflation situation, economic activity and employment. Chapter IV analyzes the behavior of financial markets and their recent volatility. Chapter V reviews monetary and exchange-rate policy, explaining the reasons for the Board of Directors' recent interest-rate decisions. Chapters VI and VII look at developments in the balance of payments and fiscal policy. Chapter VIII considers the Colombian economy's vulnerability today compared with what it was in the nineties. Chapter IX reports on the level of foreign reserves, the criteria for their management, and external-vulnerability indicators. Lastly, Chapter X reviews the Banco de la República's financial situation. The Report also contains three boxes dealing with concerns expressed to the Board during previous Congressional debates, namely: inflation, by income bracket (Box 1); recent productivity gains (Box 2); and oil-sector development and prospects (Box 3). The Banco de la República's contracting regime and Law 80/1993 are discussed in Box 4.

I. INFLATION IN THE FIRST HALF OF 2006 AND OUTLOOK

The fall in inflation relative to the year before stemmed essentially from supply shocks, especially the behavior of food and regulated prices.

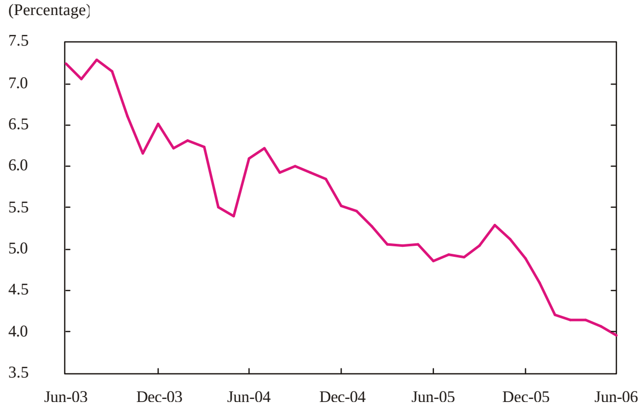
Inflation has behaved well since January. The first half of 2006 saw the headline consumer rate fall by 90 bp to 3.9%, somewhat lower than the floor of the target range set by the Board of Directors (Chart 1). Inflation has thus been falling gradually during the 15 years since the Banco de la República became independent.

The first-half results show falls in all the major groups that make up the National Statistical Agency's (DANE's) consumer-price index. Food inflation was 4.7% in June, down from 6.6% in December; nonfood CPI dropped from 4.1% to 3.6%, with the biggest fall occurring in regulated CPI, which plunged from 6.7% to 3.8%.

Trends in producer inflation are less clear, for there has been some pick-up in the past two months because of the peso's depreciation and higher world prices for a number of raw materials, including fuel and sugar. In June the PPI's annual growth rate was 4.8%, up from 2.1% in December (Chart 2), but still in line with the Bank's targets.

CHART 1

ANNUAL CONSUMER INFLATION
(ANNUAL CHANGE)



Source: DANE; calculations by Banco de la República.

A. CORE INFLATION

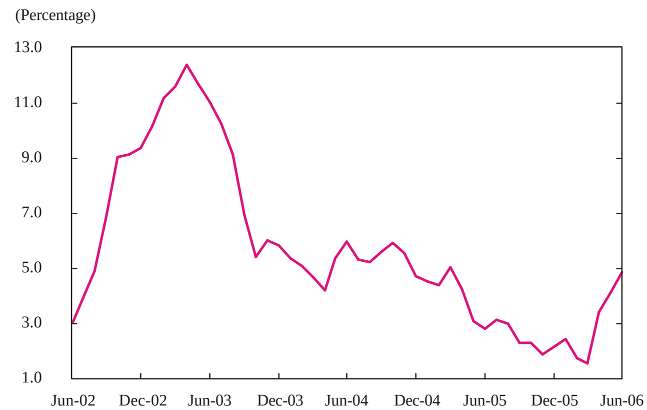
Core or underlying inflation is the component of consumer inflation directly related to monetary policy and the overall situation of the economy. To estimate this measure, all prices that are subject to transitory supply shocks and systematically face changes caused by factors of a more sectoral than macroeconomic nature are excluded from headline inflation. In the case of Colombia, in particular, we seek to exclude the more common shocks to Colombian inflation, namely, shocks arising from farm supply, fuel prices and changes to utility subsidies. The Banco de la República uses three indicators for this purpose: nonfood inflation, nucleus-20 CPI,[1] and CPI excluding food staples, fuel, utilities and public transport.

Like nonfood inflation, the other core-inflation indicators (nucleus-20 and CPI excluding food staples and utilities) were on a declining trend in the first quarter of 2006, falling to historically low levels in March and remaining stable over the following two months. To June the three most used indicators showed an annual inflation of 3.6%, significantly lower than in December (4.0%) and below the target-range floor (Chart 3).

The fall in core-inflation indicators in the first half of 2006 was bigger than forecast by the Bank and resulted essentially from the price behavior of regulated goods and services, especially from low readjustments to utility and urban-transport rates. The other two components into which core or nonfood inflation is usefully decomposed, tradables and nontradables, stayed relatively stable over those six months. Nonfood nonregulated tradables inflation was around 2.2% at the beginning of the year, on a somewhat declining trend that reversed in May and picked up further in June. The peso's depreciation in recent months has not yet produced any significant effect on either tradables or headline inflation. Nonfood nonregulated nontradables inflation fluctuated between 4.5% and 4.6%, in line with the target (Chart 4).

CHART 2

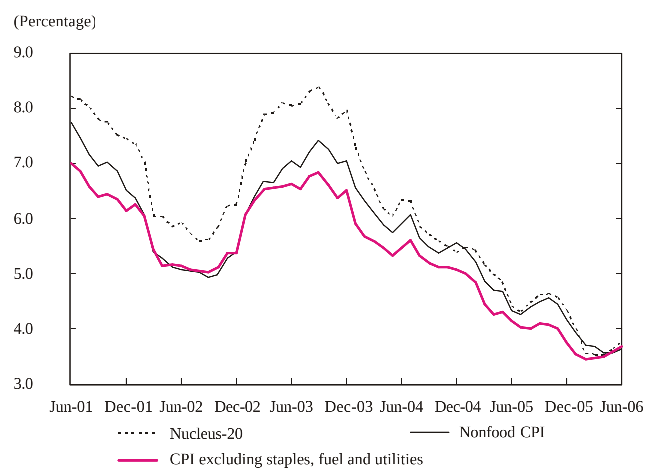
ANNUAL HEADLINE PPI INFLATION
(ANNUAL CHANGE)



Source: Banco de la República.

CHART 3

CORE INFLATION INDICATORS
(ANNUAL CHANGE)



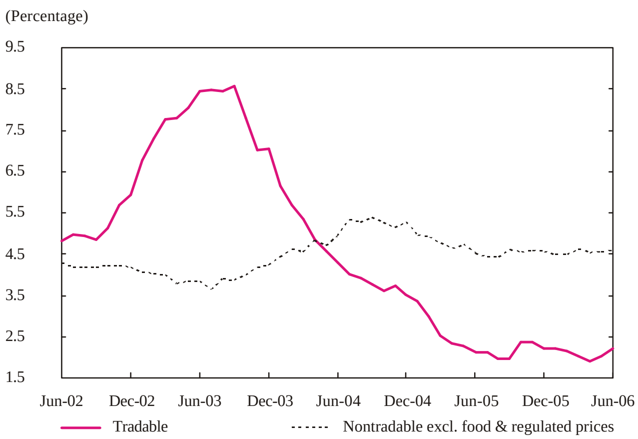
Source: DANE; calculations by Banco de la República.

1 Nucleus-20 CPI is the measure of CPI excluding 20% of the CPI basket items that showed the highest price volatility in the reference period, December 1980 to April 1999.

Table 1 compares the behavior of nonfood inflation between January and June 2006 against the same period in 2005, broken down by the part played by each of the three large groups described above. It will be seen that the biggest contribution to the drop in nonfood inflation this year came almost exclusively from the good behavior of regulated prices, which fell by 54 bp. The contribution from tradables and nontradables was practically nil, but neither did they exert any upward pressure. The situation in 2006 is in marked contrast to circumstances prevailing in 2005 (and preceding years), when the decline in core or nonfood inflation was essentially attributable to tradables and nontradables, while regulated prices were rising far above headline inflation.

Chart 4

TRADABLE INFLATION, AND NONTRADABLE INFLATION EXCLUDING FOOD AND REGULATED PRICES (ANNUAL CHANGE)



Source: DANE; calculations by Banco de la República.

B. FOOD INFLATION

As expected, annual food inflation was on a declining trend over the first six months of 2006, falling from 6.6% in December 2005 to 4.7% in June 2006. But the fall was gentler than originally expected, because of unforeseen price rises for perishable or primary foodstuffs, resulting from transport and flood problems caused by strong rains in the previous months.

The price movements of primary foods contrast with those of processed foods, the latter's pace of annual adjustment dropping sharply in the first quarter and running at barely 3.9% in June

Table 1

REDUCTION IN NONFOOD INFLATION; AND CONTRIBUTION TO IT, BY PRODUCT GROUP (BASIS POINTS)

	Cintribution to reduction in nonfood inflation between:	
	December (2004) and june (2005)	December (2005) and june (2006)
Nonfood inflation	(124)	(55)
Tradables	(48)	(3)
Nontradables	(32)	2
Regulated prices	(44)	(54)

Source: DANE; calculations by Banco de la República.

(Chart 5). This trend, which began back in early 2005, is associated with exchange-rate appreciation (until March 2006) and low world prices for several imported foodstuffs (such as cereals and oils).

C. FACTORS AFFECTING INFLATION SO FAR THIS YEAR

Various factors have had a bearing on inflation since January 2006:

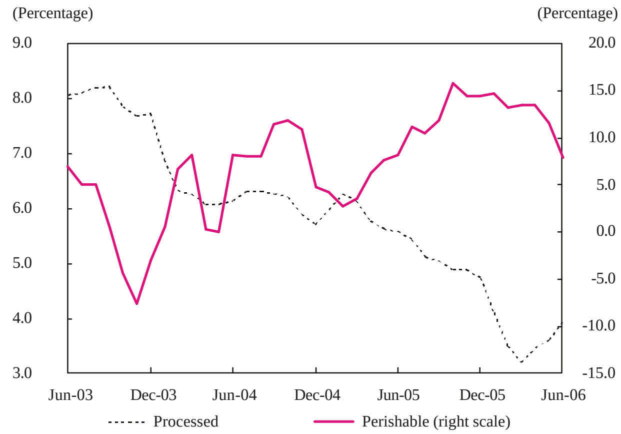
- The drop in inflation relative to last year has stemmed essentially from supply shocks, particularly from the behavior of food and regulated prices. The fall in the latter has been largely responsible for the sharp decrease in core inflation. Though the peso's appreciation may have had some part in neutralizing increases in international and benchmark fuel prices, the main explanation for the regulated-price decline has to do with the dismantling of subsidies and postponement of readjustments in urban-transport fares.

- Inflation expectations continued to decrease in the first half of this year, staying in line with the target. The results of the Bank's latest quarterly survey, conducted in April, show businesses expecting a 4.6% inflation rate by the end of the year. The monthly survey of financial-market operators, in July, produced similar expectations (4.2%). Target credibility is at a record high, with 90.1% of respondents believing that the 2006 target will be met. All this suggests that expectations were still helping to lower inflation in the first months of 2006, as they had done in 2005. It also suggests that their effect may have counterbalanced some upward pressure from pay rises and strong growth in demand.

- The peso's appreciation was limited over the first two months of 2006 and turned into a strong depreciation starting from March. Thanks to the lagged transmission of exchange-rate movements to prices, by June the new exchange situation was still not reflected in higher consumer inflation, not even in tradables. But the exchange factor's contribution to the lowering of inflation has decreased in recent months.

CHART 5

ANNUAL PRIMARY- AND PROCESSED-FOOD INFLATION



Source: DANE's Continuing Household Survey.

Inflationary pressure from demand is expected to be less subdued than in the past over the rest of this year and particularly next year, given projected buoyancy in spending and less spare production capacity.

D. INFLATION OUTLOOK

No great change is expected to occur in inflation, particularly core inflation, over the rest of this year. No further big reductions like those of earlier this year are therefore considered likely. The Bank's forecasts show nonfood inflation around the floor of the target range in December. Much the same is forecast for headline inflation.

If the peso's depreciation observed in recent months persists it is expected to have some impact on tradables inflation over the second half of the year and into 2007. On past experience, depreciation will have a moderate effect on consumer inflation if it remains within the range exhibited up to July; should pressure on the peso increase, the price effect will be greater and will be felt at the end of 2006 and in 2007.

Inflationary pressure from demand is expected to be less subdued than in the past over the rest of this year and particularly next year, given projected buoyancy in spending and less spare production capacity. In any case, the lowering of inflation in 2007 will have to depend on a credible monetary stance that anchors inflation to the targets. It is important to point out however that investment has continued to grow apace, expanding production capacity and helping to moderate price-rise pressures. The Board, it will be remembered, has predefined a range of 3.0% to 4.5% and will set the 2007 inflation target based on this range in November 2006.

Recent price increases in commodities (fuel and basic metals, among others) presage higher costs. The pay rises, of some 7%, awarded so far this year should be offset by greater gains in labor productivity, as evidenced by the latest information. This development, together with still high unemployment, will limit the effect on costs and prices.

The second half of the year is expected to see regulated prices continuing to be adjusted at a pace compatible with the inflation targets, at least in the case of utilities and collective transport. But some pick-up is expected early next year on statistical grounds (no repetition of the water-rate reduction made at the start of this year) and because of the updating of transport charges so far this year. By the end of 2006 and especially in 2007 fuel-price adjustments may also be bigger than in the previous quarters, in response to increases in the international price and a higher exchange rate.

In any case, the lowering of inflation in 2007 will have to depend on a credible monetary stance that anchors inflation to the targets.

Some contribution to inflation reduction might come from food prices, especially perishable-food prices, which are expected to rise more slowly or even fall during a good part of the second half. This behavior, arising from the usual food-production cycle, should pick up significantly in response to last year's high relative prices. Some price upturn in non-perishable foodstuffs, particularly imports, cannot be ruled out, given the peso's recent depreciation and expected rises in some external prices.

Lastly, inflation expectations should continue to favor moderate price adjustments over the rest of the year, compatible with the Board's inflation target.

INFLATION, BY INCOME BRACKET

Using price information from DANE, headline consumer inflation can be broken down by income bracket or level: high, middle and low, which are found to represent 22%, 54% and 24% of national CPI. As shown by Chart B1.1, consumer-inflation trends have been similar across income brackets over the present decade, including the first half of 2006, and have decreased significantly since the end of 2005.

Chart B1.1
CONSUMER INFLATION, BY INCOME BRACKET
(ANNUAL CHANGE)

Source: DANE; calculations by Banco de la República.

In any given year, however, annual inflation may differ significantly from one income bracket to another. The dispersion was particularly broad early in the decade, when there was a two percentage-point difference between the maximum- and minimum-inflation brackets, but it has tended to narrow with time. In May 2006 the minimum annual inflation, 3.5%, was registered by the high-income group and the maximum, 4.4%, by the middle group, while the low-income group's inflation was 3.7%, much the same as the average.

Since 2000, inflation for the low-income bracket has tended to remain above average for a longer time than inflation for the high and middle brackets. Utility, food and collective urban transport prices might generally account for this. Utility rates were raised substantially at the start of the decade in the partial dismantling of consumer subsidies, the biggest rate rises being applied to the low-income levels, which were the most heavily subsidized. Relative food prices went up at the start of the decade for various reasons, notably the peso's strong devaluation. This development has most affected the low-income group, whose spending is more concentrated in food items. Lastly, urban public transport has been undergoing large lasting price rises for several years now, and their effect too has been stronger on low-income levels.

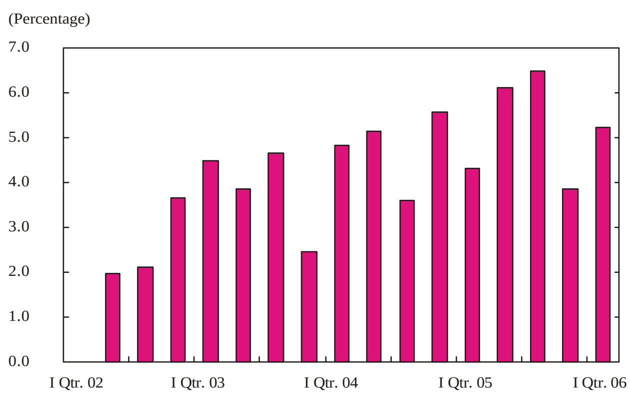
Over the past quarters, as a result of small rises in utility rates and education fees, inflation for the lower-income population has decreased by more than the national total.

II. ECONOMIC ACTIVITY

Current trends suggest a growth of 4.5%-5.0% for 2006, with further strengthening of household consumption and substantial expansion in private investment (11.2%) and civil works (12.7%). The Bank's forecasting models point to a 4.8% real increase in total exports.

CHART 6

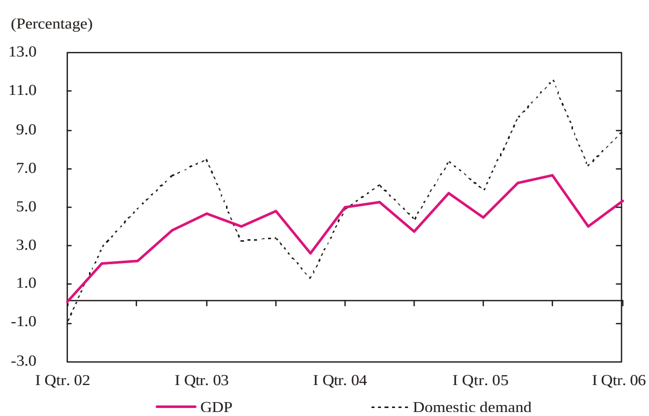
REAL ANNUAL GDP GROWTH



Source: DANE; calculations by Banco de la República.

CHART 7

REAL ANNUAL GROWTH IN GDP AND DOMESTIC DEMAND



Source: DANE; calculations by Banco de la República.

A. CURRENT ECONOMIC SITUATION

According to the latest information from DANE, Colombia's economy continued in a phase of expansion over the first quarter of 2006, growing by 5.2% and completing more than four years of recovery (Chart 6).

First-quarter growth this year was driven by strong domestic demand, which continued to outpace (8.8%) overall GDP (Chart 7). Household consumption went up by 5%, while total investment surged by more than 25%. Growth in public-administration consumption was moderate, probably affected by the Electoral Guarantees Law.

Sectorally, GDP growth was stronger in nontradables (5.7%), though tradables too expanded substantially (4.4%) (Chart 8). First-quarter growth benefited from more working days, for Easter fell in April this year, whereas last year it was in March. The fastest-growing sectors were civil works (17.8%), transport and communications (9.7%), commerce (8.4%) and manufacturing (7.3%).

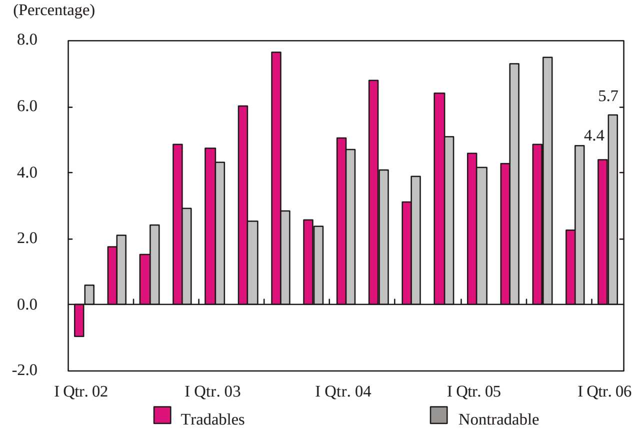
Other sectors, such as farming, private construction and government services, contributed modestly to growth. In the case of farming, this was largely because of a poor coffee crop for the 2005-2006 crop year; in effect, problems were expected from the start of the year, given climatic conditions in the previous half year, which had affected blooming of the plants and subsequent production.

Private construction showed negative performance (-1.1%), although work in progress was growing at a healthy pace (19.9%) according to construction-census data, and other indicators, such as construction licenses, rose by 9.9% in the six months to March 2006 (Chart 9). Given these figures, the deceleration may prove transitory or weaker in future than it was in the first quarter; it should be pointed out however that the first quarter saw a significant increase in paralyzed construction work.

All components of household consumption expanded: durable goods most strongly, by 18%; nondurable goods(foodstuffs, beverages, utilities, pharmaceuticals, home-maintenance products, etc.) by 3.6%, more than in 2005; semi-durable goods (apparel, footwear, glassware, metal products, books, etc.) and services (mainly housing rents, communal and personal social services and commercial services) by more than 4.0%.

CHART 8

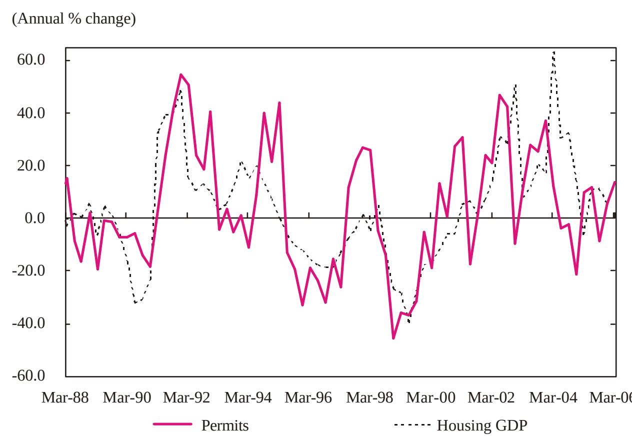
TRADABLE AND NONTRADABLE SECTORS' REAL ANNUAL GDP GROWTH



Source: DANE; calculations by Banco de la República.

CHART 9

CONSTRUCTION PERMITS AND GDP ANNUAL GROWTH



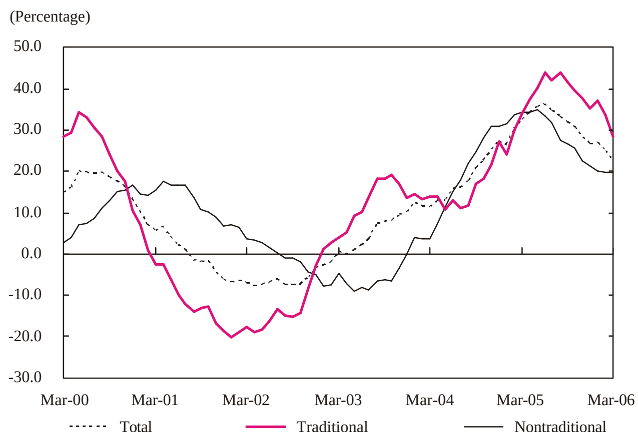
Source: DANE; calculations by Banco de la República.

The fastest rate of gross fixed capital formation (GFCF) was in transport equipment (28.3%), followed by machinery and equipment (26.9%). Investment in the farming sector grew by around 5.0%, while GFCF in housing and building construction shrank unexpectedly by 1.2%. Private investment, defined as GFCF excluding civil works, grew by 14%, while GFCF including civil works expanded by 17.8%. In all, total investment rose to 22% of GDP, a level surpassed only in 1994 and 1995.

The good behavior of investment in machinery and equipment and in transport equipment was reflected by higher capital-goods imports, which grew by 26.5% in dollars in the first quarter of 2006. Real growth in overall imports was 23.1%.

CHART 10

EXPORTS: TOTAL, TRADITIONAL AND NONTRADITIONAL
(LATEST 12 MONTHS' ANNUAL GROWTH)



Source: DANE.

The first quarter saw overall exports growing by 6.6% in real pesos (24.7% in dollars). Traditional exports as a whole increased by a moderate 2.9%. Coffee exports have shown a poor performance (-24.8%) so far this year, as have ferronickel exports (-11.6%). First-quarter exports of oil went up by 3.5% and of coal by 19.4%. Nontraditional exports, for their part, recovered from the fall suffered in the final quarter of 2005, expanding by 8.8% Growths were higher in dollar figures, thanks to the good behavior of the terms of trade. At the end of first-quarter 2006 growth in the dollar value of 12-month accumulated exports was 30.0% for traditional products, and 21.5% for nontraditionals excluding gold and emeralds (Chart 10).

B. ECONOMIC PROSPECTS

Available information to June suggests that the economy will continue buoyant for the rest of the year. Economic analysts predict an average GDP growth of 4.6% for 2006 and 4.0% for 2007 (Table 2)

Despite external volatility in recent months, overseas demand and the terms of trade are expected to continue favoring economic buoyancy. In the second quarter of 2006 the international context was characterized by a smaller appetite for risk and by high volatility in financial markets, particularly in emerging economies. This has been associated with uncertainty about the end of the US monetary-policy tightening cycle, with the dollar's recent devaluation, which has again led agents to think about the US economy's fragility, and with expected interest-rate rises in other developed countries. These changes notwithstanding, relatively high growth is forecast for some developed economies (Europe and Japan), which, together with buoyancy in China and India, would in large measure any offset loss of dynamism in the US economy.

Moreover, though financial-market volatility may have affected some commodity prices, everything suggests that prices for Colombia's main export goods will remain relatively high for the rest of 2006. Thus, for example, according to the World Bank, the price of West Texas Intermediate oil will average $69.3 a barrel in 2006, rising as high as $73.7 in 2007. The average coffee price, which stood at $1.17 in 2005, is expected

COLOMBIAN GDP FORECASTS
(REAL ANNUAL % GROWTH)

	2006	2007
Bear Stearns	5.2	4.8
Credit Suisse	5.2	4.5
Corfivalle	5.0	4.4
BBVA Banco Ganadero	4.9	3.6
Banco de Bogotá	4.8	4.4
Bancolombia Suvalor	4.8	3.8
Fedesarrollo	4.7	4.5
Dresdner Bank	4.6	4.4
J, P, Morgan Chase	4.5	4.0
Santander Colombia	4.5	4.0
Citigroup	4.5	4.0
Global Insight	4.4	3.8
IDEA global	4.4	4.1
ANIF	4.4	4.2
UBS	4.0	3.9
Fernández Riva	3.6	1.8
Average	**4.6**	**4.0**
Average domestic	4.6	3.9
Average foreign	4.6	4.2

Source: Latin American Consensus Forecast, June 2006.

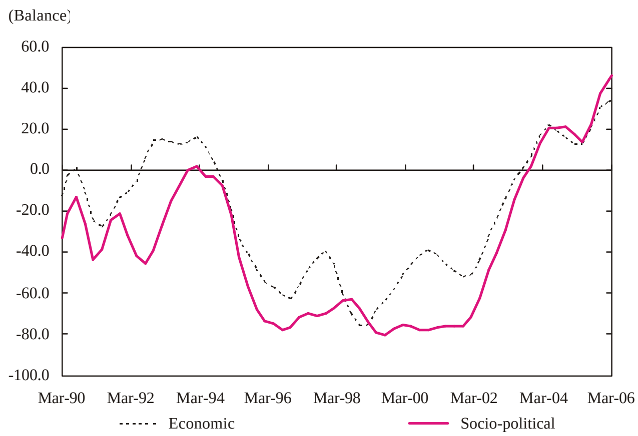
to end 2006 at $1.16 and run at $1.04 in 2007. World prices for other major exports, such as coal and ferronickel, also show relative stability at high levels.

High financial-market volatility has clearly had a negative impact on private-capital flows. As explained in Chapter VI, net private-capital outflows, excluding foreign direct investment (FDI), are expected to amount to $2,000 million (m) in 2006, compared with net inflows of $362 m in 2005. This development however does not mean that the economy will have to adjust to lower availability of external funds, to judge by projections of FDI flows and public financing and by export buoyancy.

The domestic context, too, will continue to contribute substantially to growth. For, besides marked improvement in employment, current consumer and investment confidence will still be driving domestic demand, a trend observed in the first quarter of 2006. Indicators such as Fedesarrollo's business opinion survey show investment remaining strong,

Chart 11

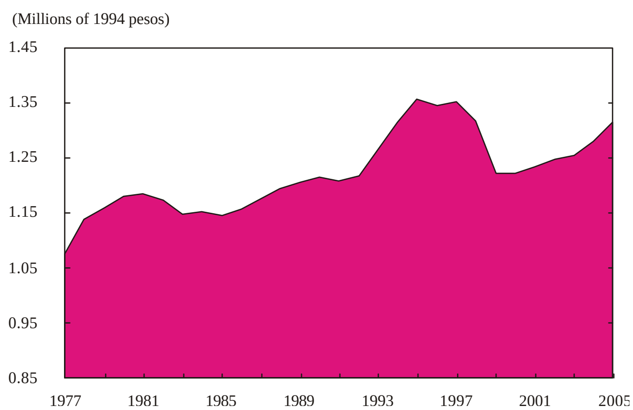
INDUSTRIAL INVESTMENT CONDITIONS
(TENDENTIAL COMPONENT)



Source: Fedesarrollo's Business Surveys.

Chart 12

PER-CAPITA HOUSEHOLD CONSUMPTION (*)
(MILLIONS OF 1994 PESOS)



(*) Intercensal population estimates by Banco de la República on information from DANE.
Source: DANE, National Planning Department and Banco de la República.

thanks to the good economic and socio-political conditions prevailing in the country (Chart 11).

Various investment projects are under way in different sectors: the oil sector, having absorbed about $1.2 bn in 2005, is forecast to receive more than $2.3 bn in 2006-2007; and the government's privatization agenda should generate $1.2 bn in foreign direct investment over the same period.[2]

On available information, major investment projects are expected in such sectors as telecommunications, manufacturing and services, partly because of a higher degree of capacity utilization, which has now been at historical averages for several quarters, and also because of the business prospects that completion and approval of the Free Trade Treaty with the United States would open up. According to the joint business opinion survey coordinated by ANDI (the major business association), ever more businesses (64%) are adopting investment strategies with the Free Trade Treaty in mind, and the biggest investments are being made in projects for modernizing plants and production processes and for becoming more competitive.

Although consumption growth has outpaced population growth since the end of 2003, per-capita consumption is still below the peaks reached in the 1990s (Chart 12). Household consumption, however, is another domestic-demand item that is expected to grow substantially–by as much as 5.0% or more–in the near future, though consumption of nondurable goods and services is still less strong than that of durable goods.

Besides higher labor income and the net transfers from abroad in the form of remittances–seemingly more stable now–, households have found different financing sources for their consumption. Low interest rates offered in the mortgage market will continue to free up funds for consumption and

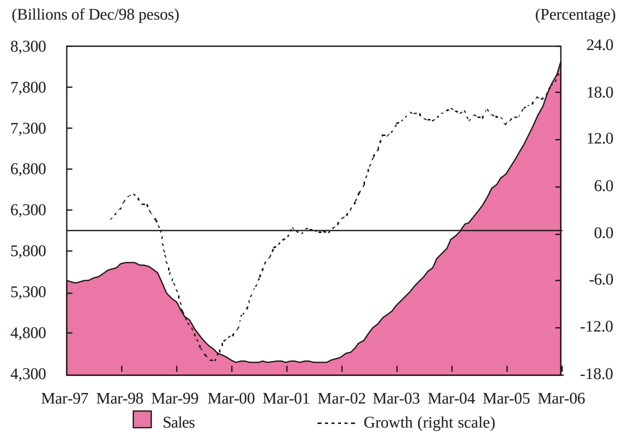
[2] The sales of Telecom, Granbanco, Propal and Monómeros Colombo Venezolanos, and concessions of the Cartagena Refinery and El Dorado airport, among other privatization projects, are estimated to generate FDI funds of up to about $1,200 m.

investment that previously went to pay for financial obligations. And consumer credit continues to grow, with the 12-month accumulated credit obtained through credit-card purchases and advances expanding by more than 25% in real terms for the fortieth month in a row (Chart 13).

The external and domestic trends described above point to a 4.5%-5.0% growth for 2006, with further strengthening of household consumption and substantial growth in private investment (11.2%) and civil works (12.7%). According to the Bank's forecasting models, overall exports should grow by 4.8% in real terms (Table 3). With consumption and investment continuing to expand fast, imports are expected to remain buoyant (17.2%). Note that growth will still be concentrated in nontradables sectors (5.3%), benefiting from the satisfactory circumstances of domestic demand (Table 4).

CHART 13

REAL CREDIT CARD SALES
AND ADVANCES
(LATEST 12 MONTHS)



Source: Red Multicolor.

TABLE 3

GDP,
BY TYPE OF EXPENDITURE
(REAL ANNUAL % GROWTH)

	2004	2005	2006 (*)
Final consumption	**3.8**	**4.7**	**5.5**
Households	4.0	4.7	5.3
Government	3.3	4.8	6.2
Gross capital formation	**14.5**	**25.2**	**15.2**
Gross fixed-capital formation (GFCF)	13.6	19.4	11.5
GFCF excl. civil works	23.4	17.7	11.2
Civil works	(18.8)	28.1	12.7
Domestic demand	**5.6**	**8.4**	**7.5**
Total exports	**11.3**	**6.3**	**4.8**
Total imports	**15.8**	**22.6**	**17.2**
Gross domestic product	**4.8**	**5.2**	**4.8**

(*) Banco de la República projections.
Source: DANE; calculations by Banco de la República.

TABLE 4

GDP, BY SECTOR
(REAL ANNUAL % GROWTH)

	2004	2005	2006 1/
Farming, forestry, hunting and fishing	4.2	2.9	1.8
Mining and quarrying	3.1	3.0	2.3
Electricity, gas and water	2.7	3.2	2.4
Manufacturing	7.0	3.9	4.0
Construction	10.8	11.9	6.6
Buildings	33.5	4.3	3.2
Civil work	(18.8)	28.1	12.7
Commerce, repairs, restaurants and hotels	6.1	9.4	6.1
Transport, storage and communication	5.4	5.1	6.5
Financial estabs., insurance, real estate and business services	4.5	3.5	1.0
Social, community and personal services	2.7	4.0	5.7
FISIM	11.9	8.5	(3.6)
Subtotal value added	4.6	4.6	4.4
GDP	**4.8**	**5.2**	**4.8**
Taxes, less subsidies	7.4	13.3	9.9
Net FISIM financial services 2/	2.3	1.9	2.6
Tradables	5.3	4.0	3.9
Nontradables	4.4	6.0	5.3

1/ Banco de la República projections.
2/ FISIM: Financial intermediation services indirectly measured.
Source: DANE; calculations by Banco de la República.

III. EMPLOYMENT AND UNEMPLOYMENT, 2002-2005

Economic recovery since 2002 has been reflected in the labor market, with the overall participation rate and the unemployment rate presenting declining trends. The drop in the overall participation rate is thus associated with improvement in household economic conditions; it is also partly attributable to the government's student retention programs.

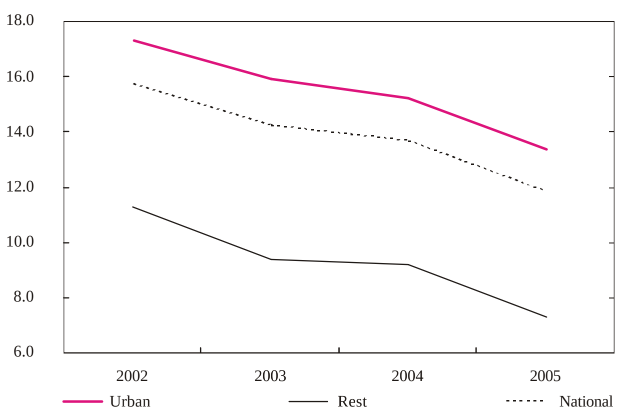
This chapter reviews recent years' variations in employment and unemployment rates. To ensure data representativity, an annual frequency analysis is performed, using each year's average overall participation rate, unemployment rate and employment rate.[3]

Economic upturn since 2002 has been reflected in the labor market, with the overall participation rate and the unemployment rate presenting declining trends. The drop in the overall participation rate is thus associated with improvement in household economic conditions, which has allowed younger members of the household to return to education activities and some spouses to return to housework. The government's student retention programs have also helped to reduce the overall participation rate. Falling unemployment (Chart 14) is connected with rising employment. In 2002-2005 the number of people with jobs in urban centers increased by 1.2 million. This increase in job openings was sufficient not only to absorb the rise in the economically active population but also to reduce the number of the jobless by 375,000 (Table 5).

CHART 14

UNEMPLOYMENT RATE

(Percentage)



Source: DANE's Continuing Household Surveys.

[3] The overall participation rate is the ratio of the economically active population (everyone taking part in the labor market, that is, both people with jobs and the unemployed) to the working-age population (people over the age of 12 in urban centers, and over the age of 10 in rural areas). This rate can be interpreted as an indicator of labor supply. The unemployment rate is the proportion of the economically active population that is jobless. And the employment rate is defined as the total number of jobholders as a ratio of the economically active population.

Labor-market recovery has not been uniform across the different population groups (Table 6). The information from urban centers shows that despite falling unemployment during 2002-2005, young people (the under-18 and 18-24 age groups) are still the most affected segment of the population, with unemployment rates remaining over 20%. Within households, too, unemployment rates for spouses and children are respectively twice and four time as high as the rate for the head of household. But the overall

TABLE 5

ECONOMICALLY ACTIVE POPULATION

Number of people	Urban centers		The rest		National	
	2002	2005	2002	2005	2002	2005
Economically active population (a + b)	**14,615,233**	**15,362,570**	**5,089,471**	**5,115,337**	**19,704,704**	**20,477,907**
a) Unemployed	2,513,092	2,037,433	571,400	368,524	3,084,492	2,405,957
b) Employed	12,102,141	13,325,137	4,518,071	4,746,813	16,620,212	18,071,950
i. Under-employed	4,919,681	4,808,603	1,853,286	1,669,244	6,772,967	6,477,847
ii. The rest	7,182,460	8,516,534	2,664,786	3,077,569	9,847,245	11,594,103

Source: DANE's Continuing Household Survey.

TABLE 6

LABOR-MARKET STATISTICS, URBAN CENTERS

	Overall partici pation rate		Employment rate		Unemployment rate		Underemployment rate	
	2002	2005	2002	2005	2002	2005	2002	2005
Total	62.5	61.0	51.7	52.9	17.2	13.3	33.7	31.3
Age groups								
Under 18	18.2	13.5	12.9	10.4	29.6	23.3	30.5	28.7
18-24	67.8	65.6	46.1	47.6	31.9	27.4	34.7	33.5
25-55	82.1	81.9	71.1	73.5	13.4	10.3	35.0	32.3
Over 55	38.1	36.9	34.5	34.4	9.4	6.7	24.5	22.5
Schooling								
None	43.7	41.8	39.4	39.0	9.9	6.7	37.9	32.3
Incomplete primary	55.8	52.6	48.3	47.7	13.3	9.3	39.1	36.2
Complete primary	64.8	62.6	55.8	56.6	13.9	9.5	36.5	33.2
Incomplete secondary	47.6	44.0	38.4	37.7	19.4	14.4	36.1	34.4
Complete secondary	78.1	76.5	61.6	63.6	21.0	16.8	31.7	30.3
Higher	76.9	76.1	64.5	66.1	16.1	13.1	28.2	26.6
Relationship								
Head of household	78.9	77.0	71.8	72.2	9.0	6.2	34.4	31.2
Spouse	56.1	55.0	46.4	48.2	17.3	12.5	32.3	29.8
Children	54.0	52.7	39.0	40.5	27.8	23.2	34.9	33.4
Other relatives	48.6	46.8	36.9	38.0	24.0	18.8	33.4	31.8
Non-relatives	77.3	77.0	69.8	71.0	9.7	7.8	23.1	20.5

Source: DANE's Continuing Household Survey.

participation rate for young people under 18 has decreased, producing a positive effect for society. This age group should be attending centers of education to complete their elementary and secondary education, not taking part in the labor market.

Underemployment[4] occurs among all segments of the population alike, and though it declined over 2002-2005, it is still high, besetting at least a quarter of the people holding jobs.

Information on the employed population's labor income shows a pick-up in it over the past four years (Table 7). The proportion of the population earning less than the prevailing minimum legal wage for a month's work fell from 36.1% in 2002 to 30.6% in 2005. Though it is worrying that a third of the

4 A person holding a job is considered underemployed if he wants to work more hours or if he *desires* to change his present job to make better use of his skills or because he *desires* to improve his income.

TABLE 7

PERCENTAGE OF EMPLOYED URBAN-CENTER POPULATION EARNING LESS THAN THE LEGAL MINIMUM MONTHLY WAGE, ADJUSTED TO NATIONAL ACCOUNTS

	Cabeceras municipales			
	Employed		Underemployed	
	2002	2005	2002	2005
Total	36.1	30.6	51.1	45.9
Age groups				
Under 18	84.5	86.6	89.9	89.3
18-24	44.9	39.2	58.6	53.8
25-55	30.1	24.8	45.7	40.4
Over 55	44.2	41.1	59.8	60.0
Schooling				
None	68.6	63.9	77.1	74.7
Incomplete primary	57.8	51.6	70.3	64.7
Complete primary	46.0	39.3	61.5	55.0
Incomplete secondary	44.8	39.1	58.5	53.4
Complete secondary	28.2	25.4	44.9	42.8
Higher	11.1	10.4	19.5	20.4
Relationship				
Head of household	27.5	22.0	41.8	35.9
Spouse	45.5	41.3	62.6	60.2
Children	44.6	37.9	56.7	51.1
Other relatives	42.0	36.3	55.5	49.5
Non-relatives	23.2	18.3	39.5	34.5

Source: DANE's Continuing Household Survey; imputed-income methodology of Francisco Lasso (2005).

people with jobs should earn less than the income set by law, it is worth noting that this information does not take into account the number of hours worked–some people in this one third may be working less than 48 hours a week–, that is, it does not necessarily signify a breach of the labor legislation.

In this respect, young people under 18 are the most affected, with 86.6% of those with jobs earning less than the minimum monthly wage for their work. Available information shows, however, that in 2005 some 80% of employed under-18-year olds were working half-time or less. Moreover, by educational level, people with lower levels of schooling get badly paid jobs. Information from the Continuing Household Survey shows that in 2005 the educational level of 49% of the employed population in urban centers ranked as incomplete secondary education or lower. The above trends are even more marked in the case of the underemployed, indicating that most underemployment is associated with lower pay for equal work.

The information presented here suggests that to continue lowering the unemployment rate will require: high sustainable economic growth: further progress in policies for providing the population with education, instruction and training to enable them to take on more productive and better paid jobs; and greater labor-market flexibility.[5]

[5] A factor working against reduction of the unemployment rate is the higher labor costs arising from the permanent fiscal and parafiscal surcharges introduced by Law 100 of 1993 and Law 797 of 2003.

RECENT PRODUCTIVITY GAINS IN COLOMBIA

For Colombia's recent economic recovery to become sustainable, growth will be needed not only in production factors (capital and employment) but also in productivity. Productivity gains are very important to the economy in general: they contribute directly to growth, boost investment, and make it possible for higher output not to lead to higher inflation. They constitute, besides, a determinant of workers' real pay.

Unfortunately, unlike inflation, unemployment or growth in output, productivity is an unobserved variable, measured indirectly through indicators. This box discusses recent movements in three productivity measures estimated by the Banco de la República, the aim being to understand the part played by this variable in the economy's recent recovery.

Total factor productivity

Total factor productivity (TFP), or multifactor productivity, is the component of growth not resulting from greater use of productive resources, that is, from more capital and more jobs. Alternatively, TFP may be understood as the joint productivity of the factors of production. It can be estimated through an economic exercise in which growth in productivity (TFP) is determined by the difference between the rise in output (Y) and the increase in capital (K) and employment (L): Equation 1, where the proportions a and (1 - a)are weighters reflecting the weight of each factor within production:

$$(1) \qquad P\hat{T}F = \hat{Y} - a\,\hat{K}(1 - a)\,\hat{L}$$

The Banco de la República's estimates show an upturn in TFP growth in recent years: in the period 2001-2005 multifactor productivity grew by an annual average of 0.5% (Table B2.1), similar to the variation estimated by some authors[1] for the period 1960-2000 (0.44%), but lower than the estimate for 1960-1995 (0.85%). The average TFP growth for 1995-2005 deduced from the above calculation is -1.02%.

Comparing Colombia's TFP with that of a sample of Asian countries[2] for the period 1960-2000 shows the latter's average variation (1.22%) to be three times as high as Colombia's; thus, these countries' acceleration of output growth per worker (4.08%

1 Armando Montenegro and Rafael Rivas (2005). Las piezas del rompecabezas, Chapter 3. Editorial Taurus, Bogotá; Barry Bosworth and Susan Collins (2003). "The Empirics of Growth: An Up-date," Brookings Institution, September 2003.

2 Korea, Taiwan, Indonesia, Malaysia, Singapore and India.

annual average, against Colombia's 1.04%), and improvement in their inhabitants' quality of life is largely explained by accumulation of physical capital, and to a lesser extent by productivity gains.

Table B2.1
GROWTH ACCOUNTING IN COLOMBIA
(ANNUAL % CHANGE)

	Output	Capital	Employment (*)	Capital per worker (*)	Total factor productivity	Marginal labor output
1996-2000	1.0	3.8	1.6	2.2	(1.5)	(0.6)
2001-2005	3.4	2.9	2.9	0.0	0.5	0.5

(*) Estimated on information about unemployment and overall participation rate in seven cities, expanded to the working age population at national level.
Source: DANE; calculations by Banco de la República.

Marginal labor productivity

Marginal labor productivity is another relevant measure of productivity. It explains the contribution of each additional unit of work to output growth. Hence, the higher the marginal labor productivity, the higher real wages can be without generating inflationary cost pressures or raising the unemployment rate. The determinants of marginal labor productivity are total factor productivity and the capital-to-labor ratio, as shown by equations 2 and 3. Large increases in investment, such as those observed in the previous two years, favor marginal labor productivity growth by raising available capital per worker (2.4%, on average, in 2004-2005). Estimates by Banco de la República show an upturn in marginal labor productivity growth since 2004 (Table B2.1).

(2 y 3)

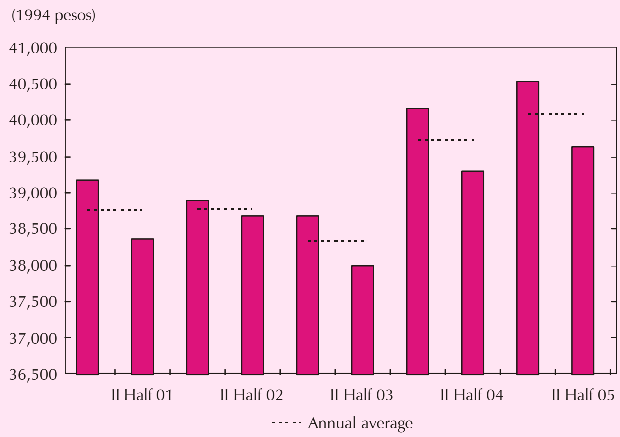
$$\hat{Y}_L = P\hat{T}F + a\hat{k}$$

$$k = K / L$$

Median labor productivity

Median labor productivity is calculated from the ratio of output to hours worked. It differs from marginal labor productivity in that it considers, not the contribution of an additional unit to the production process, but the contribution of all workers as a whole. It is calculated on information from the national accounts and the Continuing Household Survey. The results show a sustained rise in urban output per hour worked[3] since 2004 (Chart B2.1). The median labor productivity for the period 2001-2005 presented an annual average change of 0.6%.

Chart B2.1
URBAN OUTPUT PER HOUR WORKED



(*) GDP excluding government services, farming and mining.
Source: Banco de la República.

Conclusions

The different productivity measures calculated by the Banco de la República all show recovery in their respective growth rates, especially since 2004. And average growth in total factor productivity for the past five years is seen to have gone back up to the historical level estimated for 1960-200, when average GDP growth was 4.1%.

Economic history and international experience indicate that to make progress toward the aim of attaining higher growth rates, for example 6.0%, it is essential to develop a process of reforms to speed up growth in total factor productivity by dealing with the main "bottlenecks" and strengthening the favorable factors that have so far made TFP recovery possible. In the case of Colombia, Cárdenas 2005[4] finds that homicide and kidnapping rates and inequality (as measured by the Gini coefficient) have a negative impact on total factor productivity. Another study[5] finds that improvement in education, greater financial deepening, trade liberalization and investment in infrastructure boost economic growth, whereas the size of the government, inflation and currency overvaluation affect it negatively.

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3 Urban output per hour worked is calculated from information on GDP excluding government services, and farm and mining and quarrying production; the population with jobs is that of 13 cities, except for government wage-earners and employees.

4 Cárdenas, Mauricio (2005). "Crecimiento económico en Colombia: 1970:2005," in Revista Coyuntura Económic-35 años, Fedesarrollo

5 Loyaza, N.; Fajnzylber, P.; Calderón, C. (2002). "Economic Growth in Latin America and the Caribbean: Stylized Facts, Explanations , and Forecast" (mimeo), World Bank, June.

IV. FINANCIAL MARKETS

In the first half of 2006 the Colombian economy, like other economies, experienced high volatility in the exchange rate, interest rates and equity prices starting from March.

In the first half of 2006 the Colombian economy, like other economies, experienced high volatility in the exchange rate, interest rates and equity prices, as became evident from March. This volatility has been associated with greater uncertainty about monetary policy in the United States and other developed countries. It has signified a break change in the trend observed since late 2003 in which excess world liquidity was directed toward emerging economies in search of greater profitability, with the consequent repercussions on appreciation of their currencies and reduction of their risk premiums.

The change in international investors' expectations has been reflected in lower interest on risky investments and greater volatility in financial markets. In emerging economies it has caused capital outflows, affecting local equity and securities markets. Several emerging economies have seen their stockmarkets fall and currencies weaken, with Colombia being hit more than the average.

Note however that other variables of the external context, such as the terms of trade and world demand, have remained favorable. This fact and the satisfactory performance of other fundamental factors in emerging economies (current-account balance, fiscal situation, price stability, among others) explain why country-risk premiums have not been overly affected.

Various analysts see the recent behavior of Latin American financial markets as a correction of previous over-exposure to high-risk assets.

Various analysts see the recent behavior of Latin American financial markets as a correction of previous over-exposure to high-risk assets, and this correction as arising from uncertainty about more contractionary monetary policy in the United States and other economies.

As discussed in the following section, in Colombia during the first half of 2006 movements in the exchange rate and interest rates, particularly in the public-debt market were influenced by international developments, as was the financial system's performance. For there were no changes in the economy's fundamental variables that would justify the volatility.

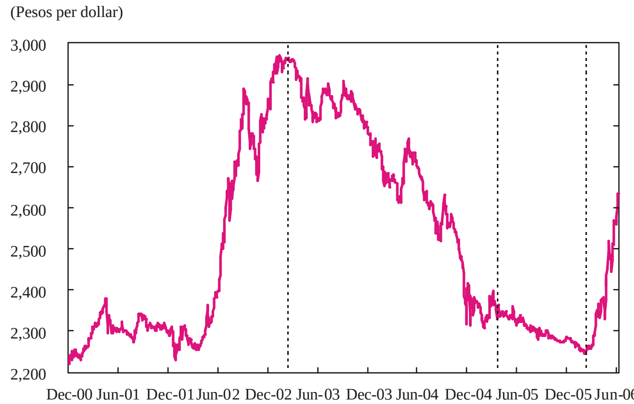
A. NOMINAL AND REAL EXCHANGE-RATE MOVEMENTS

At the end of June 2006 the Colombian peso's nominal exchange rate stood at 2,633 pesos to the dollar, representing a first-half devaluation of 15.4%. This was a change of behavior from the appreciation observed since the second quarter of 2003. The new, more volatile, trend began in early March, after the dollar had fallen to its lowest (2,245 pesos) in the period (Chart 15).

In terms of the real exchange rate index (RERI), the peso's depreciation was 12.1% if the consumer-price index is used as deflator (RERI-CPI), and 9.6% if deflated by the producer-price index (RERI-PPI) (Chart 16 and Table 8).

CHART 15

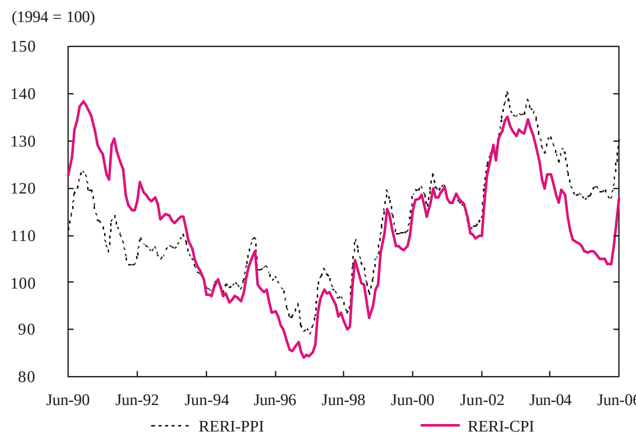
MARKET EXCHANGE RATE



Source: Banco de la República.

CHART 16

REAL EXCHANGE RATE INDEX



Source: Banco de la República.

TABLE 8

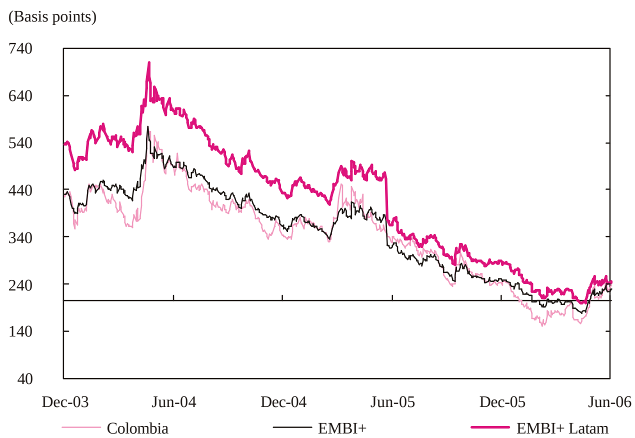
NOMINAL AND REAL EXCHANGE RATES

	End of period			Period average		
	2004	2005	Jun-06	2004	2005	Jan-jun 2006
Nominal exchange rate						
Pesos per dollar	2,389.8	2,284.2	**2,633.1**	2,626.2	2,320.8	**2,347.8**
Annual percentage change	(14.0)	(4.4)	**12.9**	(8.7)	(11.6)	**0.1**
Real exchange rate (PPI)						
Index 1994 = 100	122.7	118.8	**130.2**	128.3	118.5	**121.5**
Annual percentage change	(9.7)	(3.1)	**9.6**	(5.7)	(7.7)	**2.7**
Real exchange rate (CPI)						
Index 1994 = 100	113.5	104.5	**117.2**	120.3	106.7	**107.9**
Annual percentage change	(13.3)	(8.0)	**12.1**	(9.0)	(11.3)	**(0.1)**

Source: Banco de la República.

Chart 17

EMBI+, EMBI+ LATAM, AND EMBI+ COLOMBIA (*)



(*) December 2003 to June 2006.
Source: Datastream.

Exchange-rate rises have occurred in other economies of the region, such as Brazil, Mexico, Chile and Argentina, accompanied also by higher risk premiums on sovereign debt (Chart 17). But devaluation has been strongest in Colombia, with the result that the Colombian peso has become devalued in real terms with respect to the country's trading partners, both developed (9.4%) and developing (9.6%) (Table 9). Hence, despite its real appreciation in 2004 and 2005, the Colombian peso has depreciated in real terms since 2002 with respect to most of the country's trading partners.

The recent increases in the country-risk indicators and exchange rates of emerging economies has

Table 9

PESO'S REAL AND NOMINAL DEPRECIATION
(PERCENTAGE)

Country	Weightings	Nom. exch. rate index 1/			Real exch. rate index - PP1 1/		
		2005	2006	2002-2006	2005	2006	2002-2006
Industrialized							
United States	43.2	(5.5)	11.6	10.2	0.6	7.9	9.9
Europe 2/	10.3	(15.9)	19.1	56.1	(14.7)	15.1	33.7
Japan	2.6	(17.1)	15.2	22.8	(16.9)	10.5	(2.3)
United Kingdom	1.7	(14.0)	17.9	41.0	(13.8)	13.7	19.3
Switzerland	2.9	(17.0)	18.3	48.0	(17.8)	13.6	18.0
Canada	1.3	(1.1)	16.5	56.2	(0.7)	12.5	29.0
Sweden	0.5	(20.4)	21.7	59.5	(16.2)	17.5	39.1
External	62.5	(8.7)	13.5	23.1	(4.0)	9.6	16.2
Developing							
Mexico	5.0	(0.7)	4.2	(11.3)	0.6	2.2	(8.6)
Venezuela	12.0	(15.6)	11.6	(61.3)	(5.0)	12.2	0.9
Ecuador	6.6	(5.5)	11.6	10.2	(3.3)	8.2	6.9
Brazil	4.0	11.2	13.4	15.7	9.8	10.3	51.7
Chile	2.4	5.0	5.7	35.4	6.2	7.2	39.2
Peru	3.3	(9.3)	17.0	16.0	(7.9)	13.0	2.2
Panama	3.3	(5.5)	11.6	10.2	(3.4)	7.4	(3.6)
Argentina	0.9	(6.9)	9.1	(64.3)	(5.0)	5.0	(64.9)
External	37.5	(7.5)	9.8	(30.0)	(1.9)	9.4	3.2
Total external	100.0	(9.6)	11.1	(6.8)	(3.1)	9.6	12.4
Other countries 3/							
China		(3.2)	12.6	13.9	(6.5)	10.9	(5.1)
Korea		(2.9)	19.5	49.2	(4.9)	17.7	32.2

1/ Changes in end-of-period figures.
2/ Germany, Holland, Spain, France, Italy and Belgium.
3/ For these countries the real exchange-rate index is deflated by the CPI.
Fuente: cálculos del Banco de la República,

been associated with an international environment characterized by higher international interest rates and a greater probability of monetary-policy tightening by the US Federal Reserve. The Fed's benchmark bond rate stands at 5% and has already begun to be transmitted to longer-term rates, which is associated in the United States with stronger inflationary pressures and higher inflation expectations, from the effect of higher oil prices and the good pace of growth the US economy has shown. The central banks of other developed countries, such as the eurozone and Japan, have moved in the same direction. Those changes have affected the attraction of Latin America as a destination for capital flows, particularly portfolio capital.

Currency flows show agents shifting in the second quarter of the year toward lower exposure in pesos, by repaying loans and seeking overseas assets, …

The change of direction in currency flows was reflected in movements in the foreign-exchange balance[6] during the first half of the year. Up until March 2006 real-sector agents, continuing the trend from last year, recorded net inflows of foreign currency worth $534 m.[7] This trend reversed in the second quarter, and net outflows totaling $434 m have left a first-half accumulated amount of $100 m for 2006, way below last year's $2,053 m (Table 10).

This trend change is largely explained by foreign-exchange outflows resulting from capital-account operations; in the second quarter of 2006 those outflows were higher by $1,531 m than in the same period last year. Specifically, Table 10 shows that the private sector speeded up its debt repayment, at the same time as increasing its assets abroad (direct investment, portfolio investment, and accumulation in overseas checking accounts). In net terms, the public sector showed a similar behavior, increasing its assets with respect to the rest of the world.

The above data show agents shifting in the second quarter of the year toward lower exposure in pesos, by repaying loans and seeking overseas assets, at the same time as international markets became volatile and risk averse.

The foreign-exchange market is likely to remain volatile until there is greater clarity about future US monetary policy. Moreover, given the reduction of monetary stimulus since 2004 the US economy's pace of growth is expected to moderate but remain strong (3.4%).[8] Forecasts for greater growth in the eurozone, Japan and some other Asian countries, especially China and India, remain unchanged. In this context, it is expected that the terms of trade will

… at the same time as international markets became volatile and risk averse.

6 The foreign-exchange balance records peso-dollar cash operations in the Colombian exchange market. It is therefore a restricted indicator of the balance of payments, in which entries are recorded on an accrual basis, consolidating all operations by people residing in Colombia with those made abroad.

7 The real sector is defined as all agents operating in the foreign-exchange market. It does not include operations by the Banco de la República and the Treasury that are conducted outside the foreign-exchange market.

stay high and world demand will continue to be buoyant, though less so than in 2005. These factors will help to sustain an appropriate external environment for economic growth in Colombia and other countries of the region.

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[8] IMF World Economic Outlook (2006), *Globalization and Inflation*, April.

TABLE 10

REAL SECTOR'S FOREIGN-EXCHANGE FLOWS
(MILLIONS OF DOLLARS)

	2005	2005			2006			Annual Change		
		I Qtr.	II Qtr.	I Qtr. + II Qtr.	I Qtr.	II Qtr. (*)	I Qtr. + II Qtr.	2006 I Qtr.	2006 II Qtr.	I Qtr. + II Qtr.
Real sector foreign-exchange flows 1/	**4,504**	**1,086**	**1,066**	**2,153**	**534**	**(434)**	**100**	**(552)**	**(1,501)**	**(2,053)**
Current account	**2,236**	**768**	**453**	**1,221**	**120**	**483**	**603**	**(648)**	**30**	**(618)**
A. Trade balance	**(3,397)**	**(560)**	**(834)**	**(1,394)**	**(1,148)**	**(1,089)**	**(2,236)**	**(588)**	**(254)**	**(842)**
Goods exports receipts	4,6271,166	1,108	2,274	1,216	1,293	2,509	51	184	235	
Goods imports payments	8,024	1,725	1,943	3,668	2,364	2,382	4,745	638	439	1,077
B. Net services and transfers	**5,633**	**1,327**	**1,288**	**2,615**	**1,267**	**1,572**	**2,839**	**(60)**	**284**	**224**
Net financial services	(537)	(93)	(203)	(296)	(180)	(196)	(376)	(87)	7	(80)
Private sector	(525)	(91)	(198)	(290)	(176)	(194)	(370)	(85)	4	(81)
Public sector	(12)	(1)	(5)	(6)	(3)	(2)	(5)	(2)	3	1
Net nonfinancial services	680	205	155	359	101	76	177	(104)	(79)	(183)
Net transfers	3,555	815	887	1,702	942	1,100	2,043	127	213	341
Net currency purchases from currency agents	2,003	418	467	886	427	616	1,043	9	148	157
Net other	(68)	(18)	(18)	(36)	(23)	(24)	(47)	(5)	(6)	(11)
Capital account	**2,268**	**319**	**613**	**932**	**415**	**(918)**	**(503)**	**96**	**(1,531)**	**(1,435)**
A. Private sector	**2,295**	**455**	**580**	**1,036**	**307**	**(185)**	**122**	**(149)**	**(765)**	**(914)**
Net loans	(439)	(174)	(404)	(578)	81	(933)	(852)	256	(529)	(274)
Disbursements	4,600	1,260	407	1,667	1,644	728	2,372	384	321	705
Repayments	5,039	1,434	811	2,245	1,563	1,661	3,224	129	850	979
Foreign investment in Colombia	3,652	533	1,274	1,807	895	1,069	1,964	362	(205)	157
Direct	806	39	374	412	124	131	255	85	(242)	(157)
Supplementary	2,734	508	871	1,379	771	810	1,580	263	(61)	201
Portfolio	111	(14)	30	16	0	129	129	14	99	113
Colombian investment abroad	(224)	29	(50)	(21)	(35)	(253)	(287)	(64)	(202)	(266)
Direct	(60)	(24)	2	(22)	(11)	(84)	(96)	12	(86)	(74)
Portfolio	(164)	53	(52)	1	(23)	(168)	(192)	(76)	(116)	(192)
Net checking accounts	(693)	68	(240)	(173)	(634)	(69)	(703)	(702)	171	(531)
B. Public sector	**(27)**	**(137)**	**33**	**(104)**	**108**	**(733)**	**(625)**	**244**	**(765)**	**(521)**
Net loans	(43)	(6)	(10)	(16)	(17)	(9)	(25)	(10)	1	(9)
Special operations	22	(124)	43	(81)	110	(716)	(605)	234	(758)	(524)
Financial investments	(6)	(7)	0	(6)	14	(8)	6	21	(8)	12

(*) Preliminary figures.
1/ Excluding purchase and sale of foreign currency by the National Treasury.
Source: Banco de la República: foreign-exchange balance.

B. INTEREST RATES AND MONETARY AGGREGATES

1. Interest rates

The Colombian financial sector's performance in the first half of the year took place within the context of three developments: a) the monetary authority raised the expansion rate by 50 bp; b) the financial system's margin between lending and deposit rates decreased, as lending rates fell rapidly; and c) interest rates and volatility rose in the TES market.

a. Banco de la República's interest rates

The auction expansion rate now stands at 6.5%; and the Board of Directors at its meeting on June 20, 2006 reduced the spread of the monetary-expansion window's interest rate (Lombard rate) from 375 bp to 100 bp, bringing this rate to 7.5% (Table 11).

TABLE 11

BANCO DE LA REPÚBLICA'S INTERVENTION RATES, AND THE INTERBANK RATE
(PERCENTAGE)

Effective dates From:		Minimum auction expansion rate	Maximum Lombard expansion rate	Average interbank rate
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	1/	6.50	10.25	6.39
Sep-19-05		6.00	9.75	5.81
May-02-06	2/	6.25	10.00	6.23
Jun-21-06		6.50	7.50	-

1/ The Banco de la República has suspended the auction and Lombard contraction windows since December 22, 2004.
2/ The average interbank rate is calculated on the latest information available: June 14.
Source: Banco de la República; and Financial Superintendency (interbank rate)

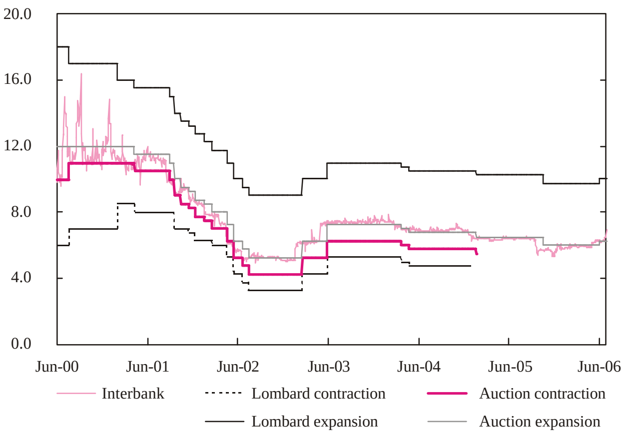
b. Market interest rates

At the end of June 2006 the interbank rate stood at 6.82%, up by 45 bp on a year earlier (Chart 18); in real terms it has risen significantly since January, averaging 2.34% in June. The interbank rate moves closely in line with the Banco de la República's minimum auction expansion rate.

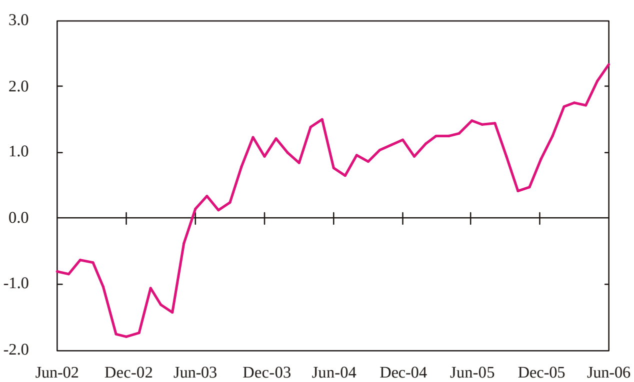
The fixed-term deposit rate (DTF)[9] averaged 6.12% in June 2006, having dropped by 19 bp since January. In real terms, however, the fall in inflation implied a rate rise of 17 bp (Chart 19).

Chart 18

NOMINAL INTERBANK RATE AND BANCO DE LA REPÚBLICA'S INTERVENTION RATES (*)



REAL INTERBANK RATE



(*) The Banco de la República has suspended the auction and Lombard contraction window since December 22, 2004.
Source: Banco de la República and the Financial Superintendency.

The DTF rate has moved closer to the interbank rate and has in fact run below it on several occasions; this is partly because institutional investors have recently made less use of CDs. For this reason their interest rate now reflects to a greater extent the return paid to individuals, who usually obtain a lower remuneration than is paid to institutional investors.

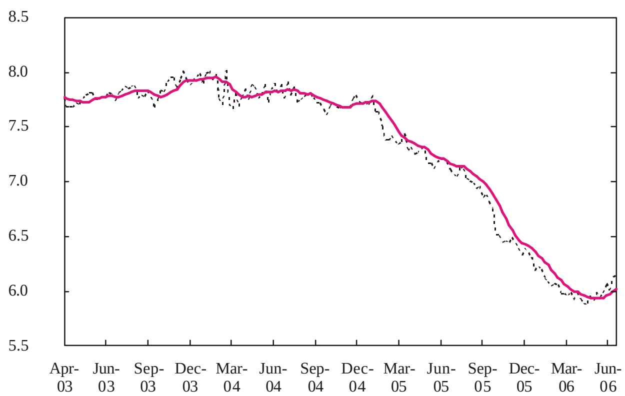
Lending rates by economic destination have also fallen substantially in nominal terms, though not always in real terms. Specifically, in June 2006 lending rates were as follows: consumer loans 20.1% (real rate 15.5%), ordinary loans 14.5% (real rate 10.1%), preferential loans 8.9% (real rate4.7%), and for treasury loans 8.0% (real rate 3.9%). Except for preferential and treasury loans, nominal lending rates fell by more than inflation did, resulting in lower real rates since January (Table 12 and Chart 20).

9 DTF is the 90-day weighted monthly average CD rate reported to the Financial Superintendency by banks, industrial development banks and commercial financing firms across the country.

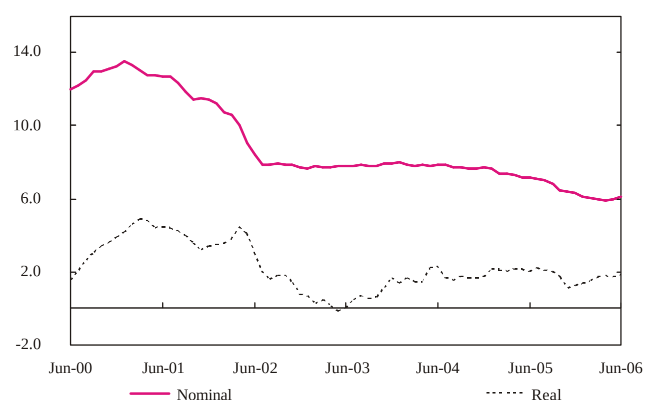
Chart 19

INTEREST RATES

NOMINAL DTF RATE



NOMINAL AND REAL DTF RATES (*)



(*) Deflated by CPI.
Source: Banco de la República.

Table 12

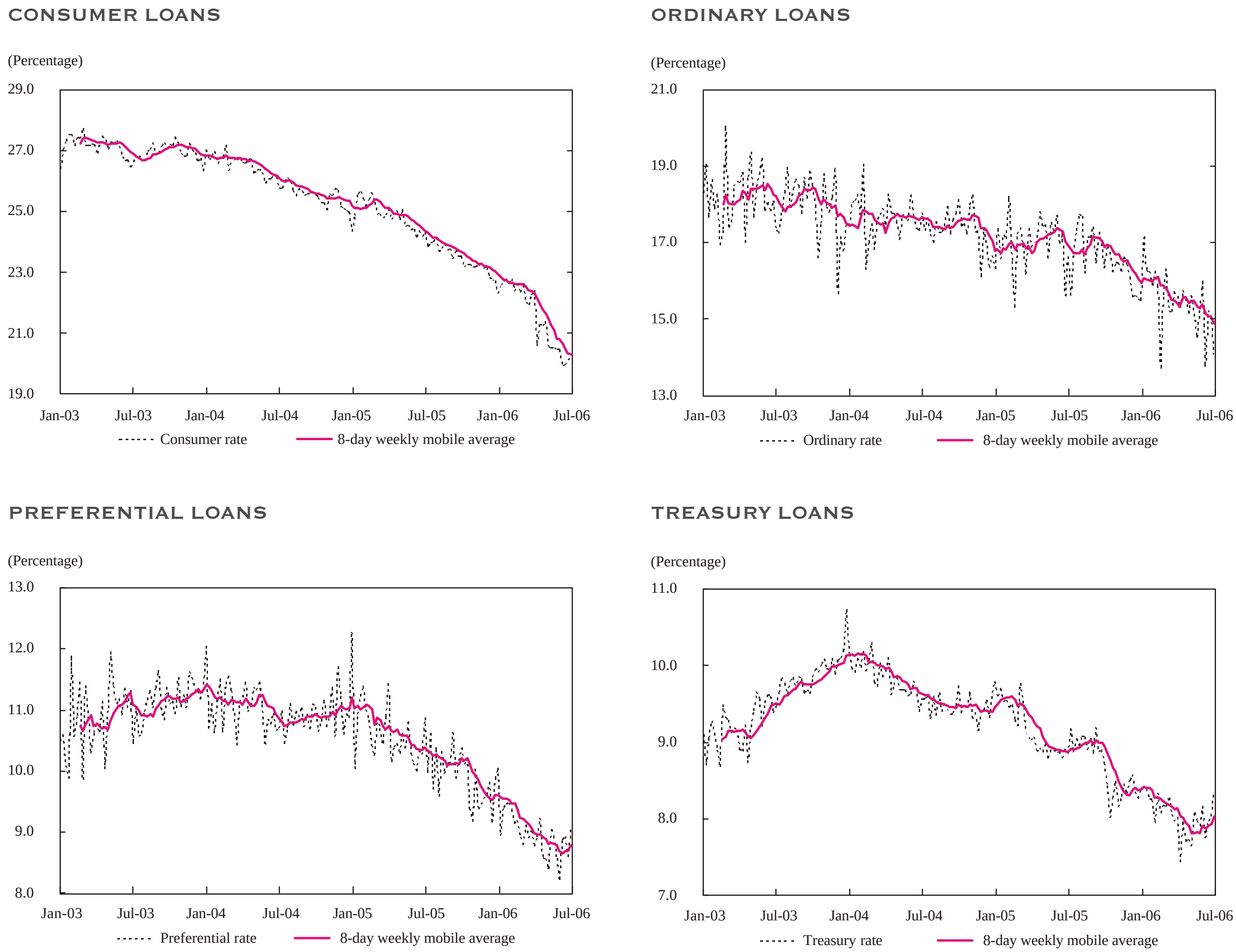
LENDING RATES (*)

	Consumer		Ordinary		Preferential		Treasury	
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
Year-to-date change (bp)	(259)	(146)	(108)	(8)	(83)	12	(35)	57

(*) Monthly average, weighted by amount.
Source: Banco de la República.

Chart 20

LENDING RATES BY ECONOMIC USE



Source: Financial Superintendency; calculations by Banco de la República.

c. Interest rates on public-debt securities

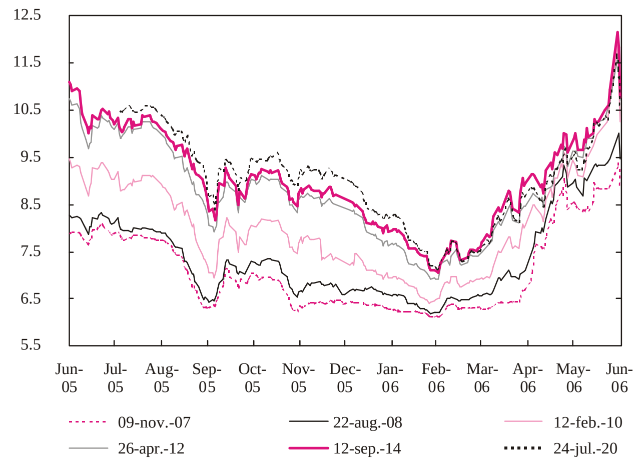
In the course of this year domestic and foreign markets have continued to keep a close watch on the US economy to anticipate the end of the Fed's interest-rate rising cycle, which began in June 2004. This continuous analysis determined to a great extent the behavior of the domestic public-debt market, characterized by trading rates on a declining trend up to the end of February and on a rising one from then until the end of June.

In the first two months of 2006 the domestic public-debt market registered high trading volumes (4.7 trillion pesos through SEN, the electronic trading system for government securities), and falling interest rates in the primary and secondary markets, down to historical lows in the last week of February (7.11% for bonds maturing in July 2020). Starting from March TES interest rates were on the rise, with greater volatility and a decline in trading volumes.

In January and February the fall in secondary-market TES trading rates occurred in an environment of calm on the foreign-exchange market, higher valuation of Colombian external debt in financial markets, and optimism in the equity market. During this period the exchange rate appreciated by 2% and the exchange market showed little volatility (the rate fluctuating between 2,246 and 2,284 pesos). The EMBI for Colombia fell by 86 bp between January and March, from 232 to 146. The Colombian Stockmarket General Index rose sharply in January, to a history peak of 11,433.25 on January 27, equivalent to a 23% valuation gain for the year to date. In this context TES rates dropped to all-time lows, the correction being greater in longer-term bonds, as illustrated by Chart 21.

CHART 21

TES FIXED TRADING RATES IN 'SEN' SECONDARY MARKET (2005)



Source: Banco de la República's Electronic Trading System (SEN).

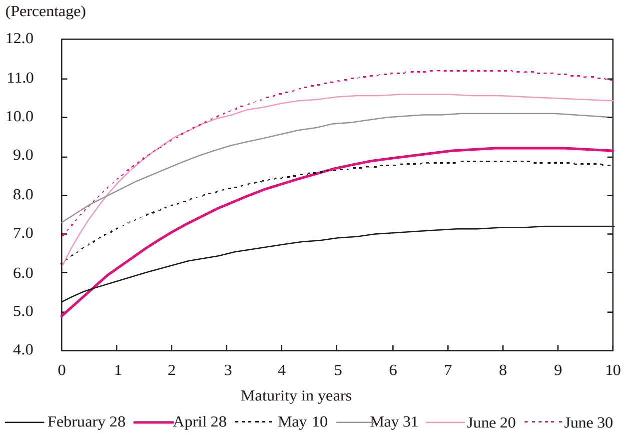
In March the chances of inflationary pressures in the United States caused great uncertainty and nervousness in international and domestic markets. The most relevant data the market heard about the US economy included, notably, capacity utilization for March: at 81.3%, the highest in five years. Core-inflation for March was 0.3%, higher than the expected rate of 0.2%. These indicators caused US Treasury rates to rise and influenced Colombia's domestic debt market, generating increases in long-term TES rates. Chart 22 shows that from February 28 to April 28 the zero-coupon curve of fixed-rate TES climbed steeply.

The Board of Directors' decision on April 28 to raise the benchmark rate by 25 bp induced an increase in the ensuing days in short- and medium-term trading rates on the secondary market, causing a flattening of the TES fixed-rate curve.

On May 10 the Fed raised its benchmark rate by 25 bp for the third time in the year, to 5%. Though this increase was already discounted by the market, the announcement of the measure left open the possibility of further increases during the rest of the year, creating uncertainty about the US interest rate's adjustment ceiling and its effect on interest rates in the major

CHART 22

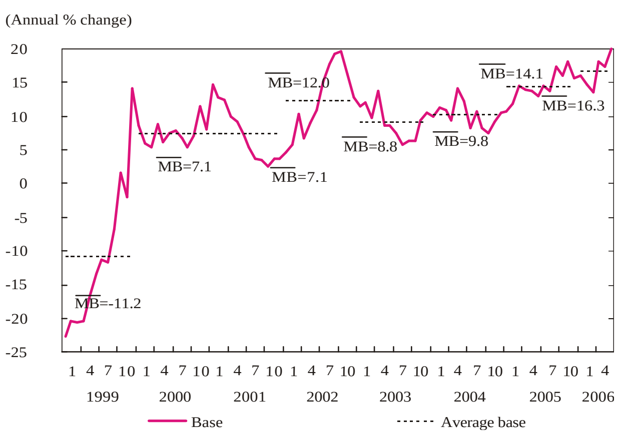
FIXED-RATE, ZERO-COUPON TES CURVE



Source: Colombia Securities Exchange (BVC); calculations by Banco de la República.

CHART 23

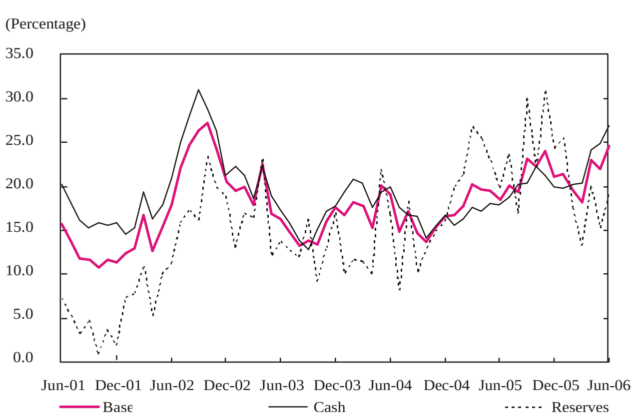
REAL MONETARY BASE



Source: Banco de la República.

CHART 24

MONETARY BASE AND ITS USES
(ANNUAL GROWTH RATE OF MONTHLY AVERAGE)



Source: Banco de la República.

economies. Investors therefore decided to reduce their exposure to risk, liquidating investments in emerging economies until the end of June and generating volatilities in those countries' markets.

Capital movements in world financial markets were reflected in Colombian TES rates, which rose on average between May 10 and June 30 by 122 bp, 205 bp and 231 bp in the short, medium and longer parts of the TES yield curve. This upward shift occurred in two movements: first, a parallel displacement up to the end of May, generated by liquidation of investments; second, a steepening of the curve until the end of June, caused by a shift in the composition of agents' portfolios, away from long-term securities and toward others with shorter maturities, to hedge against greater international volatility. Note that the public-debt market had already discounted further increases in the Banco de la República's benchmark rate, so that the 25 bp rise announced on June 20 did not significantly affect the curve's structure (Chart 22).

2. Monetary aggregates

From January to June 2006 the monetary base grew by an average rate of 21.1%, faster than nominal GDP. It has thus remained buoyant for six years, expanding more strongly over the past three years (Chart 23).

The rise in the monetary base came from increases in both bank reserves and cash holdings, with bank reserves growing by an annual average rate of 18.2% in nominal terms and 13.5% in real terms, and cash holdings by 22.4% and 17.5% respectively (Chart 24). This strong growth in cash resulted from the lagged effect of lower inflation and lower interest rates, and also from agents' having learnt how to avoid the financial-transactions levy and reduce their transaction costs.

The monetary base's annual growth to June 2006 came from: i) an increase of 2,894 bn pesos in expansion Repos; ii) an increase of 818 bn pesos resulting from smaller government deposits at the Banco de la República; iii) the transfer of profits of 793 bn pesos to the government in February; iv) the provision of liquidity of 513 bn pesos through discretionary foreign-exchange purchases worth 9,678 bn pesos by the Banco de la República, partly offset by sales of foreign exchange worth 6,848 bn pesos to the government and by the exercise of call options worth 2,316 bn pesos to control volatility; v) a net contraction of 1,755 bn pesos, from the purchase and sale of TES securities worth 1,501 bn pesos, and the contractionary effect of securities worth 254 bn pesos maturing during the period; and vi) a net expansion of 658 bn pesos from other factors associated with the Bank's profit and loss statement (Table 13).

Growth in broad money (M3) slowed a little, from an annual average rate of 17.9% for 2005 to one of 15.4% for January-June 2006, coinciding with a

Table 13

MONETARY-BASE SOURCES
(Billions of pesos)

			Annual change		
		Dec-04	Jun-05	Dec-05	Jun-06
I.	**Government**	**(236)**	**(6,432)**	**(2,637)**	**1,611**
	Profit transfer 1/	803	0	0	793
	Pesos	803	0	0	793
	Deposits at Banco de la República	(1,039)	(6,432)	(2,637)	818
II.	**Regulation TES**	**(2,524)**	**1,291**	**897**	**(1,755)**
	Definite purchases	1,023	3,671	5,230	2,499
	Definite sales	(2,972)	(1,989)	(4,000)	(4,000)
	Maturities	(575)	(391)	(334)	(254)
III.	**Repos**	**(1,058)**	**2,350**	**1,539**	**2,894**
	Expansion 2/	(1,086)	2,208	1,539	2,894
	Contraction	28	143	0	0
IV.	**Foreign Exchange**	**6,194**	**4,676**	**2,785**	**513**
	Accumulation (put) options	4,183	1,997	0	0
	Decumulation (call) options	0			(2,316)
	Discretionary intervention	3,264	7,043	10,757	9,678
	Sale of foreign exchange to government	(1,252)	(4,364)	(7,973)	(6,848)
V.	**Other** 3/	**272**	**784**	**960**	**658**
Total change in base		**2,647**	**2,670**	**3,543**	**3,921**
Balance of base		**19,262**	**17,914**	**22,805**	**21,835**

1/ In 2005 the profits transferred to the government, in the amount of 454 bn pesos ($195.9), were entirely in dollars.
2/ Includes one-day, overnight and medium-term Repos.
3/ Includes, among other things, the monetary effect of BdR's profit and loss statement, TES-A maturities, loan recoveries, and Banco de la República's investments.
Source: Banco de la República.

fall in the differential between domestic and foreign interest rates and the peso's recent depreciation. But M3 growth is still stronger than the pace of economic activity (Chart 25 and Table 14).

M3 behavior under the current monetary-policy strategy reflects changes in money demand rather than in the Banco de la República's stance.

M3 behavior under the current monetary-policy strategy reflects changes in money demand rather than in the Banco de la República's stance. Changes in M3 should therefore be viewed in the light of the behavior of money-demand determinants such as: i) aggregate demand; ii) present and future conditions on the exchange market; iii) changes in inflation; and iv) domestic and foreign interest rates.

Strong M3 growth in the previous years had coincided with periods of greater confidence in the Colombian financial system and greater capital inflows (Table 15); in 2003 and 2004, in particular, the Colombian peso had appreciated on average by 9.5% and 6.5%, respectively. This result, together with the behavior of net external private portfolio flows and low external interest rates, had led to a shift in agents' portfolios toward domestic assets.

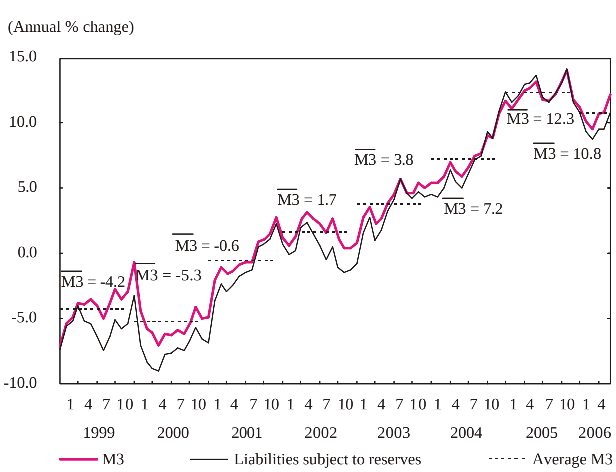
By component, the dynamics of M3 was determined by a slowdown in liabilities subject to reserve requirements, whose annual growth to May 2006 averaged 14.2%. Average annual growth in CDs slowed from 10.1% in 2005 to 7.0% in January to May this year; similarly, savings slowed from 30.0% to 24.2%, checking accounts from 16.7% to 15.2%, and bonds from 21.1% to 5.7%.

Table 16 presents the breakdown of M3 for the public and private sectors individually. Last May private-sector deposits in credit institutions grew by an annual rate of 17.4%; their growth between January and May 2006 averaged 16.8%, down from 18.4% over the same period last year. This bears out the statement above about money demand growing more slowly for the reasons explained.

Public-sector deposits in the financial system increased by an annual rate of 1.4% last May. If we exclude Repos between the financial system and the National Treasury, the growth rate is 9.9%; note also that these public-sector deposits are determined more by specific factors concerning management of the resources of the National Treasury and other bodies in connection, among other things, with tax collection, than by the determinants of money demand listed above.

CHART 25

REAL BROAD MONEY M3



Source: Banco de la República.

MONETARY AGGREGATES

Nominal annual % change in monthly average of weekly data

	Base	Cash	Reserva	M1	Quasi-money	M2	LSR (*)	M3
Jan-05	16.5	15.3	19.6	14.8	20.3	18.6	18.5	17.8
Feb-05	17.4	16.0	21.0	14.1	19.5	17.9	17.5	17.0
Mar-05	19.9	17.3	26.5	18.1	20.8	20.0	17.7	17.4
Apr-05	19.3	16.9	25.2	17.2	22.5	20.9	18.6	18.1
May-05	19.2	17.7	22.7	18.3	19.7	19.3	18.7	18.3
Jun-05	18.1	17.6	19.5	17.8	20.7	19.9	19.1	18.6
Jul-05	19.8	18.4	23.5	18.0	20.1	19.5	17.4	17.3
Aug-05	19.0	20.0	16.6	20.6	19.5	19.8	17.0	17.1
Sep-05	22.8	20.0	29.7	19.7	21.1	20.7	17.9	17.9
Oct-05	21.9	21.9	21.8	21.1	22.8	22.3	19.0	19.1
Nov-05	23.7	21.0	30.6	19.9	23.3	22.3	20.0	19.8
Dec-05	20.8	19.6	24.0	19.1	19.0	19.1	16.9	17.2
Jan-06	21.0	19.5	25.2	18.4	17.3	17.6	15.9	16.3
Feb-06	19.2	19.9	17.3	18.1	17.4	17.6	13.9	14.7
Mar-06	17.9	20.0	13.0	16.6	16.3	16.4	13.2	14.0
Apr-06	22.7	23.9	19.8	20.0	16.0	17.2	14.1	15.3
May-06	21.7	24.6	15.0	21.3	16.3	17.7	14.0	15.3
Jun-06	24.4	26.6	18.9	23.5	15.7	17.9	15.2	16.6

Annual nominal average

	Base	Cash	Reserva	M1	Quasi-money	M2	LSR (*)	M3
2005	19.9	18.5	23.4	18.2	20.8	20.0	18.2	17.9
2006 to June	21.1	22.4	18.2	19.6	16.5	17.4	14.4	15.4

Real annual % change in monthly average of weekly data

	Base	Cash	Reserva	M1	Quasi-money	M2	LSR (*)	M3
Jan-05	10.4	9.3	13.5	8.9	14.1	12.5	12.3	11.7
Feb-05	11.6	10.2	15.0	8.4	13.6	12.0	11.6	11.1
Mar-05	14.2	11.7	20.5	12.4	15.0	14.3	12.1	11.7
Apr-05	13.6	11.3	19.2	11.6	16.6	15.1	13.0	12.5
May-05	13.5	12.1	16.8	12.6	14.0	13.6	13.0	12.6
Jun-05	12.7	12.2	14.0	12.4	15.2	14.4	13.6	13.2
Jul-05	14.2	12.9	17.7	12.4	14.5	13.9	12.0	11.8
Aug-05	13.5	14.4	11.2	14.9	13.9	14.2	11.6	11.6
Sep-05	16.9	14.3	23.5	14.0	15.3	14.9	12.3	12.2
Oct-05	15.8	15.8	15.7	15.0	16.6	16.2	13.1	13.1
Nov-05	17.7	15.1	24.2	14.1	17.3	16.4	14.2	14.0
Dec-05	15.2	14.0	18.3	13.6	13.5	13.6	11.5	11.7
Jan-06	15.8	14.2	19.8	13.2	12.2	12.5	10.8	11.2
Feb-06	14.4	15.1	12.6	13.4	12.7	12.9	9.3	10.1
Mar-06	13.3	15.3	8.5	12.0	11.7	11.8	8.7	9.5
Apr-06	17.8	19.0	15.1	15.3	11.4	12.5	9.5	10.7
May-06	17.0	19.8	10.5	16.6	11.8	13.2	9.5	10.8
Jun-06	19.7	21.8	14.4	18.8	11.4	13.5	10.8	12.2

Annual real average

	Base	Cash	Reserva	M1	Quasi-money	M2	LSR (*)	M3
2005	14.1	12.8	17.5	12.5	15.0	14.2	12.5	12.3
2006 to June	16.3	17.5	13.5	14.9	11.9	12.7	9.8	10.8

(*) Liabilities subject to reserves.
Source: Financial Superintendency; calculations by Banco de la República.

TABLE 15

M3 AND ITS DETERMINANTS

		2003	2004	2005	I Qtr. 2006
Annual M3 growth	1/				
Total		11.84	14.17	16.72	12.65
Excluding Treasury Repos		10.76	15.95	18.63	14.11
Real annual M3 growth					
Total		4.42	7.77	11.23	8.19
Excluding Treasury Repos		3.41	9.46	13.05	9.60
Change in inflation rate	2/	0.79	(1.23)	(0.86)	(0.85)
Real annual GDP growth		3.89	4.79	5.14	5.30
Domestic interest rates					
CDs		7.73	7.71	6.91	5.92
Change in CD rate		(1.13)	(0.02)	(0.80)	(1.46)
External interest rates					
90-day US term deposits		1.15	1.56	3.51	4.00
Change in external rate		(0.57)	0.41	1.95	2.00
Nominal exchange rate					
Average annual variation	3/	13.04	(9.47)	(6.55)	(3.59)
Change in average annual variation		2.32	(22.51)	2.92	6.41

1/ Average annual growth of quarterly data.
2/ Calculated as the annual average of quarterly data.
3/ Average variation of annual depreciations from quarterly data.
Source: Banco de la República, DANE, and Federal Reserve Economic Data.

TABLE 16

COMPOSITION OF M3
(BILLIONS OF PESOS)

	September			December			March			May		
	2004	2005	% change	2004	2005	%, change	2005	2006	% change	2005	2006	% change
Private M3	68,625	83,468	21.6	77,487	91,598	18.2	77,127	89,890	16.5	78,170	92,577	18.4
Cash	10,547	12,925	22.5	13,832	16,397	18.5	12,121	14,864	22.6	12,311	15,286	24.2
LSR	58,078	70,543	21.5	63,655	75,200	18.1	65,006	75,026	15.4	65,859	77,291	17.4
Checking accounts	7,582	9,403	24.0	10,250	12,474	21.7	8,932	10,799	20.9	8,786	11,061	25.9
CDs	24,471	26,935	10.1	24,418	26,855	10.0	25,228	27,253	8.0	25,812	27,381	6.1
Savings	21,613	29,320	35.7	24,330	30,861	26.8	26,279	32,149	22.3	26,342	33,795	28.3
Other	4,411	4,885	10.7	4,656	5,011	7.6	4,568	4,825	5.6	4,918	5,053	2.7
Public M3	19,324	20,353	5.3	19,629	20,998	7.0	19,788	20,597	4.1	21,818	22,117	1.4
Checking accounts	3,780	3,956	4.7	5,041	5,510	9.3	4,091	4,261	4.2	4,254	4,149	(2.5)
CDs	2,614	2,392	(8.5)	2,276	2,179	(4.3)	2,365	2,447	3.4	2,349	2,739	16.6
Savings	7,870	10,838	37.7	8,307	9,834	18.4	9,637	10,702	11.1	10,328	11,673	13.0
Repos	2,265	0	0.0	1,194	0	0.0	922	0	0.0	1,694	0	0.0
Other	2,796	3,167	13.3	2,810	3,475	23.7	2,772	3,186	14.9	3,193	3,556	11.4
Total M3	87,949	103,821	18.0	97,116	112,596	15.9	96,915	110,487	14.0	99,987	114,694	14.7
Cash	10,547	12,925	22.5	13,832	16,397	18.5	12,121	14,864	22.6	12,311	15,286	24.2
LSR	77,402	90,896	17.4	83,283	96,198	15.5	84,794	95,623	12.8	87,677	99,408	13.4

Source: Financial Superintendency.

C. FINANCIAL SYSTEM'S LOAN PORTFOLIO AND ASSET QUALITY

The first part of this section analyzes the Colombian financial system's main indicators, comparing the behavior of domestic entities against foreign ones. The second part performs a number of credit, liquidity and market risk exercises.

1. Loan portfolio

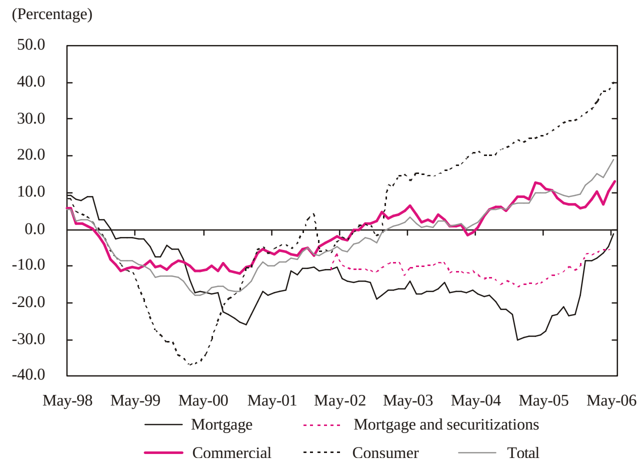
To May 2006 the financial system's loan portfolio continued to be as dynamic as in the past several years, growing at a real rate of 19.4%, driven largely by consumer loans, which surged by 40.3% in real terms, while growth in commercial loans remained moderate, at 13.0% (Chart 26).

Two loan-portfolio developments stand out: 1) an upturn in the mortgage portfolio, which, though still decreasing, did doing so at an increasingly slower pace: 1.1% in May 2006 compared with 27.6% a year earlier; and (2) strong growth in consumer loans. Consumer loans, however, have deteriorated somewhat in quality; and, requiring less collateral than other loans, might pose a greater risk to the system. This means that consumer loans and the underlying risks will need closer monitoring, as stated in previous *Financial Stability Reports*.

Foreign and Colombian banks alike have increased their loan portfolios since the end of 2002, foreign banks much more strongly than local ones since 2004, the two groups reaching real growth rates of 63% and 32.6%, respectively in May 2006 (Chart 27). Foreign banks' performance had been comparatively much stronger only back in early 1998 and then at significantly lower levels: 20% against 6.6% in real terms.

CHART 26

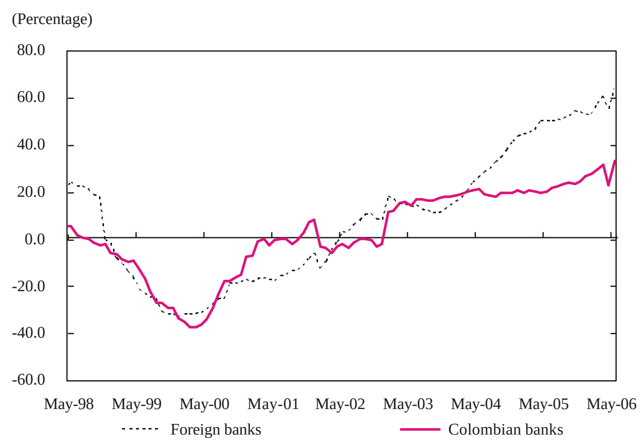
CREDIT INSTITUTIONS' GROSS LOAN PORTFOLIO (REAL ANNUAL GROWTH)



Source: Financial Superintendency; calculations by Banco de la República.

CHART 27

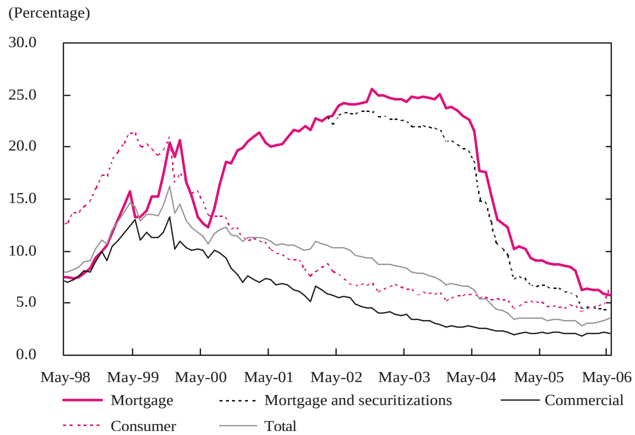
REAL GROWTH IN CONSUMER PORTFOLIO



Source: Financial Superintendency; calculations by Banco de la República.

CHART 28

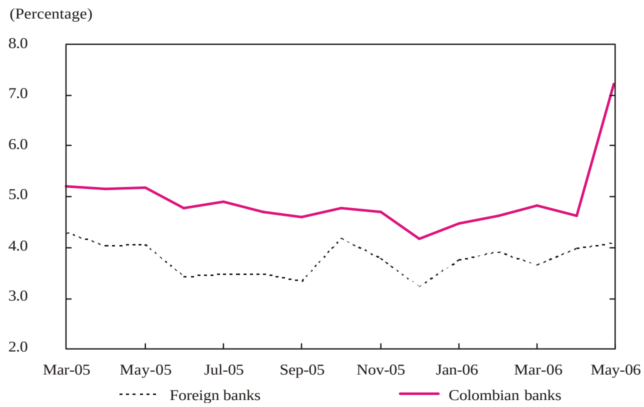
PORTFOLIO QUALITY, BY TYPE OF LOAN (*)



(*) The portfolio-quality index is calculated as overdue loans / gross loans.
Source: Financial Superintendency; calculations by Banco de la República.

CHART 29

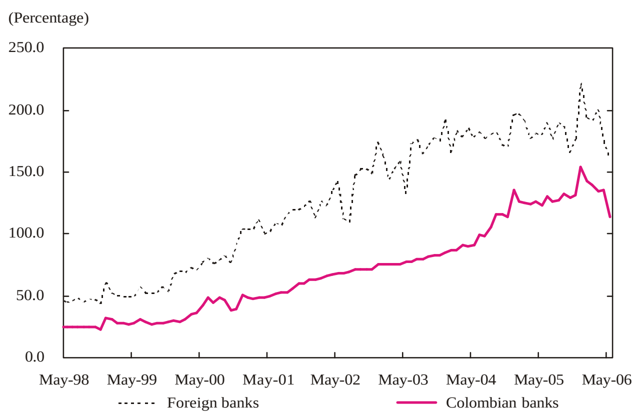
CONSUMER PORTFOLIO QUALITY INDEX



Source: Financial Superintendency; calculations by Banco de la República.

CHART 30

COVERAGE: PROVISIONS / OVERDUE LOANS



Source: Financial Superintendency; calculations by Banco de la República.

The portfolio-quality indicator has remained relatively stable in 2006, rising slightly to 3.3%, some 0.8 percentage points higher than in December 2005.[10] This deterioration was caused by a trend change in the consumer loan quality indicator, which rose by 2.4 pp from December 2005 to May 2006 (Chart 28).

Chart 29 shows movements in consumer loan quality indicators for Colombian and foreign banks over the past 12 months. The indicator for domestic banks runs consistently higher. Both groups present a trend change in their consumer loan-quality ratios from December 2005, with the Colombian banks' quality ratio deteriorating faster and the foreign banks' ratio showing a slight correction recently.

As stated earlier in this Report, the loan-coverage ratio (provisions/overdue loans) is still high, around its historical peak, at 208%, though it has decreased in the course of this year. Chart 30 presents the behavior of this ratio for domestic and foreign banks separately. It will be seen in particular that foreign banks maintain a higher coverage than Colombian banks, the difference being 47.3 pp in May 2006.

Analyzing the coverage indicator in respect of risky loans[11] we see the existing gap between domestic and foreign banks' ratios appearing only since the end of 2005, which is consistent with greater growth in foreign banks' risky loans and, hence, in their provisioning.

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10 The portfolio-quality indicator is the ratio of overdue loans to gross loans.

11 The financial system's risky portfolio consists of loans overdue by at least one day; technically this means all loans rated below A.

In short, the loan portfolio is growing strongly, driven by consumer loans and to a lesser extent by the smaller fall in mortgage loans. The loan-quality indicator is at its best historical levels, though a trend change is observed in the case of consumer loans. Foreign banks show a far higher rate of growth in consumer loans than do domestic banks, but they have also increased their coverage to cope with the rise in overdue and risky loans.

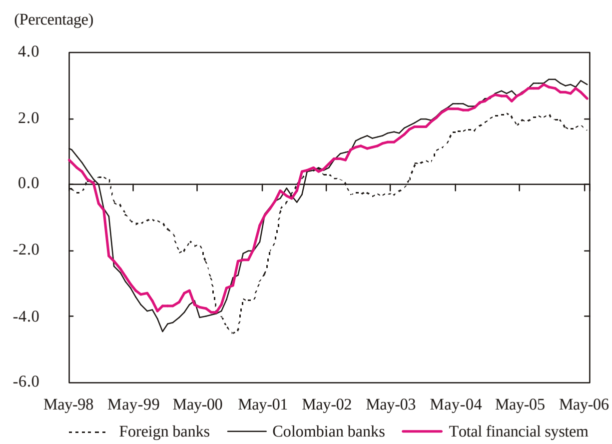
2. Financial system's profitability

At 2.6%, the financial system's profitability indicator in May 2006 was slightly lower (by 0.13 pp) than a year earlier (Chart 31). The drop came largely from lower investment income because of valuation losses. Investments accounted for 20.5% of the system's total financial income in May this year, 3.6 pp less than a year earlier, signifying a fall of 192.6 bn pesos in investment income over the past 12 months.

Colombia's financial system earns one of the highest returns on assets in the region; Table 17 presents the figures for a number of Latin American countries since December 2004. The average return on assets has been rising, and Colombia's has at all times been higher than average, running second only to Venezuela's.

CHART 31

RETURN ON ASSETS



Source: Financial Superintendency; calculations by Banco de la República.

TABLE 17

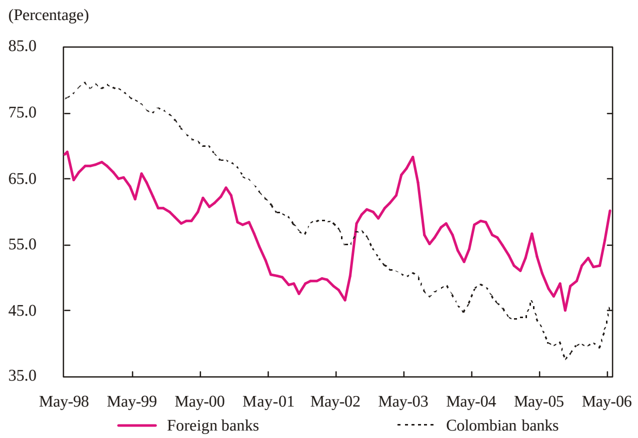
FINANCIAL SYSTEM'S PROFITABILITY RATIO: PROFITS/ASSETS

	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05
Brazil	1.67	1.78	1.84	1.89	2.02
Chile	1.24	1.20	1.23	1.29	1.27
Mexico	1.21	1.33	1.76	1.90	2.13
Peru	1.18	1.23	1.42	1.85	1.90
Venezuela	4.62	4.00	3.41	3.40	3.01
Colombia	**2.40**	**2.38**	**2.62**	**2.75**	**2.51**
Average	**2.05**	**1.99**	**2.05**	**2.18**	**2.14**

Source: Financial Superintendency of each country, Central Bank of Brazil; calculations by Banco de la República.

CHART 32

DEBT INCOME MINUS INVESTMENT INCOME, AS A SHARE OF OVERALL FINANCIAL INCOME



Source: Financial Superintendency; calculations by Banco de la República.

CHART 33

REAL EX-POST SPREADS

Source: Financial Superintendency; calculations by Banco de la República.

Asset profitability has been higher for domestic institutions, essentially because they have obtained higher income on investments (Chart 32). This greater significance of investment income, especially for domestic banks, is evidenced by the difference between the share of debt income and that of investment income in overall financial income. In May, however, there was a trend change, largely because of the TES crisis, which reduced the share of investment income in overall income.

In addition, compared with foreign banks, domestic banks have a higher intermediation spread, because of their higher *ex post*[12] lending rates, since deposit rates are practically the same in both groups (Chart 33).

In general terms, both domestic and foreign banks present favorable and rising profitability ratios, confirming the fact that the Colombian financial system is going through a good period, with a return-on-assets ratio above the average for a number of Latin American countries.

3. Risk analysis

a. Credit risk

As discussed earlier, credit growth has been accompanied by high loan quality and high provisioning. Hence, *credit risk*, which reflects the possibility of debtors failing to meet their commitment to repay their debts to financial intermediaries, will not be a source of instability for the financial system in the short term. But drastic movements in the chief macroeconomic variables may cause major debtors' balance sheets to deteriorate and so increase the credit institutions' portfolio of non-performing loans. For instance, slowdowns in economic activity, higher interest rates or steep

[12] The ex post lending rate is calculated as the ratio of interest income to productive loans.

changes in asset prices in the economy may increase defaults of credit responsibilities by financial-system debtors.

Various tests have been conducted[13] to assess the impact of an adverse macroeconomic situation on the soundness of financial institutions. In particular, the behavior of a sample of 21 banks (representing 86% of the assets of credit institutions) was tested in the face of such major changes as had occurred in the economic crisis of the late nineties.[14] The test assessed the soundness of credit institutions in terms of the solvency ratio, which measures the capacity of institutions for cushioning unexpected losses.

The tests performed show that the system's soundness provides greater protection today than at the time of the 1998-1999 crisis. An economic downturn such as occurred in the late nineties would cause the solvency ratio of six banks to fall below 9%, set as the regulatory minimum (Table 18). And if the slowdown is accompanied by a rise in interest rates or a fall in house prices, the solvency ratios of seven financial intermediaries would drop below the minimum. Though the impact on the system would be considerable, the aggregate solvency ratio would not be under 9% in any of these events.

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13 A detailed description of these test is to be found in the December 2005 Financial Stability Report.

14 For consumer and mortgage loans the tests assume a 6.8% fall in economic activity, as occurred in the second quarter of 1999, an interest-rate rise of 450 bp, as occurred in May-June 1998, and an 8% fall in house prices, the average fall in 1996-2000. In the case of commercial loans, a 9% fall in sales, as occurred in 1999, is assumed.

TABLE 18

NUMBER OF BANKS WHOSE SOLVENCY RATIO WOULD FALL BELOW THE MINIMUM (12 MONTHS)

	Shock 1 1/	**Shock 2** 2/	**Shock 3** 3/
Commercial	0	2	3
Consumer	2	2	2
Mortgage	0	0	0
Total	0	6	7
Solvency ratio	12.6	10.6	9.8

1/ Interest rates (consumer and commercial) or housing prices (mortgage).
2/ GDP (consumer and mortgage) or sales (commercial).
3/ Combination.
Source: Financial Superintendency; calculations by Banco de la República.

b. *Liquidity risk*

Financial intermediation by its nature involves transforming short-term (liquid) liabilities into long-term (illiquid) assets. Hence the possibility of a financial institution becoming unable to meet its obligations because of a lack of liquid resources. Liquidity risk is associated with this possibility.

A good approximation to liquidity risk is the difference between redeemable liabilities and liquid assets. This difference, as a percentage of illiquid assets, is the uncovered liability ratio.[15] Therefore, the more negative the ratio, the smaller the liquidity risk faced by the institution.

One simulated shock scenario consisted of estimating the impact that a sudden withdrawal of 12% of deposits[16] would have on the uncovered-liability ratio of each institution in the banking system. According to Chart 34, in February 2006 no institution had a positive uncovered-liability ratio, suggesting a low incidence of liquidity risk. In this shock scenario, four institutions (representing about 8% of the system's total assets) would present a positive uncovered-liability ratio, averaging 5%. These results suggest that even in an extreme scenario Colombia's financial system displays high resistance in terms of liquidity needs.

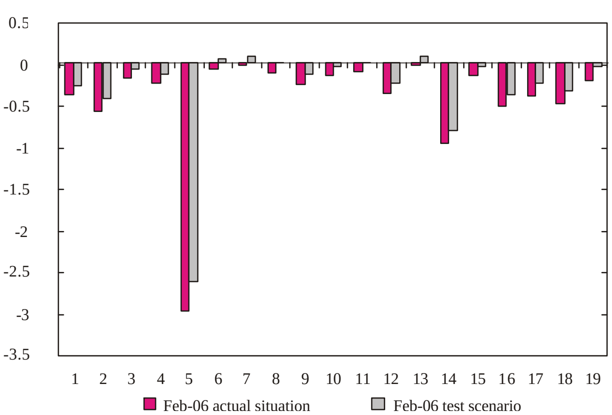
c. *Market risk*

The mounting share of investments in the financial system's assets has aroused greater interest in measuring and managing the market risk associated with the portfolio of financial-system agents.

Previous *Financial Stability Reports* have emphasized the need to monitor closely any rise in market-risk exposure, given the increase in the financial institutions' securities holdings. For greater exposure makes the portfolio more sensitive to changes in investment interest rates, potentially resulting in substantial losses in the event of an adverse change in asset prices and of insufficient capital to deal with the situation.

CHART 34

SENSITIVITY TEST: UNCOVERED-LIABILITY RATIO, COMMERCIAL AND MORTGAGE BANKS 2/



1/ Razón de pasivos no cubiertos.
2/ Bancos especializados en cartera hipotacaria.
Source: Calculations by Banco de la República.

15 The uncovered-liability ratio = [(*TrL* + *LL*) - *LA*] / *TA* - *LA*, where *TrL* is the transitory component of non-liquid liabilities, *LL* liquid liabilities, *TA* total assets, and *LA* liquid assets.

16 This percentage is the average of the highest withdrawals observed during the financial crisis of the late 1990s.

In effect, the secondary market for public-debt securities has gone through a period of low prices since the beginning of March,[17] clearly affecting the market value of the financial institutions' portfolio. The effect on the prices of these assets brought a period of stress in the market, with agents liquidating substantial quantities of their portfolios and facing possible valuation losses.

The secondary market for public-debt securities has gone through a period of low prices since the beginning of March, clearly affecting the market value of the financial institutions' portfolio.

In this connection, the present section makes a preliminary assessment of the effect of price changes on the portfolios' market value. First, we assess the change in the market value of the credit institutions' portfolio from February 28 to May 26, 2006; these dates refer to the latest period of price falls for which information is available so far. The object of the exercise is to find out what has been the effect on the portfolio's value of changes in both the stock of securities and their prices. Note that this is not a valuation-loss exercise, for no information is yet available on when the securities were actually sold between those two dates and at what price. In a second exercise, therefore, we shall assess the potential losses agents would incur in a specific scenario.

i) The financial system's exposure to the TES-B market

As stated above, the prices of investments in public-debt securities began to fall from the start of March. The traded market value of TES-B securities fell by 7.9% from February to May 2006, from 51.91 trillion pesos to 47.8 pesos.[18] As a result of this valuation loss and the non-renewal of securities maturing up to April, agents' portfolio at May 26, 2006 was less exposed to public-debt securities.

The financial system's lower exposure to public-debt securities is attributable first and foremost to credit institutions, whose exposure to TES-B securities fell by 9.2%, from 25.7 tr pesos on February 28 to 23.4 tr pesos on May 26, 2006 (Table 19). The non-banking financial sector, for its part, reduced its TES-B exposure by 6.5%, from 26.2 tr pesos to 24.5 tr pesos (Table 20).

The traded market value of TES-B securities fell by 7.9% from February to May 2006, from 51.91 trillion pesos to 47.8 tr pesos.

[17] Note that securities indexed to the Real Value Unit and CPI (i.e. variable rate) are valued differently from peso securities (i.e. fixed rate) and, given the good behavior of inflation during the months considered in this section, their prices showed greater stability (some even increased). Therefore, when we speak of a context of falling prices, we refer to the fixed-rate securities, which represent a little over 70% of agents' portfolio.

[18] Valuation of TES-B securities encompasses all these securities held by agents: negotiable, available-for-sale, and to-maturity.

By type of intermediary, among credit institutions commercial banks continue to show the highest concentration of TES-B, with 93.4%, while in the non-banking financial sector pension fund managers still have the biggest share (68.1%). Fixed-rate (peso) securities continue to make up the greater part of the portfolio of both credit institutions and the non-banking financial sector.

TABLE 19

CREDIT INSTITUTIONS' TES-B BALANCES
AT MARKET PRICE
(MILLIONS OF PESOS)

	Pesos	Variable rate	UVR	Total
Balance at February 28, 2006				
Commercial banks	18,184,198	925,063	4,851,008	**23,960,269**
Commercial financing companies	64,998	0	23,784	**88,782**
High-grade cooperatives	10,730	0	0	**10,730**
Industrial development banks	1,548,694	18,256	136,031	**1,702,982**
Total credit institutions	**19,808,621**	**943,319**	**5,010,823**	**25,762,763**
Balance at May 26, 2006				
Commercial banks	16,506,390	934,485	4,270,975	**21,711,849**
Commercial financing companies	90,692		25,314	**116,006**
High-grade cooperatives	14,643			**14,643**
Industrial development banks	1,270,111	16,437	256,473	**1,543,021**
Total credit institutions	**17,881,836**	**950,921**	**4,552,762**	**23,385,519**

Source: Banco de la República.

TABLE 20

NON-BANKING FINANCIAL SYSTEM'S TES-B BALANCES
AT MARKET PRICE
(MILLIONS OF PESOS)

	Pesos	Variable rate	UVR	Total
Balance at February 28, 2006				
Stockbrokers	274,006	1,635	157,314	432,954
Insurance and capitalization companies	1,456,089	193,921	902,854	2,552,864
Pension fund managers	13,876,068	856,814	4,587,987	19,320,868
Trust companies	2,694,225	583,770	631,880	3,909,875
Total non-banking financial sector	**18,300,387**	**1,636,140**	**6,280,035**	**26,216,561**
Balance at May 26, 2006				
Stockbrokers	388,960	1,505	124,918	515,383
Insurance and capitalization companies	1,399,804	190,191	1,201,595	2,791,590
Pension fund managers	12,621,172	663,739	4,825,383	18,110,294
Trust companies	1,973,885	541,037	577,109	3,092,030
Total non-banking financial sector	**16,383,821**	**1,396,472**	**6,729,005**	**24,509,298**

Source: Banco de la República.

ii) Loss evaluation

As stated above, the changes in the portfolio's market value described in the first part of this section do not in themselves constitute a valuation-loss exercise, for no information is yet available on the time and prices of the actual sales of securities between those two dates. For this reason a second exercise has been performed in which agents are assumed to be faced with an unexpected price change in their securities and forced to liquidate their portfolio at the new prices.

To this end, the portfolio at February 28 is valued using May 26 prices and then compared with its initial value (i.e. at February 28 prices). This exercise assumes two things: i) that agents are obliged to liquidate all their portfolio at May 26 prices,[19] and ii) that during the period of liquidation they may not alter the composition of their portfolio. The difference between the portfolio values is therefore the valuation loss agents incur from a given price change, regarded as the greatest potential loss.

The results are presented in Table 21: credit institutions as a whole would lose around 1.1 tr pesos, and the non-banking financial sector 1.9 tr pesos. Among the former, losses would be concentrated in commercial banks

[19] The portfolio to be liquidated includes all positions: negotiable, available-for-sale, and to-maturity.

TABLE 21

VALUATION LOSSES:
SHOCK EQUAL TO PRICE CHANGES
BETWEEN FEBRUARY 28 AND MAY26, 2006
(MILLIONS OF PESOS)

	Fixed rate (pesos)	Variable rate	UVR	Overall total
Total credit institutions	**679,369**	**52,778**	**363,056**	**1,095,203**
Commercial banks	640,805	50,774	346,012	1,037,591
Commercial financing companies	1,676	0	942	2,618
High grade cooperatives	206	0	0	206
Industrial development banks	36,681	2,004	16,103	54,788
Total non-banking financial sector	**1,165,943**	**77,633**	**727,157**	**1,970,733**
Pension fund managers	995,507	41,288	576,039	1,612,834
Trust companies	95,197	28,028	45,788	169,013
Insurance and capitalization companies	58,085	8,189	91,098	157,372
Stockbrokers	17,155	128	14,232	31,515

Source: Banco de la República.

(1.0 tr pesos); among the latter the greatest impact would be on the portfolio of pension fund managers (1.6 tr pesos). The long duration of pension fund managers' portfolios would be accountable for their elevated losses, for the very nature of their business requires them to hold long-dated securities. This longer duration makes the prices of these securities more sensitive to interest-rate changes.

V. MONETARY AND EXCHANGE-RATE POLICY

The prime objective of Colombian monetary policy is to achieve and keep a low, stable rate of inflation and attain the highest output growth sustainable with price stability.

A. MONETARY POLICY

The prime objective of Colombian monetary policy is to achieve and maintain a low, stable rate of inflation and attain the highest sustainable growth compatible with price stability. Price stability will contribute to a sustained growth that generates employment and improves the population's standard of living. But if the economy were to grow at a pace that is not sustainable, a crisis would occur sooner or later, with serious consequences for the economy, deterioration of social indicators, loss of public confidence, and falls in investment and employment.

To achieve the objective described above, the monetary authority relies on inflation targeting, a monetary-policy framework applied by over 50 economies in the world, both developed and developing. The Bank's Board of Directors implements inflation targeting by setting quantitative inflation targets. For 2006 the specific inflation target is 4.5%, within a range of 4% to 5%. To help anchor inflation expectations further ahead, the Board has also defined a range of 3% to 4% within which the inflation target for 2007 will be set, and a range of 2% to 4% for the long-term target.

To achieve this objective, the monetary authority relies on inflation targeting, a monetary-policy framework applied by over 50 economies in the world.

The Banco de la República implements monetary policy by modifying the interest rates it applies in providing liquidity to the economy or in withdrawing it. These intervention rates are the instrument of monetary policy, for through them the Bank affects market interest rates.

When the Bank alters its intervention rates, it affects market interest rates, the rate of exchange and the cost of credit, setting in motion a series of mechanisms that influence financial markets, agents' spending decisions, output and employment, the expectations of economic agents and the

Monetary policy affects inflation and output through four main channels, namely:…

rate of inflation. This succession of mechanisms is referred to as "transmission mechanisms": the processes or channels by which monetary-policy decisions are transmitted to output and inflation, after a long and variable time lag.

1. Monetary-policy transmission mechanisms and time lags

a. Monetary-policy transmission channels

Monetary policy affects inflation and output through four main channels, namely: the direct interest-rate channel, the credit channel, the exchange-rate channel, and the expectations channel. Moreover, some of these channels are interconnected and may work complementarily.

i) The direct interest-rate channel

This is the more traditional transmission channel. The central bank, by varying the money supply, causes changes in the nominal interest rate, which, given some overall price rigidity in the economy, result in changes in the real interest rate. These changes in the real interest rate affect consumption and investment and, thus, aggregate demand.

ii) The credit channel

The direct interest-rate channel works simply because the interest rate is the opportunity cost against which, for example, production-investment decisions are compared. But where there are financial intermediaries ready to extend credit, the source of funding for companies or households becomes important in their investment decision-making. Two main sources of funding are available to them: bank credit and internal funding (own funds). In this context, the relative cost of credit against own funds becomes relevant; so, if the central bank lowers interest rates, credit becomes cheaper and companies and households will want to finance themselves to a greater extent with credit. Consequently, access to more credit funds (through lower interest rates on loans) allows them to finance consumption and investment expenditures that they would not otherwise incur, thereby boosting economic activity and employment.

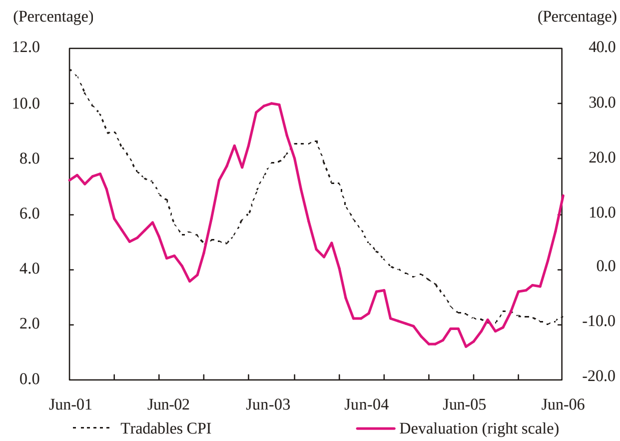
… the direct interest-rate channel, the credit channel, the exchange-rate channel, and the expectations channel.

iii) The exchange-rate channel

Monetary policy can affect the exchange rate either through interest-rate movements or, directly, through central-bank intervention in the exchange market. Other things being equal, an unexpected rise in the domestic interest rate should cause the local currency to appreciate; and, given short-term price rigidities, changes in the nominal exchange rate affect exports and imports and through them aggregate demand. Depreciation generates an increase in net exports and in aggregate demand; it also has a direct impact on inflation through the import component.

Chart 35

TRADABLES INFLATION, AND DEVALUATION



Source: DANE and Banco de la República.

Chart 35 shows the relation between devaluation and tradables inflation from 2002 to date. The two series are seen to be directly correlated, though there is a transmission lag between devaluation and inflation, and the size of the transmission is low: a 10% rise n the exchange rate is estimated to increase inflation by 0.4% - 0.6% within three to six months.

The effects of exchange-rate variations also depend on the financial system's characteristics and on the hedging alternatives it offers. Thus, if local residents are net debtors, the currency's strong appreciation can significantly improve their balance sheets and produce an expansionary effect on aggregate demand that may reduce the relative price effect.

iv) Expectations channel

Given the intertemporal nature of economic agents' decision-making, this channel defines the way in which agents form their expectations about the future. Expectations are at play in all the other channels, especially the credit and exchange-rate channels. Thus, over-reactions to asset prices, such as those observed in cycles of share-price expansion and contraction, may produce "wealth" effects that are then transmitted to firms and households by the mechanisms described above.

The effect of policy change on expectations may vary at different points of time or of the cycle. Uncertainty over the impact of policy change on the economy makes it even more important to have a credible, transparent regime. Inflation expectations are thus a determining component of pay negotiations and contract setting, being a direct source of the price- and inflation-generating mechanism.

The central bank's credibility has an important part to play, for it guides agents' inflation expectations. A credible inflation target allows agents to

The transmission mechanisms of monetary policy operate with long, variable lags because it takes time for the economy to adjust to changes in monetary conditions.

form clearer and less erratic expectations about future monetary-policy behavior. Thus the impact of a policy decision today on the economy's overall interest-rate structure should be more predictable where there is a greater degree of credibility in the central bank's objectives.

b. Policy transmission lags

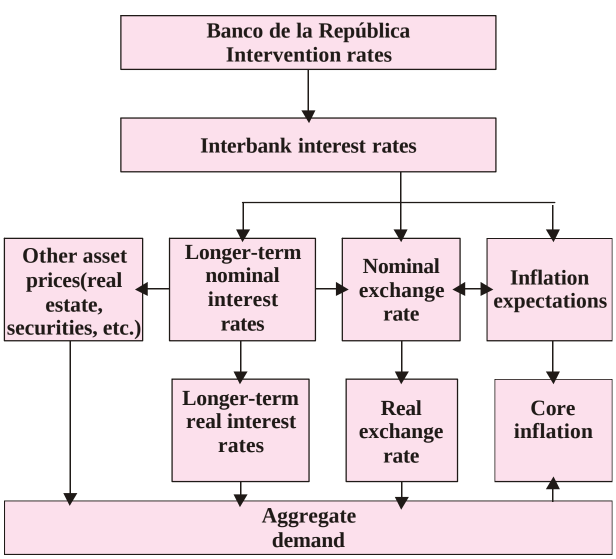
As described above, monetary policy can produce an impact on output and inflation through different transmission mechanisms, but these operate with long, variable lags because it takes time for the economy to adjust to changes in monetary conditions.

According to international literature, it takes from four to eight quarters for monetary policy to feed through. A number of studies specifically on Colombia have found the lag to be around six to eight quarters. Diagram 1 illustrates the main monetary-policy transmission channels that generate a dynamic adjustment process in the economy.

The time lags between the various stages shown in Diagram 1 differ. Since monetary-policy actions take a considerable time to produce an effect on prices, the Banco de la República needs to identify any sign indicating the emergence of upward or downward pressure on prices as soon as possible. It will then be in a position to take corrective measures ahead of the time such pressures would be felt. Policy measures need to be taken in time to ensure the economy can grow on a sustainable basis, that is, at the pace of potential output, without generating inflationary pressures or macroeconomic imbalances.

DIAGRAM 1

MONETARY-POLICY TRANSMISSION MECHANISMS



If, for any reason, monetary policy delays in reacting when economic conditions indicate that inflation might overshoot the target, interest rates will subsequently have to be raised more aggressively to bring inflation under control again. Empirical evidence and international experience show clearly that excessive interest-rate volatility leads to loss of growth in output and employment.

Central banks that apply quantitative inflation targeting focus their attention more on inflation forecasts than on the current inflation situation.

They use econometric models for their forecasting, taking into account a wide range of information, such as indicators of economic activity and employment, costs and wages, exchange rate, world demand, international interest rates, and import prices of goods.

Since the end of the 1990s monetary policy has maintained a posture of stimulating economic growth and employment,…

2. Monetary-policy decision

Since the end of the 1990s, monetary policy has maintained a posture of stimulating economic growth and employment, while the economy has continued to progress toward the long-term aim of price stability. Over the past three years average growth has strengthened around 4.6%, basically thanks to low interest rates, which have given a significant impetus to aggregate demand. As stated earlier, the economy has also benefited from favorable external conditions and an improved climate of household and corporate confidence.

In this setting, there was a pick-up in capital flows, especially FDI, which together with higher revenues from goods and services exports were reflected in the peso's tendency to appreciate starting from 2004. The peso's appreciation caused tradables inflation and overall inflation expectations to decline faster. In this context, the Board of Directors found conditions favorable for reducing interest rates by 25 bp in December 2004 and by a further 50 bp in September 2005. As explained below, this policy was complemented by intervention in the exchange market through foreign-exchange purchases amounting to $7,179 m between 2004 and 2006, part of which was sold on to the government to facilitate turning a portion of external debt into domestic debt. The purpose of the intervention was to accumulate foreign reserves and reduce the Nation's external liabilities, so as to protect the economy against unforeseen changes in the external environment. A further aim was to avoid the peso's temporary over-appreciation, which, by negatively affecting the tradables sectors, would jeopardize the economy's future sustainable growth.

The Colombian economy's results for 2005 and data for the year to date show that its growth stems from diverse, sustainable sources and surpasses analysts' original forecasts. Buoyancy in retail sales and consumer credit, and heightened consumer confidence indicate that consumer-spending expectations continue to rise strongly; the same is true of private investment, as evidence by its behavior reflected in capital-goods imports, which expanded by an

…while the economy has continued to progress toward the long-term aim of price stability.

The essential factors determining Colombia's and other emerging economies' growth prospects are still highly favorable.

annual rate of 25.9%[20] in the first quarter of 2006. External conditions are still being reflected by dynamic global demand and high terms of trade. Credit continues to recover, including even mortgage loans, which had been shrinking in absolute terms for several years. In those conditions, the Board of Directors considered that the Colombian economy no longer needed the same monetary impetus it had been receiving to maintain its momentum.

Increases in the exchange-rate and falls in equity and TES prices since March 2006 have not essentially altered this scenario, for these movements have stemmed from market nervousness, associated largely with external developments and expectations about higher US Treasury rates (Chapter IV). It is as yet difficult to determine the duration and final size of adjustments in these variables, but the essential factors determining Colombia's and other emerging economies' growth prospects are still highly favorable.

Based on these considerations and taking into account the above-discussed time lag with which monetary policy operates, the Board of Directors decided to raise the Bank's intervention rates by 25 bp on April 28 this year and by a further 25 bp on June 20, lifting the auction expansion rate from 6% to 6.5%. Monetary policy sought in this way to contribute to future dynamism in output and employment being maintained in an environment of low, stable inflation. The Board indicated that the economy's future performance would determine the level and structure of interest rates required to ensure these conditions.

B. EXCHANGE-RATE POLICY

Since 1999, when Colombia adopted a floating exchange-rate system, inflation targeting has been combined with exchange-market interventions by the Banco de la República as a complementary mechanism to avoid volatility in economic growth and in the real exchange rate. The Bank intervenes in the foreign-exchange market to accumulate international reserves–so as to make Colombia less vulnerable externally–, reduce exchange-rate volatility, or moderate any pressures toward unsustainable appreciations or excessive devaluations liable to affect inflation behavior.

To achieve these aims the Bank relies on two instruments besides its discretionary interventions in the exchange market. The rules of operation of these instruments were devised in 1999 and have been amended only slightly. The two are:

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[20] Preliminary information.

i) Auction of put options (accumulation) or call options (decumulation) to move the amount of international reserves toward desired levels.

ii) Auction of put or call options to control volatility.[21]

Fluctuating conditions in the foreign-exchange market this year have led to activation of the Bank's different intervention-policy instruments. Between January and March, with the exchange-rate appreciation trend from late 2003 still prevailing, the Bank continued to apply the intervention strategy of the past two years by making discretionary purchases amounting to $1,96.7 m (Table 22), which were offset in part by selling $1,000 m to the government. Moreover, in accordance with established rules, on five occasions between April and June high exchange-rate volatility automatically set in motion call-option auctions for controlling volatility; through this mechanism the Bank sold $944.9 m in foreign reserves. The Bank's net sales in the first half of 2006 amounted to $747.6 m.

[21] Details on the operation of auctions of put and call options will be found on the Banco de la República's website: www.banrep.gov.co.

TABLE 22

BANCO DE LA REPÚBLICA'S FOREIGN-EXCHANGE PURCHASE AND SALE OPERATIONS (MILLIONS OF DOLLARS)

	2005	2006						Jan-jun
		January	February	March	April	May	June	
Purchases	4,658.4	454.7	655.9	86.1				1,196.7
Put options								
For accumulating international reserves								
For volatility control								
Discretionary intervention	4,658.4	454.7	655.9	86.1				1,196.7
Sales	3,250.0	600.0	400.0		168.5	608.0	167.8	1,944.3
Call options					168.5	608.0	167.8	944.3
For volatility control					168.5	608.0	167.8	944.3
Government	3,250.0	600.0	400.0					1,000.0
Net purchases	1,408.4	(145.3)	255.9	86.1	(168.5)	(608.0)	(167.8)	(747.6)

Source: Banco de la República.

VI. BALANCE OF PAYMENTS: FIRST QUARTER 2006 AND OUTLOOK

A. FIRST-QUARTER 2006 BALANCE-OF-PAYMENTS BEHAVIOR

Colombia's balance of payments in the first quarter of 2006 presented a current-account deficit of $568 m (-1.7% of quarterly GDP), financed from capital flows of $609 m (1.8% of quarterly GDP), gross reserves accumulation of $149 m[22], and other flows (errors and omissions) of $109 m. The balance of gross reserves in March stood at $15,1157 m, equivalent to 8.5 months of goods imports and 6.9 months of goods and services imports (Table 23).

1. Current account

The current-account deficit increased by $29 m between January and March 2006 relative to the same period last year. The deficit to March stemmed largely from substantial factor-income payments ($1,372 m) and a negative balance of nonfactor services ($450 m), which were partly offset by net current transfer receipts ($1,035 m) and a trade surplus in goods ($219 m).

The first-quarter current-account deficit increased by $29 on a year earlier.

[22] Gross international reserves increased by $200 m, from $14,957 m in December 31, 2005 to $15,157 m at the end of March 2006. This result is not the same as that recorded in the balance of payments, because the balance of payments records only variations arising from transactions and does not include gains from exchange-rate adjustments and price valuations, which amounted to $51 m for the first quarter.

BALANCE OF PAYMENTS
(SUMMARY)

		Millions of dollars			Percentage GDP			Difference 2006-2005 Millions of dollars
		I Qtr. 05 (pr)	I Qtr. 06 (pr)	2006 (e)	I Qtr. 05 (pr)	I Qtr. 06 (pr)	2006 (e)	
I. Current account		**(539)**	**(568)**	**(1,589)**	**(1.9)**	**(1.7)**	**(1.2)**	**(28.7)**
Receipts		6,472	7,710	33,677	22.5	23.4	26.2	1,238.8
Payments		7,011	8,279	35,266	24.4	25.1	27.4	1,267.6
A. Goods and nonfactor services		**(34)**	**(231)**	**(768)**	**(0.1)**	**(0.7)**	**(0.6)**	**(196.9)**
1. Goods		433	219	1,050	1.5	0.7	0.8	(214.2)
Exports		4,760	5,598	24,472	16.6	17.0	19.0	837.8
Imports		4,327	5,379	23,422	15.1	16.3	18.2	1,052.0
2. Nonfactor services		(467)	(450)	(1,818)	(1.6)	(1.4)	(1.4)	17.3
Exports		556	718	2,952	1.9	2.2	2.3	162.0
Imports		1,023	1,168	4,770	3.6	3.5	3.7	144.7
B. Factor income		**(1,399)**	**(1,372)**	**(5,181)**	**(4.9)**	**(4.2)**	**(4.0)**	**26.8**
Receipts		212	297	1,630	0.7	0.9	1.3	84.9
Payments		1,610	1,669	6,810	5.6	5.1	5.3	58.1
C. Transfers		**893**	**1,035**	**4,360**	**3.1**	**3.1**	**3.4**	**141.4**
Receipts		943	1,098	4,624	3.3	3.3	3.6	154.2
Payments		50	63	263	0.2	0.2	0.2	12.8
II. Capital and financial account		**(236)**	**609**	**1,262**	**(0.8)**	**1.8**	**1.0**	**845.2**
A. Financial account		**(236)**	**609**	**1,262**	**(0.8)**	**1.8**	**1.0**	**845.2**
1. Long-term financial flows		793	(253)	3,744	2.8	(0.8)	2.9	(1,046.2)
a. Assets		38	140	965	0.1	0.4	0.7	101.4
i. Colombian direct investment abroad		40	140	965	0.1	0.4	0.7	100.1
ii. Loans	1/	(1)	0	0	0.0	0.0	0.0	1.3
iii. Leasing		0	0	0	0.0	0.0	0.0	0.0
iv. Other assets		0	0	0	0.0	0.0	0.0	0.0
b. Liabilities		832	(113)	4,757	2.9	(0.3)	3.7	(945.2)
i. Direct foreign investment in Colombia		915	978	4,917	3.2	3.0	3.8	62.9
ii. Loans	1/	(121)	(1,063)	(29)	(0.4)	(3.2)	0.0	(942.7)
Public sector		102	(841)	875	0.4	(2.6)	0.7	(943.3)
Private sector		(222)	(222)	(904)	(0.8)	(0.7)	(0.7)	0.7
iii. Leasing		37	(28)	(131)	0.1	(0.1)	(0.1)	(65.4)
Public sector		(3)	(3)	(10)	0.0	0.0	0.0	0.2
Private sector		40	(25)	(122)	0.1	(0.1)	(0.1)	(65.6)
iv. Other liabilities		0	0	0	0.0	0.0	0.0	0.0
c. Other long-term financial movements		0	0	(48)	0.0	0.0	0.0	0.3
2. Short-term financial flows		(1,030)	862	(2,482)	(3.6)	2.6	(1.9)	1,891.4
a. Assets		928	(515)	2,841	3.2	(1.6)	2.2	(1,443.3)
i. Portfolio investment		1,078	(140)	2,908	3.8	(0.4)	2.3	(1,217.4)
ii. Loans	2/	(149)	(375)	(66)	(0.5)	(1.1)	(0.1)	(225.9)
b. Liabilities		(102)	347	359	(0.4)	1.1	0.3	448.1
i. Portfolio investment		(7)	0	0	0.0	0.0	0.0	6.7
ii. Loans	2/	(95)	347	359	(0.3)	1.1	0.3	441.4
B. Special capital flows		**0**	**0**	**0**	**0.0**	**0.0**	**0.0**	**0.0**
III.Net errors and omissions		**183**	**109**	**109**	**0.6**	**0.3**	**0.1**	**(74.1)**
IV.Change in gross international reserves	3/	**(593)**	**149**	**(218)**	**(2.1)**	**0.5**	**(0.2)**	**742.3**
VI.Balance of gross international reserves		**12,784**	**15,157**	**14,806**			**11.5**	**2,372.6**
Months of goods imports		9	8	8				
Months of goods and services imports		7	7	6				
Nominal GDP in millions of dollars		28,735	32,972	128,723				

(pr) Preliminary.
(e) Estimated.
1/ Includes portfolio investment, direct loans and commercial credit.
2/ Includes direct loans and commercial credit.
3/ According to balance-of-payments methodology.
Source: Banco de la República.

The first-quarter trade balance in goods (including special trade operations) showed a surplus of $219 m.

The factor-income deficit was similar to the figure a year earlier and came essentially from profit and dividend remittances by foreign-capital firms to their parent companies ($867 m) and interest paid on foreign debt ($798 m), less income from overseas investments, estimated at $297 m.

The trade deficit in services (1.4% of quarterly GDP) was similar to what it was for the first quarter of 2005. Deficit balances in nonfactor services and factor income were partly offset by net transfer receipts of $1,035 m, made up mostly of workers' remittances of $856 m, which rose by an annual rate of 17% (or $125 m), and income on donations to nongovernmental organizations and nonprofit institutions ($149 m).

In the first quarter of 2006, the trade balance in goods (including special trade operations) showed a surplus of $219 m, the net result of export earnings of $5,598 m and import payments of $5,379 m. This surplus was smaller by $214 m than a year earlier, because of slower growth in external sales ($838 m, or 17.6%) than in external purchases ($1,025 m, or 24.3%). Export growth was notable in oil and oil products, coal and industrial products, while the higher value of imports came mostly from greater purchases of capital and intermediate goods.

Table 24 summarizes the behavior of exports (excluding special trade operations) in the first quarter of 2006, by product. Traditional exports amounted to $2,690 m, up by 16.1% (or $374 m) on a year earlier, thanks to higher external sales of oil and oil products and coal, which grew respectively by 31.5% (or $347 m) and 21.5% (or $124 m). Growth in oil sales came from higher world prices, and in coal from both the volume and value sold. By contrast, export earnings from coffee and ferronickel fell by 15.5% (or $68 m) and (14.4% (or $29 m) respectively, in both cases because of a decrease in the volume sold. Nontraditional exports expanded by an annual rate of 18.6% in the first quarter of 2006, driven essentially by industrial products.

Table 25 shows that, by export destination, Venezuela and the United States were still the country's main trading partners in the first quarter.

Intermediate goods accounted for 41% of first-quarter import growth, with a 21.8% expansion on a year earlier.

Intermediate goods accounted for 41% of first-quarter import growth, having expanded by 21.8% on a year earlier, driven in particular by chemicals and pharmaceuticals. Another 38% of import growth came from capital goods, which increased by 26%, attributable mostly to transport equipment and industrial machinery (Table 26).

FOB EXPORTS, BY MAIN PRODUCT AND ECONOMIC SECTOR 1/

	Millions of dollars		Variation		Contribution to growth	
	I Qtr. 2005	I Qtr. 2006 (pr)	Absolute 2/	Percentage	% points	Percentage
Traditional exports	**2,316**	**2,690**	**374**	**16.1**	**8.2**	**47.3**
Coffee	437	369	(68)	(15.5)	(1.5)	(8.6)
Oil and oil products	1,101	1,447	347	31.5	7.6	43.9
Coal	576	700	124	21.5	2.7	15.7
Ferronickel	202	173	(29)	(14.4)	**(0.6)**	(3.7)
Nontraditional exports 3/	**2,236**	**2,653**	**417**	**18.6**	9.2	**52.7**
Nonmonetary gold	**124**	**89**	**(36)**	**(28.6)**	(0.8)	**(4.5)**
Emeralds	**20**	**21**	**2**	**9.0**	0.0	**0.2**
All other	**2,092**	**2,543**	**450**	**21.5**	9.9	**57.0**
Farming sector	462	491	29	6.2	**0.6**	3.6
Industrial sector	1,567	1,891	324	20.7	7.1	41.0
Mining sector	63	161	98	154.9	2.1	12.4
Total exports	**4,553**	**5,343**	**791**	**17.4**	17.4	**100.0**

(pr) Preliminary.
1/ Excluding special trade operation exports.
2/ In millions of dollars.
3/ Excluding temporary exports, re-exports and others; including balance-of-payments adjustments.
Source: DANE and Banco de la República.

2. Capital and financial account

In the first quarter of 2006 the capital and financial account showed a net inflow of funds to the economy amounting to $609 m, up by $845 m on a year earlier. Specifically, this was the net result of long-term capital outflows of $253 m and short-term inflows of $862 m (Table 23).

Net foreign direct investment, a component of long-term flows, amounted to 839 m, much the same as in the first quarter of 2005. By sector, foreign direct investment went largely to coal mining ($451 m), oil activity ($331 m) and manufacturing ($219 m). Colombian direct investment abroad came to $140 m, up by $100 on a year earlier (Table 27).

Net direct investment receipts were partly offset by the consolidated public sector's net foreign debt payments and accumulation of net overseas assets, amounting to $1,038; this figure includes reduction of

Table 25

NONTRADITIONAL EXPORTS, BY COUNTRY OF DESTINATION (PR)
(January-March 2006)

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	China	Rest	Total
Annual percentage change in dollar value:									
Total	**27.0**	**31.5**	**4.4**	**0.8**	**(27.0)**	**9.3**	**(25.8)**	**12.7**	**17.8**
Traditional	**33.8**	**6.2**	**(88.3)**	**(9.5)**	**(35.3)**	**6.0**	**49.3**	**8.8**	**16.2**
Nontraditional	**16.5**	**31.7**	**9.1**	**63.1**	**(4.5)**	**10.4**	**177.7**	**17.3**	**19.3**
Farming sector	12.5	(15.0)	(42.2)	9.1	6.0	(37.0)	(59.1)	7.2	6.2
Industrial sector	11.2	42.6	9.2	30.5	(20.1)	11.3	180.9	19.9	21.6
Food, beverages and tobacco	30.2	45.1	9.2	16.4	(33.3)	118.8	(100.0)	7.4	19.2
Yarns and fabrics	(18.8)	61.0	(2.8)	n,a	(33.3)	12.2	n,a	16.6	20.6
Garments	(24.2)	76.5	11.7	n,a	(10.7)	15.9	n,a	17.2	(3.0)
Plastic and rubber products	5.4	31.8	19.2	13.7	38.1	4.6	n,a	24.1	20.0
Leather and leather goods	5.9	16.9	13.3	n,a	(20.7)	21.1	(53.9)	45.1	24.1
Wood and wood products	7.8	85.0	(1.9)	n,a	(87.5)	34.6	166.7	5.5	22.4
Graphic arts and publishing	3.8	74.4	11.2	60.9	n,a	(25.1)	(100.0)	41.4	28.3
Chemical industry	28.9	35.4	9.0	0.0	(62.1)	8.4	(58.6)	13.5	16.8
Nonmetallic minerals	12.8	100.7	3.3	n,a	123.7	48.1	n,a	23.1	26.4
Common metals industry	64.8	19.3	(4.2)	0.0	200.0	8.0	294.2	27.5	51.2
Machinery and equipment	3.8	91.6	27.9	n,a	36.4	(50.6)	33.3	51.9	38.7
Transport materials	92.6	20.3	8.7	n,a	n,a	250.0	n,a	25.8	21.1
Optical, cinema and other apparatuses	112.4	31.7	12.1	n,a	(85.7)	91.5	n,a	30.3	43.5
Other industries	31.0	14.8	38.4	n,a	158.3	8.9	n,a	11.9	21.5
Mining sector **(*)**	44.7	2.3	10.3	n,a	(64.3)	(92.9)	n,a	13.2	30.8
Value of exports in March 2006 (millions of dollars):									
Total	**2,355.3**	**516.4**	**285.3**	**89.2**	**77.9**	**142.1**	**50.0**	**1,937.9**	**5,454.0**
Traditional	**1,514.3**	**3.1**	**1.5**	**68.7**	**50.5**	**34.3**	**5.0**	**1,013.1**	**2,690.5**
Nontraditional	**841.0**	**513.3**	**283.7**	**20.5**	**27.4**	**107.8**	**45.0**	**924.8**	**2,763.5**
Farming sector	267.4	61.5	0.7	5.5	18.9	0.3	0.1	136.3	490.8
Industrial sector	421.9	450.0	246.9	6.7	8.4	107.4	44.9	715.5	2,001.6
Mining sector **(*)**	151.7	1.8	36.1	8.3	0.2	0.0	0.0	73.1	271.1
Contribución en puntos porcentuales al crecimiento									
Total	**10.8**	**2.7**	**0.3**	**0.0**	**(0.6)**	**0.3**	**(0.4)**	**4.7**	**17.8**
Traditional	**8.3**	**0.0**	**(0.3)**	**(0.2)**	**(0.6)**	**0.0**	**(1.0)**	**1.8**	**8.1**
Non traditional	**2.6**	**2.7**	**0.5**	**0.2**	**0.0**	**0.2**	**0.6**	**2.9**	**9.7**
Farming sector	0.6	(0.2)	0.0	0.0	0.0	0.0	0.0	0.2	0.6
Industrial sector	0.9	2.9	0.5	0.0	0.0	0.2	0.6	2.6	7.7
Mining sector **(*)**	1.0	0.0	0.1	0.1	0.0	0.0	0.0	0.2	1.4

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

Table 26

FOB IMPORTS, BY ECONOMIC USE OR DESTINATION 1/

	January-March (pr) 2005 2/	2006 2/	Variation Absolute 3/	%	Contribution to growth % points	Percentage
Consumer goods	**764**	**979**	**215**	**28.2**	**5.1**	**20.7**
Durables	368	454	86	23.5	2.0	8.3
Nondurables	396	525	129	32.6	3.0	12.4
Intermediate goods	**1,969**	**2,399**	**430**	**21.8**	**10.1**	**41.3**
Fuel and lubricants 3/	63	197	134	211.3	3.1	12.9
For farming	149	184	35	23.4	0.8	3.4
For industry	1,756	2,018	261	14.9	6.1	25.1
Capital goods	**1,516**	**1,911**	**395**	**26.1**	**9.3**	**38.0**
Construction materials	83	107	23	27.9	0.5	2.2
For farming	12	13	1	11.0	0.0	0.1
For industry	961	1,177	215	22.4	5.1	20.7
Transport equipment	460	615	155	33.8	3.7	15.0
Unclassified goods	**2**	**1**	**0**	**(22.5)**	**0.0**	**0.0**
Total imports	**4,251**	**5,290**	**1,040**	**24.5**	**24.5**	**100.0**

(pr) Preliminary
1/ Excluding temporary imports, re-imports and others; including balance-of-payments adjustments.
2/ In millions of dollars.
3/ Including byproducts of both oil and coal
Source: DANE and Tax Administration.

Table 27

PUBLIC AND PRIVATE CAPITAL FLOWS: 2004-2006
(MILLIONS OF DOLLARS)

	I Qtr. 2004	2005	2006 (pr)	2006 (proj)
Capital and financial account (A + B + C + D)	**871**	**(236)**	**609**	**1,262**
A. Net foreign investment (FDI) in Colombia	**675**	**876**	**839**	**3,952**
Foreign investment in Colombia	724	915	978	4,917
Colombian investment abroad	(49)	(40)	(140)	(965)
B. Total public sector	**27**	**(1,243)**	**(1,038)**	**(790)**
Nonfinancial	150	(1,002)	(709)	270
Financial	(123)	(241)	(329)	(1,059)
C. Total nonfinancial private sector excl. FDI	**169**	**131**	**809**	**(1,852)**
Nonfinancial	99	252	(358)	(1,901)
Financial	70	(121)	1,167	48
1. Nonfinancial private sector	**99**	**252**	**(358)**	**(1,901)**
Leasing	(50)	40	(25)	(122)
Long term	(211)	(295)	(209)	(815)
Short term	361	507	(124)	(964)
2. Financial private sector	**70**	**(121)**	**1,167**	**48**
Long term	36	72	(13)	(88)
Short term	34	(194)	1,180	137
D. Other capital flows	**0**	**0**	**0**	**(48)**

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

Net capital inflows to the private sector from external borrowing and portfolio investment are estimated at $809, compared with $131 m in 2005.

the central government's external liabilities through prepayment of external-debt bonds worth $670 m.

Net capital inflows to the private sector from external borrowing and portfolio investment are estimated at $809 m, compared with $131 m in 2005. As shown by the Table 27, up to March 2006 the private sector tended to reduce its long-term external borrowing ($247 m), while increasing its net short-term funding, both through foreign debt and portfolio capital flows ($1056 m). Short-term borrowing was largely connected with growth in commercial activity, particularly with higher imports. As will be seen below, this private-capital trend reversed completely in the second quarter, which saw outflows of private capital because of the uncertainty produced in world financial markets by higher external interest rates.

The country's overall foreign-debt balance is forecast to run at $38,550 m (39.5% of GDP) by December 2006, with the public sector accounting for $24,998 m (65%) of this amount and the private sector for $13,553 m (35%) (Tables 27 and 28). Short-term foreign debt is projected to show a balance of $6,346 m (6.5% of GDP), 94% of it owed by the private sector (Table 28).

3. Variation in international reserves

As a result of movements in goods and service and capital between January and March 2006, gross international reserves–not including valuation gains of $149 m–rose to $15,157 m, equivalent to 8.5 months of imports of goods and 6.9 months of imports of goods and services.

B. BALANCE-OF-PAYMENTS OUTLOOK FOR 2006 AND THE MEDIUM TERM

A current-account deficit of $1,589 m (or 1.2% of GDP) is forecast for 2006. It would result largely from the surplus in goods trade decreasing from $1,595 m (1.3% of GDP) in 2005 to $1,050 m (0.8%) in 2006 (Table 29).

A current-account deficit of $1,589 m (or 1.2% of GDP) is forecast for 2006.

The factor-income deficit is projected to narrow by $381 m in 2006 relative to 2005, from the combined effect of higher interest receipts on international reserves and lower interest payments on public and private foreign debt.

It is estimated that net foreign direct investment funds will be more than sufficient to finance the current-account deficit.[23] Foreign direct investment is expected to remain buoyant in the oil, coal and manufacturing sectors and would partly make up for capital outflows from the private sector. As shown by Table 27, agents' expectations about a widening of the external-domestic profitability gap observed since April this year have prompted a portfolio shift away from peso investments toward dollar investments,

[23] It is believed that privatization of Telecom, ISA, Granbanco, Ecogas, Propal, Monómeros Colombo Venezolano and other companies will produce $1,162 m.

TABLE 28

COLOMBIA'S EXTERNAL-DEBT BALANCE

	Millions of dollars						Percentage of GDP (*)					
	2001	2002	2003	2004	2005 (pr)	2006 (proj)	2001	2002	2003	2004	2005	2006
Overall balance	39,101	37,329	38,012	39,445	38,350	38,550	47.7	46.0	47.8	40.4	39.3	39.5
Public sector	23,468	22,781	24,527	25,779	24,133	24,998	28.6	28.1	30.9	26.4	24.7	25.6
Private sector	15,633	14,547	13,485	13,667	14,218	13,552	19.1	17.9	17.0	14.0	14.6	13.9
1. Medium and long term	35,979	33,837	34,693	34,534	32,364	32,204	43.9	41.7	43.7	35.4	33.2	33.0
a. Public sector												
according to borrower	23,053	22,262	24,228	25,321	23,677	24,552	28.1	27.4	30.5	26.0	24.3	25.2
Nonfinancial public sector	22,020	21,428	23,634	24,856	23,253	24,332	26.9	26.4	29.7	25.5	23.8	24.9
Government	18,188	18,013	20,663	22,320	20,852	21,502	22.2	22.2	26.0	22.9	21.4	22.0
Decentralized entities	3,832	3,415	2,970	2,536	2,401	2,830	4.7	4.2	3.7	2.6	2.5	2.9
Financial public sector	1,033	834	594	465	424	220	1.3	1.0	0.7	0.5	0.4	0.2
b. Private sector	10,324	9,137	8,361	7,184	6,585	5,682	12.6	11.3	10.5	7.4	6.8	5.8
Financial	434	216	166	151	253	164	0.5	0.3	0.2	0.2	0.3	0.2
Nonfinancial	9,890	8,921	8,195	7,034	6,333	5,518	12.1	11.0	10.3	7.2	6.5	5.7
c. Arrendamiento financiero	2,601	2,438	2,104	2,029	2,101	1,970	3.2	3.0	2.6	2.1	2.2	2.0
Public	95	91	76	67	56	46	0.1	0.1	0.1	0.1	0.1	0.0
Private	2,507	2,347	2,028	1,962	2,045	1,924	3.1	2.9	2.6	2.0	2.1	2.0
2. Short term	3,122	3,492	3,319	4,911	5,986	6,346	3.8	4.3	4.2	5.0	6.1	6.5
a. Public sector	320	429	224	391	399	399	0.4	0.5	0.3	0.4	0.4	0.4
b. Private sector	2,802	3,063	3,095	4,521	5,587	5,946	3.4	3.8	3.9	4.6	5.7	6.1
Memo item:												
Overall balance excl. leasing												
Financial	36,500	34,891	35,908	37,417	36,249	36,580	44.5	43.0	45.2	38.4	37.2	37.5
Public	23,373	22,691	24,452	25,712	24,077	24,952	28.5	28.0	30.8	26.4	24.7	25.6
Private	13,126	12,200	11,456	11,705	12,172	11,628	16.0	15.0	14.4	12.0	12.5	11.9

(pr) Preliminary.
(proj) Projected.
(*) Calculated using end-of-period exchange rate.
.Source: Banco de la República.

resulting in outflows of private capital and pressures on the exchange rate. The projections presented here assume that international financial markets will be calm over the second half of the year.

Lastly, the Bank's medium-term forecasts point to the country's current-account deficit remaining on average at around 2.5% of GDP until 2011. This forecast is based on the absence of any significant negative shocks to the current account and on the evolution of external-financing sources. Export earnings from oil and oil products and from coal should remain relatively stable, at around 4.5% and 2.2% of GDP, respectively, while revenues from nontraditional exports are expected to rise, from 8.6% of GDP in 2006 to about 13% in 2011. According to projections of FDI and external funding of the public sector, capital flows should rise from an average of $2,400 in 2004 -2006 to an average of $4,900 in 2007-2011.

TABLE 29

COLOMBIA'S PROJECTED BALANCE OF PAYMENTS

	Millions of dollars			Percentaje of GDP		
	2004	2005 (pr)	2006 (proj)	2004	2005 (pr)	2006 (proj)
I. Current account	(938)	(1,978)	(1,589)	(1.0)	(1.6)	(1.2)
A. Nonfactor goods and services	(333)	(505)	(768)	(0.3)	(0.4)	(0.6)
1. Goods	1,346	1,595	1,050	1.4	1.3	0.8
2. Nonfactor services	(1,679)	(2,100)	(1,818)	(1.7)	(1.7)	(1.4)
B. Factor income	(4,332)	(5,562)	(5,181)	(4.4)	(4.5)	(4.0)
C. Transfers	3,727	4,089	4,360	3.8	3.3	3.4
II. Capital and financial account, and change in gross international reserves	6,021	5,435	1,153	6.2	4.4	0.9
A. Net direct investment	2,975	5,754	3,952	3.0	4.7	3.1
B. Other capital movements (*)	3,046	(319)	(2,799)	3.1	(0.3)	(2.2)

(proj) Projection.
(pr) Preliminary.
(*) Includes public- and private-sector transactions, errors and omissions, and change in gross international reserves. Source: Banco de la República.

OIL ACTIVITY: RECENT DEVELOPMENTS AND OUTLOOK

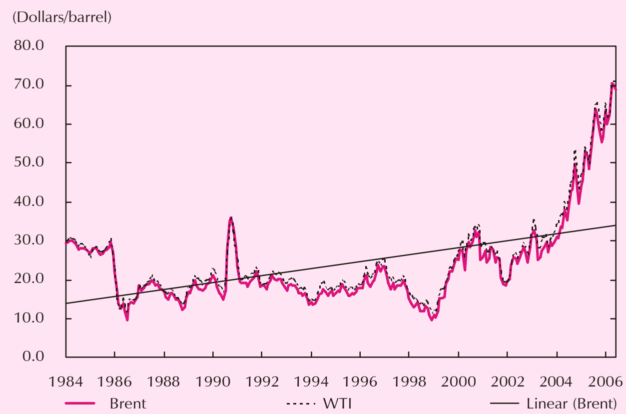
Since discovery of the Caño Limón field in the early 1980s and, later, the Cusiana and Cupiagua fields in the 19900s, oil activity has had a great bearing on the country's economic performance, particularly through big projects that attract foreign investment and bring development, employment and, naturally, foreign exchange to the country.

There have been no significant discoveries since Cusiana and Cupiagua, so the country's crude reserves have been gradually declining. Oil-sector authorities have developed different strategies for cushioning the impact that lower crude production would have on the economy, in a context of high world prices. To slow down the decrease in the country's overall crude reserves, the National Hydrocarbons Agency and Ecopetrol, in partnership with foreign companies, have intensified exploration in Colombia.[1] Moreover, Ecopetrol has steered efforts and budget to large investments in oil-field recovery, optimizing production from mature fields, and extracting heavy crudes. There have also been important developments in the refining and production of oil products, as also in gas exploration, exploitation and production. Furthermore, construction of the Colombia-Venezuela gas line and development of a master plan for expanding the Cartagena refinery will be reflected in higher exports of oil products by the beginning of the next decade.

Recent developments in the international hydrocarbon market, connected with a large world energy demand that is driven, among other factors, by global economic growth, particularly growth in China, have caused world crude prices to rise by amounts unheard-of in the past twenty years. In this price situation, all efforts to expand Colombia's crude reserves will prove profitable (Chart B3.1). Given the oil authorities' policies, and the prospects of high prices, the sector can be expected to keep on contributing to the country's economic activity, at least in the medium term. Indeed, as will be seen below, the Banco de la República's medium-term forecasting (prepared on a conservative scenario of crude production) shows that, at least up until 2010, export earnings from crude oil and oil products will remain above 4.0% of GDP.

[1] A partir de January de 2004 la Agencia Nacional de Hidrocarburos asumió las actividades relacionadas con la administración de los recursos petroleros y la generación y dictamen de la política petrolera; Ecopetrol. por su parte. se dedica únicamente a actividades de tipo industrial y comercial,

Chart B3.1
WORLD CRUDE-OIL PRICES
BRENT AND WTI BENCHMARKS



Source: International Monetary Fund.

1. Macroeconomic impact of oil

The impact of oil activity on the economy is mostly discernible on external and fiscal accounts. A brief description follows of its impact on the country's balance of payments.

a. Crude reserves and domestic production

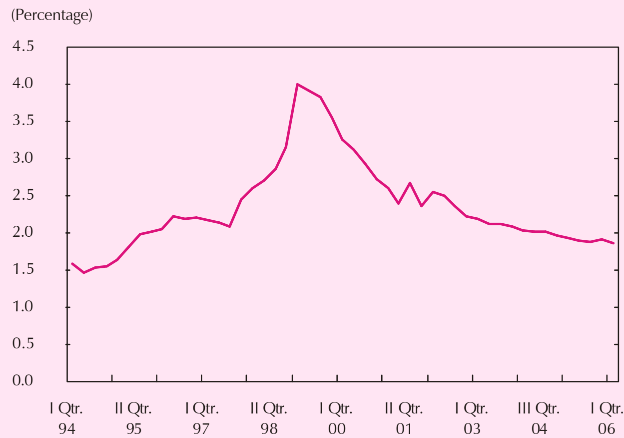
Discovery of the Cusiana and Cupiagua fields raised the country's reserves to their highest level in fourteen years, the average for 1992-1994 reaching 3,175 million barrels (Chart B3.2). Between those years and 2001 the level of reserves fell sharply by an annual average rate of 15%. But the decline has been more gradual since 2002, averaging 5% at an rate, thanks among other factors to Ecopetrol's policy of recovering inactive fields and extracting heavy crudes, which have become important in world markets.

The oil sector's share of domestic production thus increased in real terms from an average 1.9% of GDP in 1994-1997, to 3.2% in 1998-2000, when the country's crude production reached an all-time high. Over the past five years that oil as a share of GDP has averaged around an annual 2.2%.

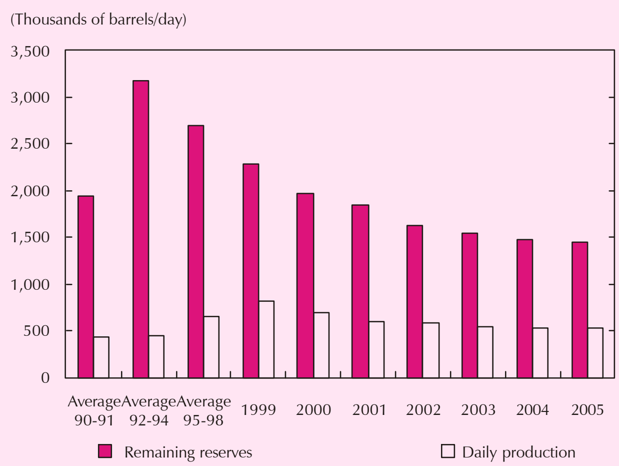
b. Oil sector's balance of payments[2]

Since 1994 the oil sector's current-account operations (foreign trade in non-factor goods and services, and remuneration of production factors), and its financing

Chart B3.2
OIL ACTIVITY AS A SHARE OF OVERALL GDP



OIL RESERVES AND PRODUCTION



Source: Banco de la República and Ecopetrol.

operations (foreign investment and foreign debt, among others) have shown a positive balance, providing net inflows of funds into the economy. During 1994-1997 the sector's balance of payments averaged 2.0% of GDP, then declined to

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[2] La balanza de pagos del sector petrolero. al igual que la consolidada para el país. registra los Receipts y Payments corrientes por concepto de exportaciones e importaciones de bienes y servicios. renta factorial y transferencias del sector, Así mismo contabiliza el flujo de capitales por inversiones directas y de portafolio. endeudamiento externo neto y otros movimientos de capital, En su medición se involucran las cuentas de todas las empresas vinculadas al sector: Ecopetrol. las empresas de exploración y explotación. de prestación de servicios técnicos y las empresas dedicadas al transporte de gas y crudo; para más detalle sobre aspectos conceptuales y metodológicos. consúltese: C, Pulido. E, Montes y G, Beltrán (2004), "Balanza de pagos petrolera. 1990-2002". en Borradores de Economía. núm, 278. *Banco de la República*. <http://www,banrep,gov,co/docum/ftp/borra278,pdf>,

1.6% over 1998-2000, before rising in recent years to bring in net receipts averaging around 2.5% (Table B3.1).

As illustrated by Chart B3.3, the oil sector's current-account operations resulted in surpluses in all these years. Income from external sales of crude and refinery byproducts amply made up for import payments and profit remittances associated with foreign investment. Moreover, the excess foreign-exchange receipts from oil activity went to reduce the country's overall current-account deficit, which reached critical levels between 1994 and 1998, running at around 5.0% of GDP.

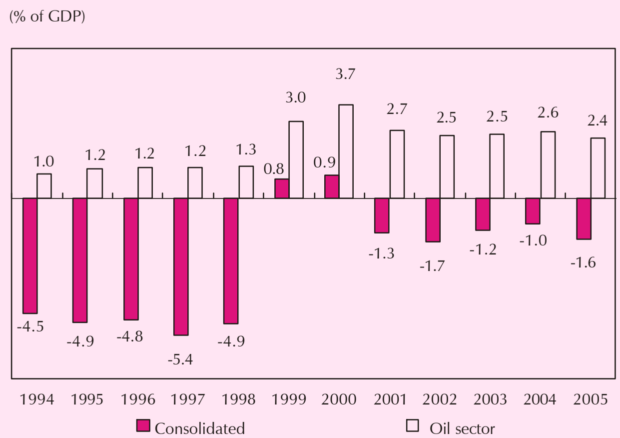
In the second half of the 1990s export earnings from crude and crude products were connected with the start of exploitation operations in the Cusiana and Cupiagua fields. From 2000 oil earnings began to be affected by falling production from these fields. The decline in crude has been partly offset, however, by expanding refinery production and higher world prices, particularly since 2004.

Table B3.1
OIL-SECTOR BALANCE OF PAYMENTS
(MILLIONS OF DOLLARS)

	Annual averages			2004	2005
	1994-1997	1998-2000	2001-2003		
Current account	1,093	2,329	2,076	2,550	2,928
Percentage of GDP	1.15	2.68	2.57	2.63	2.39
1. Goods	1,506	2,963	2,878	3,765	4,746
Exports 1/	2,377	3,698	3,397	4,350	5,737
Imports 2/	871	735	519	585	991
2. Services and transfers	(139)	(41)	(69)	0	49
3. Factor income	(274)	(593)	(734)	(1,215)	(1,866)
Financial account (a - b)	858	(914)	(59)	(170)	213
A. Long-term liabilities (1 + 2)	886	(578)	99	227	963
1. Net direct investment	362	(268)	422	525	1,232
Percentage of GDP	0.37	(0.32)	0.52	0.54	1.01
Foreign investment in Colombia	362	(268)	422	525	1,232
Investments	1,660	1,431	1,908	2,004	2,635
Reimbursements	1,299	1,699	1,486	1,479	1,402
2. Other long-term operations	525	(310)	(323)	(298)	(270)
B. Net short-term assets	28	350	158	396	750
Overall balance	1,951	1,415	2,017	2,380	3,141
Percentage of GDP	2.01	1.61	2.49	2.46	2.57

Note: The Colombian oil sector's balance of payments is constructed on information from the entities making up the sector. The sector's main operating activities include exploration, exploitation, foreign trade, refining, transportation and distribution. Detailed information on the sector's companies and activities and their quantification in the balance of payments will be found in Pulido, Montes, Beltrán, "Balanza de pagos petrolera 1990-2002. Resultados, aspectos conceptuales y metodológicos," Borradores de Economía, No. 278, Banco de la República, February 2004.
1/ Including crude exported by Ecopetrol in 1994, 1995 and 1996 for transformation abroad; including also fuel sales to international vessels and re-exportation of machinery and equipment.
2/ Including imports of gasoline and other oil products by agents not belonging to the sector.
Source: Banco de la República's Economic Studies Division, on information from the Tax Administration (DIAN) and National Statistics Agency (DANE) and International Exchange Department.

Chart B3.3
COLOMBIA'S CONSOLIDATED AND OIL-SECTOR CURRENT ACCOUNTS



Source: Banco de la República.

Rising world prices have also had a bearing on the oil sector's import value and profit remittances. Some 70% of the sector's imports has consisted of fuel (to meet diesel and fuel consumption in the country's border areas), with machinery and equipment making up the rest.[3] Oil-exporting firms operating in Colombia have seen their profits rise with the increase in prices. Note that foreign firms are the ones that have had a considerable impact on factor income in the balance of payments, with their profit remittances surging by 60% in 2004 and by 64% in 2005[4].

Regarding capital flows, direct foreign investment has been the strongest, bringing significant inflows between 1994 and 1997 to meet the development needs of the Cusiana and Cupiagua fields. There ensued a transition period, during which the pace of growth of these external flows slowed, partly because of expectations aroused by the government's announced amendments of the sector's investment regime and revision of administrative procedures pertaining to foreign companies.

Then, starting from 2002 the inflow of direct investment increased, thanks to revival of exploration and camp recovery, which has led to a considerable rise in the number of exploration and exploitation agreements signed with foreign companies (Table

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3 Colombia importa combustibles para atender las zonas de frontera. en especial Leticia. por razones de costos de transporte desde el interior,

4 También hacen parte de este concepto los rendimientos netos de Ecopetrol. gracias a sus inversiones financieras en el exterior. los cuales aportan al pago de intereses de la deuda External,

B3.2). In 2005 direct investment flows (net of capital reimbursements) amounted to 1% of GDP, a particularly high level compared with the 0.5% average for the period 1994-2004.

2. Outlook

Despite the decline in crude production in recent years, the medium-term outlook for the oil sector is favorable. First, because no significant reduction is expected in output, thanks to recent exploration efforts by oil companies. And, second, because world crude prices are likely to remain relatively high, since world oil supply is not expected to increase greatly.

Based on a scenario of high price expectations and a conservative level of hydrocarbon reserves[5], the oil sector is forecast to continue making good contributions to the country's current account in the coming years (Table B3.3). The assumptions made in this forecasting are as follows:

Table B3.2
MOVEMENTS IN SOME EXPLORATION INDICATORS

	2000	2001	2002	2003	2004	2005	2006 (April 30)
Exploration							
Seismic kilometers	1,356	2,399	2,067	3,470	6,767	11,896	5,921
National Hydrocarbon Agency (ANH)	-	-	-	-	4,068	9,559	5,489
Ecopetrol	187	114	512	1,651	1,143	524	0
Ecopetrol associates	1,169	2,285	1,555	1,819	1,556	1,813	432
No. of exploratory wells	16	13	10	28	21	35	20
ANH contractors						4	
Ecopetrol	-	1	1	3	1	9	
Associates	16	12	9	25	20	23	
Contracts							
No. of contracts signed during the year	32	28	14	21	32	59	20

Source: Ecopetrol and ANH.

5 Este escenario se considera conservador en producción de crudo y gas. ya que no incluye nueva actividad exploratoria. ni compra de reservas de hidrocarburos por parte de Ecopetrol y sus socios; además. no incluye los estimativos adicionales de producción de crudo y gas proyectados por la Agencia Nacional de Hidrocarburos; no obstante. Ecopetrol cuenta con un escenario denominado "Portafolio reto" (nivel de confianza entre el 60% y 80%) en el cual la producción de crudo aumentará. para ubicarse en cerca de 600 mbd a partir de 2010,

" Daily crude production is assumed to decrease at an average rate of 3% between 2007 and 2010, down to 470,000 barrels a day by the end of 2010 (Chart B3.2). Given the size of domestic demand, no imports of crude are expected during this period.

" Total output of byproducts from the refining of crude oil is estimated to average some 300,000 barrels a day between 2007 and 2010 and to increase thereafter with the Cartagena refinery coming on stream. Based on that level of output and on estimated growth in domestic demand, petrochemical imports are projected to average around 25,000 barrels a day over the same period.

" Ecopetrol will continue to develop all stages of the gas business, including construction of the gas line between Venezuela, Colombia and Panama. Gas exports are projected at around 120 million cubic feet between 2007 and 2008, rising to 190 m cubic feet between 2009 and 2010.

Based on the above assumptions, export earnings from crude oil and oil products should remain over 4.0% of GDP until 2010.

Table B3.3
ACTUAL AND PROJECTED MOVEMENTS IN SOME OIL-SECTOR INDICATORS (*)

Annual averages	1994-1997	1998-2000	2001-2004	2005-2006	2007-2010
Volume figures (thousands of barrels/day)					
Daily crude production	552	719	561	529	491
Colombian crude export prices (dollars/day)	18	20	29	54	61
Dollar figures					
Total hydrocarbon exports	2,275	3,552	3,543	6,004	6,931
Total crude oil exports	1,922	3,148	2,660	4,314	4,232
Total exports of oil products	352	404	883	1,690	2,700
Percentage figures					
Total hydrocarbon exports / GDP	2.37	4.06	4.17	4.74	4.32
Total hydrocarbon exports / overall exports	20.99	28.25	25.30	26.12	22.59

(*) Projections for the years from 2006 to 2010 are by Banco de la República, using a conservative scenario of crude production, which does not necessarily coincide with Ecopetrol's official scenario.
Source: Banco de la República.

VII. FISCAL POLICY

Good fiscal performance earlier in the year, in particular higher tax receipts, led the authorities to revise the annual financial plan in mid-June and reduce the consolidated fiscal deficit target to 1.5% of GDP.

A. 2006 FIRST-QUARTER RESULTS

At the end of March the public-sector fiscal deficit stood at 1,760 bn pesos, equivalent to 0.6% of GDP, practically the same level as a year earlier. By sector, this was the outcome of a central-government deficit of 2% of GDP, partly offset by a 1.4% surplus in the decentralized sector. Ecopetrol and the social-security sector were responsible for most of this surplus, with fiscal balances of 0.7% and 0.4% of GDP, respectively (Table 30).

Central-government finances showed revenues rising by 20.7% and expenditures by 11.8%. Tax receipts increased by 20.1%, with income tax, external and domestic VAT and customs duties exhibiting the strongest growths: 20.1%, 30.4%, 20.1% and 18.5%, respectively. Higher income-tax revenues were associated with stronger economic activity last year, and higher domestic VAT collection with the raising of the rate on a group of goods and services from 7% to 10%, as authorized by the 2003 tax reform. The increase in external-VAT revenues largely reflected the ending of the Plan Vallejo tax benefits for input imports intended to foster exports (Table 31).

At the end of March the public-sector fiscal deficit stood at 1,760 bn pesos, equivalent to 0.6% of GDP, practically the same level as a year earlier.

Central-government spending presented a 6% fall in operating expenditures, a 14.0% rise in interest on debt and a 226.9% surge in investment. Among operating expenditures, personal services went up by 24.6% and overhead by 59.6%. The significant expansion in these items is attributable to implementation of spending commitments to the armed forces and police. Transfers decreased by 13.6% because changes were made in the way the government transfers funds for pension payments by the Social Security Institute, and also because transfers to the Subnational Pension Liabilities Fund (Fonpet) were reduced, as were payments to

CONSOLIDATED PUBLIC SECTOR
FISCAL BALANCE: FIRST QUARTER 2006

Item	Billions of pesos		Percentage of GDP	
	2005	2006 (pr)	2005	2006 (pr)
A. Total nonfinancial public sector (1 + 2)	**(734)**	**(1,799)**	**(0.3)**	**(0.6)**
1. National government	**(6,231)**	**(6,073)**	**(2.2)**	**(2.0)**
2. Subtotal decentralized sector	**5,497**	**4,274**	**1.9**	**1.4**
Power sector	81	177	0.0	0.1
Emcali (Cali municipal utilities co.)	96	32	0.0	0.0
EPM (Medellín municipal utilities co.)	112	9	0.0	0.0
FAEP (oil stabilization fund)	132	95	0.0	0.0
Ecopetrol	1,332	2,085	0.5	0.7
Rest of entities	370	292	0.1	0.1
Social security	2,170	1,318	0.8	0.4
Regional and local	1,204	266	0.4	0.1
B. Banco de la República cash profit and loss	(133)	141	0.0	0.0
C. Fogafin (deposit insurance agency) cash profit and loss	80	202	0.0	0.1
D. Financial restructuring costs	(503)	(427)	(0.2)	(0.1)
E. Adjustments	(248)	123	(0.1)	0.0
F. Total consolidated public sector (A + B + C + D + E)	**(1,538)**	**(1,760)**	**(0.5)**	**(0.6)**

(*) Preliminary.
Source: Fiscal Policy Council.

meet teachers' benefit entitlements. The surge in investment essentially reflects future budget items executed under the 2006 budget, which account for 60% of investment outlays; but this will not jeopardize meeting the annual investment target, set at of 5,413 bn pesos (1.7% of GDP) for 2006.

Funding for the central government's deficit came largely from domestic borrowing. External financing showed a net outflow of 1,757 bn pesos, the outcome of disbursements of 382 bn pesos and debt repayments of 2,139 bn pesos. By contrast, net domestic indebtedness rose by 7,146 bn pesos, with disbursements amounting to 7,630 bn pesos, against debt repayments of 484 bn pesos. TES securities worth 7,215 bn pesos were sold in the first quarter.

The above funding operations reduced the central government's debt balance from 50.3% of GDP in December last year to 49.3% in March. This reduction is associated with the external component, which fell from 16.9% of GDP to 15.9%, as a result of debt outflow in the first quarter.

TABLE 31

CENTRAL-GOVERNMENT FISCAL BALANCE:
FIRST QUARTER 2006
(BILLIONS OF PESOS)

		2005	2006 (pr)	Annual growth 2005-2006
I. Total revenues (A + B + C + D + E)		**10,022**	**12,100**	**20.7**
A. Tax revenues		9,620	11,553	20.1
Income tax		3,400	4,085	20.1
Domestic IVA		3,241	3,892	20.1
External IVA		1,360	1,774	30.4
Impost		600	711	18.5
Gasoline tax		274	278	1.5
Financial-transaction levy		570	606	6.3
Other		175	207	18.3
B. Non-tax revenues		38	43	13.2
C. Special funds		70	114	62.9
D. Capital resources		274	374	36.5
E. Accrued receipts		20	16	(20.0)
II. Total expenditures (A + B + C + D + E)		**16,253**	**18,173**	**11.8**
A. Interest		3,023	3,447	14.0
External		1,364	1,212	(11.1)
Domestic		1,659	2,235	34.7
B. Operating expenses	1/	11,946	11,233	(6.0)
Personal services		1,384	1,724	24.6
Overhead		525	838	59.6
Transfers		10,037	8,671	(13.6)
C. Investment	1/	997	3,259	226.9
D. Net loans		69	92	33.3
E. Accrued payments		218	142	(34.9)
III. Deficit or surplus (I - II)	2/	**(6,231)**	**(6,073)**	**(2.5)**
Financial restructuring costs		**503**	**427**	**(15.1)**
IV. Funding (A + B + C + D)		**(6,734)**	**(6,500)**	**(3.5)**
A. Net external credit		596	(1,757)	(394.8)
Disbursements		1,206	382	(68.3)
Repayments		610	2,139	250.7
B. Net domestic credit		6,524	7,146	9.5
Disbursements		9,232	7,630	(17.4)
Repayments		2,708	484	(82.1)
C. Banco de la República profits		454	793	74.7
D. Other		(840)	318	(137.9)
V. Deficit as percentage of GDP		**(2.2)**	**(2.0)**	

(pr) Preliminary
1/ Including payments and floating debt.
2/ Excluding financial-restructuring costs.
Source: Fiscal Policy Council.

In the decentralized public sector, Ecopetrol stands out for its good fiscal performance, reporting a surplus increase of 0.2% of GDP relative to the first quarter of 2005, while social security and the regional and local public sector saw their finances deteriorating. Ecopetrol's income behavior was favorable thanks to the policy of dismantling fuel subsidies, a higher world oil price, and greater export volumes of heavy crude. In the case of social security, the sector's surplus decreased because of lower receipts from the Solidarity and Guarantee Fund's offset account, and reduction of government transfers to the Social Security Institute for pension payments. Lastly, subnational finances were affected by higher investment payments, and the accelerated execution of operating expenditures in January by virtue of the Electoral Guarantee Law.

The revised financial plan projects a central-government deficit of 5% of GDP by the end of 2006, with revenues rising by 17% and expenditures by 15.9%.

B. 2006 FULL-YEAR FISCAL OUTLOOK

The Board of Directors' March report to Congress stated that the Fiscal Policy Council (Confis) had approved a consolidated fiscal-deficit target equivalent to 2% of GDP for 2006. Bu, thanks to a good fiscal performance in the first months of the year, especially the government's higher tax receipts, the authorities revised the annual financial plan in mid-June and reduced the consolidated fiscal-deficit target to 1.5% of GDP. The imbalance between the central government's revenues and expenditures is expected to narrow, and the decentralized sector's surplus is projected to widen thanks to Ecopetrol's higher prospects (Table 32).

The revised financial plan projects a central-government deficit of 5% of GDP by the end of 2006, with revenues rising by 17% and expenditures by 15.9%. The strongest-growing tax items will be income tax (19.9%), customs duties (18.1%), external VAT (14.6%) and domestic VAT (10.3%). Higher tax receipts from external economic activity will come largely from imports, which are expected to increase by 16% relative to 2005. As pointed out in the March report, capital receipts will expand substantially (by 47.8%) over the year to 2,000 bn pesos, thanks to profit transfers from Ecopetrol.

In annual terms, central-government expenditures will increase by 33.2% in debt interest payments, 10.8% in operating costs, and 26.6% in investment. Among operating costs, personal services will go up by 13.5%, overhead by 10.7%, and transfers by 10.2%. Higher overhead and personal-services expenditures are associated in particular with the defense sector, for troop expansions, and with the elections held earlier in the year. The increase in transfers largely reflects projected pension payments, which will rise by 15%. As reported in March, investment spending shows considerable growth, connected with implementation of a number of road infrastructure projects and the funding of massive transport systems in some cities.

Financing for the central government's deficit will fall on domestic sources and the resources of the National Treasury; at the beginning of the year the Treasury held available foreign-currency funds of $2,200 m. Net external credit will amount to 375 bn pesos, with disbursements totaling 5,056 bn pesos and debt repayments 4,681 bn pesos. By contrast, net domestic credit will reach 8,689 bn pesos, the result of 23,722 bn pesos in disbursements and 15,033 bn pesos in debt repayments. Sale of long-term TES securities in 2006 is projected at 23,800 bn pesos, with 9,500 bn pesos of this amount being sold through auctions.

Regarding the decentralized sector, the recently revised financial plan contains no major adjustments to the projections discussed in the March report. The authorities do, however, expect Ecopetrol to widen its surplus, thanks to the favorable behavior of world crude prices; and they foresee a slight deterioration in the finances of the regional and local public sector, because of higher expected expansion in subnational investment over the rest of the year.

TABLE 32

PUBLIC SECTOR CONSOLIDADO
BALANCE FISCAL 2005-2006

Item	Billions of pesos		Percentage of GDP	
	2005	2006 (proj)	2005	2006 (proj)
A. Total nonfinancial public sector (SPNF) (1 + 2)	**(988)**	**(5,046)**	**(0.3)**	**(1.6)**
1. National government	**(13,730)**	**(15,389)**	**(4.8)**	**(5.0)**
2. Subtotal decentralized sector	**12,742**	**10,343**	**4.5**	**3.3**
Power sector	359	434	0.1	0.1
Emcali (Cali municipal utilities co.)	161	432	0.1	0.1
EPM (Medellín municipal utilities co.)	193	183	0.1	0.1
FAEP (oil stabilization fund)	637	1,342	0.2	0.4
Ecopetrol	1,134	686	0.4	0.2
Rest of entities	2,261	811	0.8	0.3
Social security	5,844	4,775	2.1	1.5
Regional and local	2,153	1,680	0.8	0.5
B. Banco de la República cash profit and loss	**669**	**960**	**0.2**	**0.3**
C. Fogafin (deposit insurance agency) cash profit and loss	**610**	**557**	**0.2**	**0.2**
D. Financial restructuring costs	**(1,233)**	**(1,187)**	**(0.4)**	**(0.4)**
E. Adjustments	**919**	**0**	**0.3**	**0.0**
F. Total consolidated public sector (A + B + C + D + E)	**(23)**	**(4,716)**	**0.0**	**(1.5)**

(proj) Projection.
Source: Fiscal Policy Council.

VIII. HOW VULNERABLE IS THE COLOMBIAN ECONOMY NOW COMPARED WITH THE 1990s?

Economic growth has been driven in recent years by a better external environment, easy monetary conditions consistent with inflation targets, recovered confidence, expanding credit and rehabilitation of household and company balance sheets.

In the 1990s Colombia's economy went from a situation of strength to one of crisis. Economic growth, having averaged 5.1% over the first half of the decade, shrank by 4.2% in 1999, its steepest fall in a hundred years.

By the end of 2005, however, the pace of growth had speeded up to 5.1%, a figure not seen since 1995 (Chart 36). This was in continuation of the dynamic behavior the economy has shown since 2003, with average growth of 4.6% a year.

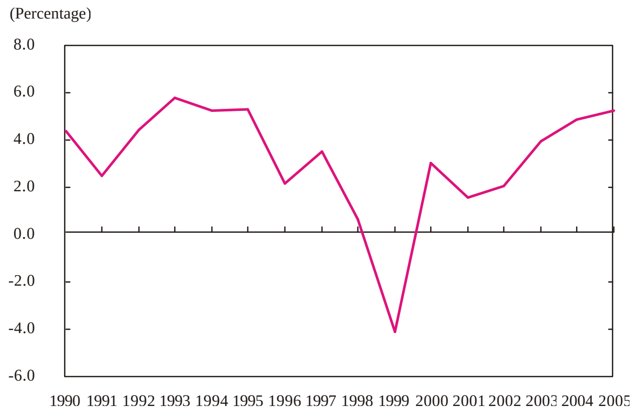
The high volatility observed in recent months in foreign and domestic financial markets raises the question: how vulnerable is the Colombian economy today? This becomes even more pertinent considering that it has taken the country almost a decade to regain growth rates of over 4%.

Economic growth has been driven in recent years by a better external environment, easy monetary conditions consistent with inflation targets, recovered confidence, expanding credit and rehabilitation of household and company balance sheets. These factors together have resulted in an increase in domestic demand through higher private spending on consumption and investment, and in good behavior of external demand and the terms of trade, accompanied by a strong pick-up in productivity gains.

The high volatility observed in recent months in foreign and domestic financial markets raises the question: how vulnerable is the Colombian economy today? This becomes ever more pertinent considering that it has taken the country almost a decade to regain growth rates of over 4%. It would be useful, in particular, to analyze possible current risks, in comparison with the economy's situation in the years before the late 1990s' crisis. To this end, a review follows of vulnerability indicators connected with the external, real, fiscal and financial sectors.

Chart 36

GROSS DOMESTIC PRODUCT
(REAL ANNUAL CHANGE)



Source: DANE.

Chart 37

INFLATION (PERCENTAGE CHANGE)

Source: DANE.

As far as external variables are concerned, an economy's vulnerability depends inversely on the degree of economic opening, defined as the size of foreign trade in GDP. In effect, in more open economies, the real exchange-rate increase or economic slowdown needed to adjust the economy to a negative shock is less than in closed or less open economies. Other external indicators that determine an economy's degree of vulnerability are the size of the current-account deficit, its financing structure between short- and long-term capital, the economy's degree of solvency and external liquidity. These indicators pertain to the economy's capacity to service its foreign debt and cover its financing needs at any time.

Indicators of financial deepening, too, determine the economy's degree of vulnerability. Greater financial deepening makes for more efficient resource allocation, allows economic agents to hedge heavily against income fluctuations, and reduces macroeconomic volatility. Appropriate regulation and the existence of prudent laws and regulations on the financial sector can mitigate its procyclical effects on economic activity, thereby helping to make economic growth sustainable.

The vulnerability of economic growth also depends inversely on the quality and sustainability of macroeconomic policies. Thus, for instance, a growth based on monetary over-expansion, or on an expansion of public spending that involves large fiscal deficits and an unsustainable accumulation of public debt would inevitably culminate in deterioration of confidence and in a crisis of large proportions–as shown by the experience of several Latin American countries and Colombia's own experience in the 1990s. By contrast, the application of consistent, sustainable macroeconomic policies fosters economic stability, by making the future more predictable and by heightening household and corporate confidence, which in turn raises the economy's rate of investment and improves efficiency and productivity.

One of the main indicators of the quality of macroeconomic policy is the rate of inflation. From 1990 to 2005 inflation in Colombia plunged from 31.2% to 4.8% (Chart 37). The fact that the 2004 and 2005 inflation targets were met, and the further fact that economic agents are confident the 2006 target will also be met have helped to reinforce the credibility of macroeconomic policy. This credibility gives the Banco de la República more scope for applying countercyclical policies and keeping output and employment growth stable.

Greater monetary-policy credibility also allows of accommodating higher economic growth, while ensuring price stability.

Greater monetary-policy credibility also allows of accommodating higher economic growth and at the same time ensuring price stability. Moreover, the existence of low inflation expectations that are in line with the inflation target makes it possible for long-term interest rates to be lowered. This has actually occurred, particularly in the case of mortgages rates, to the benefit of large segments of the population.

A. EXTERNAL DEMAND AND EXTERNAL FINANCING

Colombia's economy is more open today. Whereas in the 1990s the degree of openness–exports plus imports as a percentage of real GDP– averaged 36%, in 2005 it was of the order of 43% (Chart 38).

Greater external openness in recent years largely reflects recovery in imports (especially of capital goods), but also buoyancy in nontraditional exports, which rose as a share of GDP from 9.9% in 1998 to 12.8% in 2005. In the case of manufacturing, the export-openness ratio (ratio of exports to real value added) climbed from 28% to 46% over the same period (Chart 39). The growing share of nontraditional exports is explained by recovery among the country's trading partners, extension of trade agreements, preferential tariffs with the United States, efforts by Colombian companies to capture external markets,[24] and the rise in the real exchange rate.

Yet, the Colombian economy's degree of openness is still modest compared with other, more dynamic, emerging economies. The integration of these economies into global markets has been a major component of their medium- and long-term development strategies. In Colombia implementation of the Free Trade Treaty with the United States should provide an impetus in this direction.

The Colombian economy's degree of openness is still modest compared with other, more dynamic, emerging economies.

The results of the balance-of-payments current account and the trade balance show an improved situation and prospects today than in the 1990s. At the

[24] In 1995, 12% of the companies surveyed by Fedesarrollo maintained that they were redirecting production toward external markets as a strategy to deal with international competition. By 2001-2003 the percentage had risen to 33%.

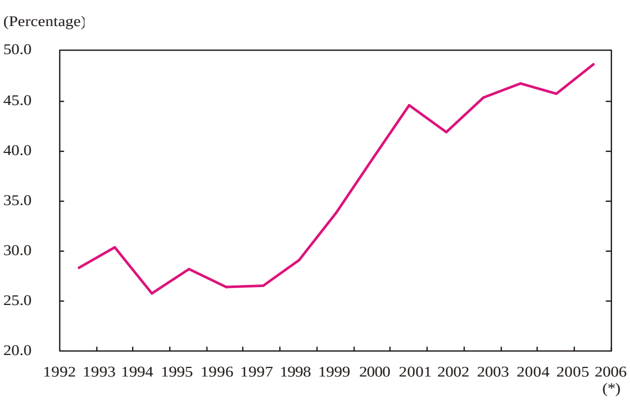
Chart 38

COLOMBIAN ECONOMY'S DEGREE OF OPENNESS, VARIABLES IN REAL TERMS

Source: DANE and Banco de la República.

Chart 39

MANUFACTURING INDUSTRY'S EXPORT OPENNESS RATIO (EXPORTS/VALUE ADDED)



(*) First quarter.
Source: Calculations by Ministry of Finance on information from DANE's annual and monthly (2005-2006) manufacturing surveys.

end of 2005, the current-account deficit was 1.6% of GDP, lower than the 4.7% average for 1993-1998, and the trade balance showed presented a surplus of 1.1% of GDP, compared with a 3.0% deficit in 1995 and a 2.7% deficit in 1998 (Table 33 and Chart 40).

The fall in the current-account deficit in recent years is largely attributable to remittances from Colombians living abroad, which have become significant, improving external accounts and favoring domestic investment and consumption. The flow of workers' remittances expanded on average by over 20% a year from 2001 to 2003 and has tended to stabilize since then, becoming the current account's second largest source of receipts (Chart 41). In 2005 remittance receipts represented 2.7% of GDP and 15.3% of export value, up from 0.9% and 7.6%, respectively, in 1995. This behavior is associated with the emigration of Colombians since 1996, estimated today at some 1.9 million people.

TABLE 33

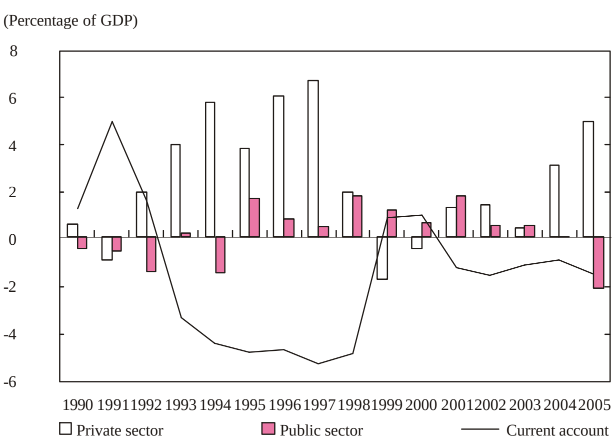
SELECTED INDICATORS OF COLOMBIAN ECONOMY: 1995, 1998, 2005

	1995	1998	2005
GDP (real % growth)	5.2	0.6	5.1
Inflation (%)	19.5	16.7	4.9
Current-account balance (% of GDP)	(4.9)	(4.9)	(1.6)
Degree of openness: (X + M)/GDP (%)	36.1	37.9	42.9
Exports/GDP (%)	14.8	16.9	19.8
Imports/GDP (%)	21.3	21.8	23.5
Net international reserves/GDP (%)	9.9	9.6	12.0
NIR/total foreign debt (%)	32.1	23.8	39.0
NIR/short-term foreign debt (%)	153.3	219.7	249.7
Total foreign debt/GDP (%)	30.8	40.3	30.9
Foreign-debt service/exports (%)	75.2	85.1	66.1
Nonfinancial public sector balance/GDP (%)	(0.3)	(3.7)	(0.3)
Central-government balance/GDP (%)	(3.1)	(5.3)	(4.8)
Total central-gov. public debt/GDP (%)	13.7	22.2	49.8
Unemployment rate (seven cities)	7.9	14.1	13.6
Poverty ratio (% of total population)	49.5	55.3	49.2
Financial-system provisions/overdue loans (%)	31.9	35.8	137.3
Overdue loans/gross loans (%)	5.8	10.7	2.6

Note: Foreign-debt data refer to public and private debt of financial and nonfinancial sectors and include leasing and securitizations.
Source: Banco de la República and National Planning Department.

CHART 40

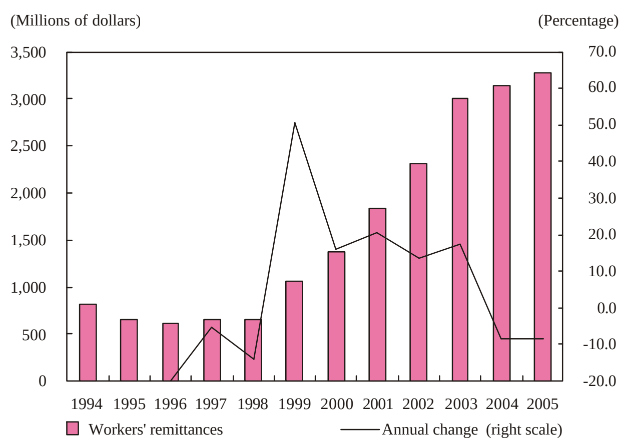
PRIVATE- AND PUBLIC-SECTOR EXTERNAL FINANCING, AND CURRENT ACCOUNT



Source: Banco de la República.

CHART 41

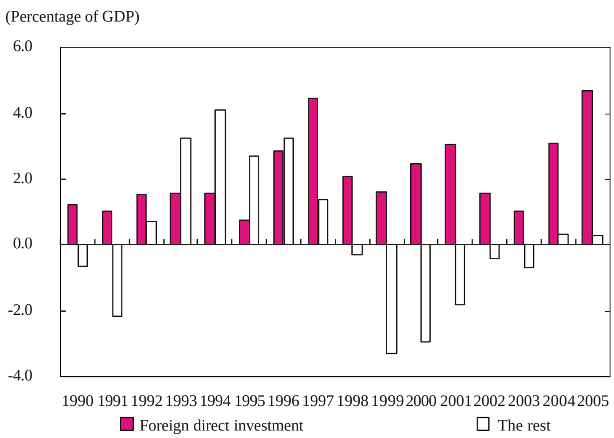
INCOME FROM WORKERS' REMITTANCES



Source: Banco de la República.

CHART 42

NET PRIVATE-SECTOR EXTERNAL FLOWS



Source: Banco de la República.

In the past two years the current account's funding needs have been met by private-capital flows, as they were in the mid-1990s (Chart 42). At that time however private capital was concentrated in foreign debt and portfolio investment, for financing the government's privatizations program, whereas today the main source of private funding is FDI (Chart 42). International evidence shows FDI flows to be less volatile in the face of changes in international liquidity.

In 2005 the consolidated public sector reduced its net external liabilities (2.2% of GDP), the outcome both of building up its assets abroad, and of decreasing its liabilities to the rest of the world as part of a strategy of converting foreign debt to domestic debt to lower its exposure to exchange-rate risk. By contrast, in the 1990s the public sector was a great beneficiary of external resources, which flowed into the Colombian economy, attracted by the privatizations program and telecommunications concessions; these resources financed a good part of the sector's imbalance from 1993 to 1997. At the end of the 1990s and beginning of the present decade the public sector again received relatively substantial foreign credit funds, which made up for the fall in private-sector resources and helped ease devaluationary pressure on the peso and the recessionary adjustment to economic activity (Chart 40).

Sustainability, solvency and external-liquidity ratios have improved significantly compared with levels in the 1990s: total foreign debt has decreased as a proportion of GDP, of exports and of international reserves. Whereas in 1995 foreign reserves covered 60% of one year's financing needs, in 2005 they covered 100% (Table 34).

Nevertheless, the external vulnerability of emerging economies such as Colombia's is very high. So, for example, country-risk premiums may change suddenly at times of international turbulence, as occurred in Colombia in 2002, when the premium soared by 530 bp between June and September (Chart 43). In recent episodes of financial instability in world markets the rise in EMBI Colombia has been much smaller (about 100 bn), albeit bigger than the rise in EMBI global (60bp).

To sum up, the country's current-account and trade-balance deficits are smaller today than in the mid-1990s. Projections indicate that, though they may increase, they will still be sustainable and quite smaller than in

Table 34

SUSTAINABILITY, SOLVENCY AND LIQUIDITY RATIOS, BY TERM

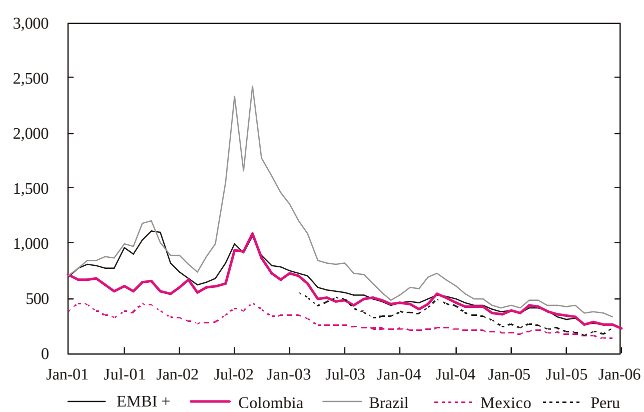
	1995	1998	2005
Foreign debt/GDP			
Short term	6.4	4.4	4.9
Medium and long term	24.4	35.9	26.0
Foreign debt/FOB exports			
Short term	54.2	36.4	29.1
Medium and long term	205.1	299.2	155.3
Short-term foreign debt / international reserves	65.2	45.5	40.4
Int'l. reserves/(debt repayments + current-acct. deficit)	0.6	1.1	1.0

Note: All debt figures refer to total public and private debt.
Source: Banco de la República.

the 1990s, when the closing of international markets signified an adjustment of 5%-6% of GFP through contraction of economic activity, particularly private-sector consumption and investment. Hence, a much smaller adjustment would be needed today if external markets were to close. This, coupled with the existence of more solid sources of current-account financing (such as foreign investment), and better solvency and external-liquidity ratios (supported by an adequate level of international reserves), leads to the conclusion that the country's degree of external vulnerability is lower today than in the pre-crisis years.

Chart 43

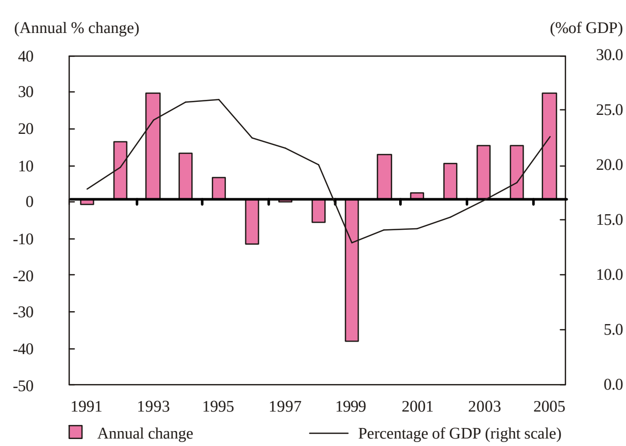
EMBI



Source: Bloomberg.

Chart 44

PRIVATE INVESTMENT



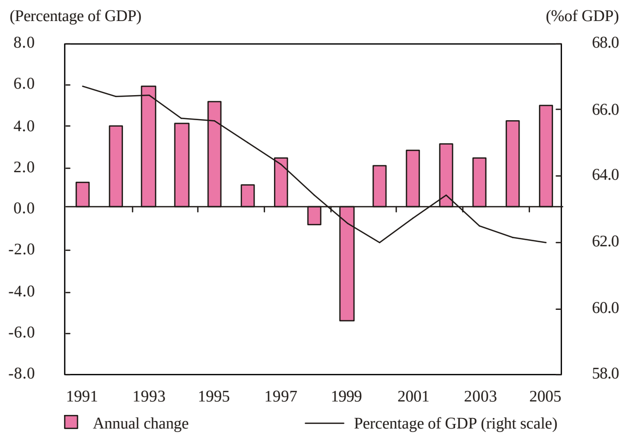
Source: Banco de la República.

B. DOMESTIC DEMAND

As stated earlier, the economy's favorable foreign and domestic conditions have allowed domestic demand to expand on the back of higher investment and consumption in the past three years. The strong growth of private investment, 29% in 2005, is also reflected by its rising share of GDP, 22.3% (Chart 44). Though private investment as a share of GDP is still smaller than in the mid-1990s (25.7%), it is likely to continue growing in the short term, according to business expectations.

CHART 45

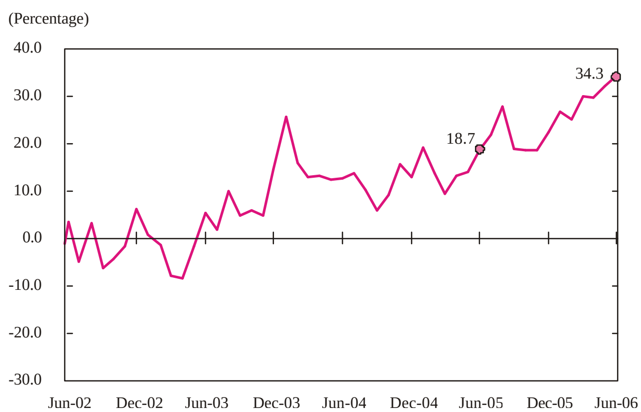
PRIVATE CONSUMPTION



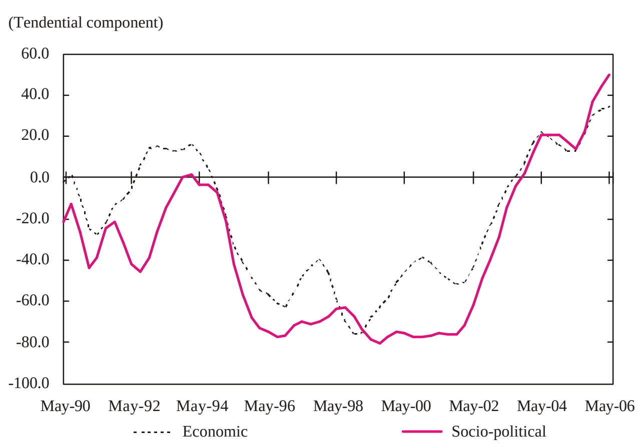
Source: Banco de la República.

CHART 46

FEDESARROLLO'S CONSUMER CONFIDENCE INDEX



INDUSTRIAL INVESTMENT CONDITIONS



Source: Fedesarrollo, and its Business Opinion Surveys.

Private consumption has recovered in the past two years, expanding on average by 4.4%, a pace not seen for a decade. But as a proportion of GDP it has continued to decline; the chief reason for this is the rise in public consumption and, consequently, the rise the tax burden from 15.9% en 2000 to 20.4% in 2005.

One of the essential factors accounting for buoyancy in private demand is the recovery of confidence. Chart 46 shows that both the consumer confidence index and the business one are high and rising, with business confidence running even higher than in the mid-1990s. These same results suggest that, on available information, the recent volatility in international and domestic financial markets has not affected the climate of confidence among consumers and businessmen.

The recent increase in domestic demand has also been driven by low inflation and the decrease in real lending and deposit rates.

C. PUBLIC FINANCES

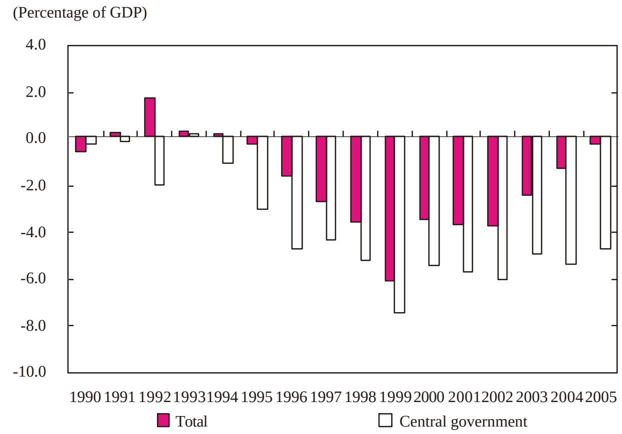
In the 1990s Colombia's public finances went from a fiscal surplus in the early years to a deep deficit at the end of the decade. This situation was caused by an increase in spending (subnational transfers, pensions, military spending and interest payments) that was not offset by efforts to generate revenues (Chart 47). The process of fiscal adjustment initiated in 2000, improvement in the economy's domestic and external conditions, and a number of exogenous changes have been reflected in the nonfinancial public sector's fiscal equilibrium in 2005. The size of the State rose to an all-time high of around 35% of GDP last year, and the tax burden increased to 20.4%. As a result of improvement in the fiscal situation, gross public debt as a percentage of GDP fell to 55.3% in 2005, having peaked at 63.5% in 2002 (Chart 48).

Despite this fall in the debt ratio, sustainability of the State's finances calls for reforms in spending and revenues, above all to ensure that the central government's fiscal balance does not deteriorate in the coming years. In particular, consideration must be given to eliminating transitory sources of revenues such as the income tax surcharge and the wealth tax, and to the fact that subnational transfers will increase upon expiry of the transition period provided for by Constitutional Amendment 001 of 2001, which has reformed the transfer system. It must also be taken into account that improvement in the decentralized sector's balance is associated with higher oil revenues–from high crude prices–and local-governments surplus funds, two factors that may change greatly in the medium and long term.

The structural aspects of Colombia's fiscal situation thus make a great difference relative to the mid-1990s but are still a major source of vulnerability.

Chart 47

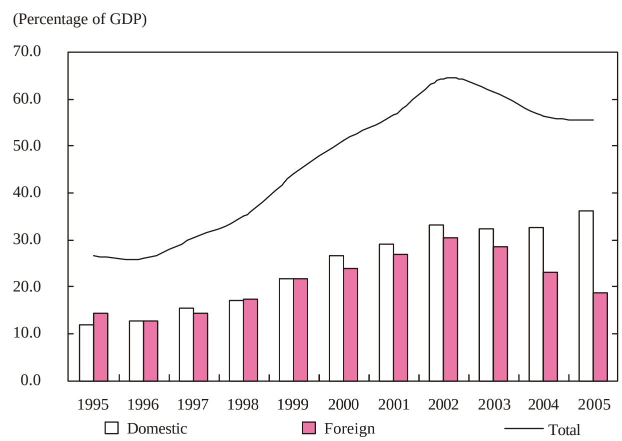
FISCAL BALANCE, NONFINANCIAL PUBLIC-SECTOR AND CENTRAL GOVERNMENT



Source: Fiscal Policy Council.

Chart 48

NONFINANCIAL PUBLIC-SECTOR GROSS DEBT



Source: Banco de la República.

D. FINANCIAL SYSTEM AND ASSET PRICES

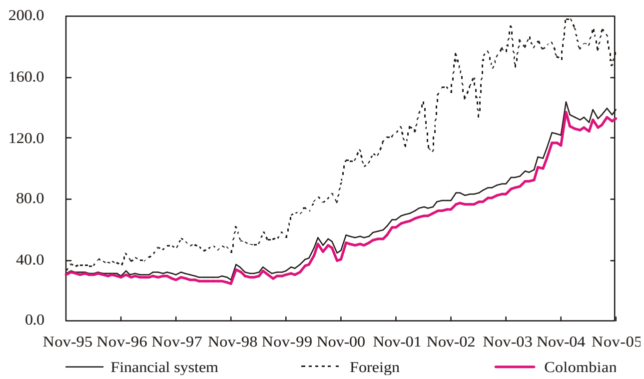
The Colombian financial system is deeper and more diversified today than in the middle of the past decade. This makes it stronger but also involves new future challenges, requiring greater progress in reasonable regulation of the sector.

Recovery over the past three years has been accompanied by the consolidation of credit establishments and non-banking financial institutions and increases in their profits and capital strength. In 2005 both domestic and foreign credit establishments regained their 1990s profitability levels, improving the conditions for the sector's expansion and heightening its capacity to react to adverse shocks. In effect, the credit establishments reported accumulated profits of 3.4 trillion pesos in 2005, a real growth of 20.8% relative to the year before. And their portfolio-quality ratios for the different types of loans showed ever stronger improvement, reaching historical levels. Thus, for example, coverage for overdue loans was substantially higher, at 135%, than the mid-nineties' levels of around 30% (Chart 49).

CHART 49

COVERAGE: PROVISIONS / OVERDUE LOANS

(Percentage)

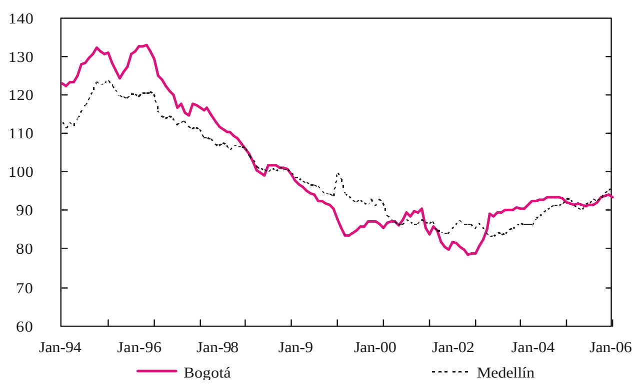


Source: Financial Superintendency; calculations by Banco de la República.

CHART 50

NEW-HOUSING REAL PRICE INDEX: BOGOTÁ AND MEDELLÍN

(December 1998 = 100)

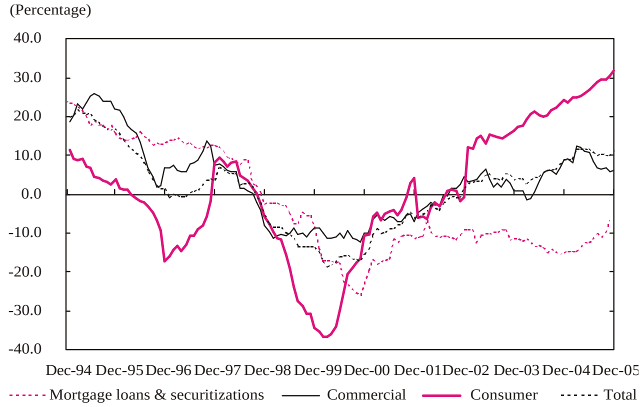


Source: National Planning Department.

CHART 51

CREDIT INSTITUTIONS' GROSS LOAN PORTFOLIO: REAL ANNUAL GROWTH

(Percentage)



Source: Financial Superintendency; calculations by Banco de la República.

Quality ratios have also improved for the mortgage portfolio, which was badly hit from late 1995 on by the ending of the mortgage bubble of the first half of the decade: in effect, rising housing prices at the time went hand in hand with unprecedented growth in mortgage loans. The bursting of the bubble threw the mortgage banks into crisis, when property values fell below guarantee prices. Today, though housing prices have been rising, they are still below the late-1980s' levels, to say nothing of the pre-crisis levels of the 1990s (Chart 50). Moreover, the market's low interest rates help to increase household disposal income, reducing the probability of failure to pay the loans.

The credit institutions' gross loan portfolio has been growing in real terms since December 2002, having shrunk during and after the nineties' crisis. In 2005 the overall portfolio grew by 11.3% in real terms and represented 27.2% of GD; this was still a long way from the mid-nineties' level of 41.6% of GDP (Charts 51 and 52), partly because of the continued fall in mortgage loans since mid 1998. In effect, at the end of 2005 the mortgage portfolio including securitizations represented 2.4% of GDP, compared with 11.4% in December 1997. The latest figures show the mortgage portfolio contracting at a slower pace, which, combined with a 19.7% real rise in mortgage-loan disbursements in 2005, suggests a change of behavior in this portfolio.

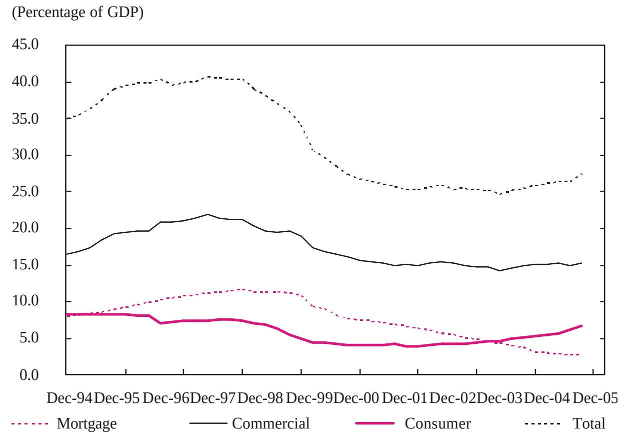
The consumer-loan portfolio almost doubled as a share of GDP, from 3.6% in mid-2002 to 6.3% at the end of 2005, without yet reaching its mid-nineties' levels of around 8%.

Among banking institutions there has been a profound rationalization of state banks, whose past operation had always involved large losses. Another characteristic of the financial system today is the presence of new institutions and the strengthening of others that were less important in the middle of the past decade. Non-banking financial institutions, particularly pension fund managers, have gained importance, altering the financial sector's exposure to the different risks. At the end of 2005 the non-banking financial institutions' investment portfolio represented about 25% of GDP, growing at real rates of over 30%. Their investment strategies therefore have considerable repercussions both on the markets where they look for investment opportunities, and on the savings managed by households.

The non-banking financial institutions' buoyancy is attributable in great measure to the behavior of pension fund managers, whose portfolio under management has doubled in size over the past four years. This increase in the pension fund managers' portfolio has been largely invested in TES securities, with the result that by November 2005 they held 16.5% of the total TES balance, and their exposure to public-debt securities had expanded to 47.2% of their overall portfolio, close to the permitted limit (50%). The real sector's share in the pension fund managers' portfolio has increased in recent years; in December 2005 equities made up some 13% of the portfolio of mandatory pension funds. Furthermore, development of the capital market has also been reflected in the credit institutions' portfolio: the share of investments in their total assets tripled between December 1997 and December 2005, from 11.7% to 32.6%, while loans fell over the same period from 65.2% to 50.7% (Chart 53).

Chart 52

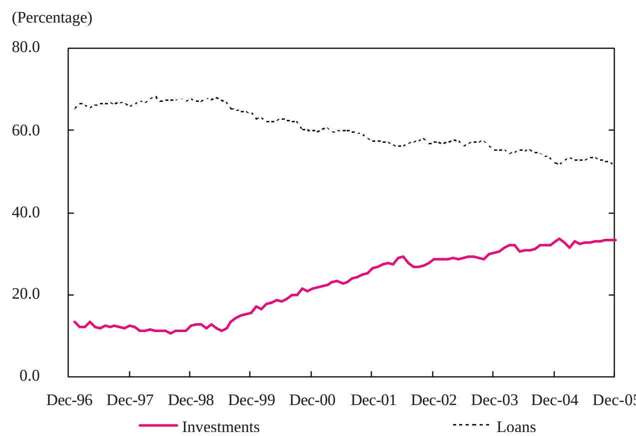
GROSS LOAN PORTFOLIO, BY TYPE OF LOAN



Source: Financial Superintendency; calculations by Banco de la República.

Chart 53

CREDIT INSTITUTIONS' LOANS-TO-ASSETS AND INVESTMENTS-TO-ASSETS RATIOS



Source: Financial Superintendency; calculations by Banco de la República.

A public-debt market has thus become entrenched in recent years, at the same time as considerable changes have occurred in its management. In the first place, the government has embarked on a strategy of replacing foreign debt by domestic debt and has shifted the sources of external funding toward market instruments, reducing direct credit from international banks and multilateral institutions. In the second place, an even more radical change has occurred regarding the domestic-debt market, considering that there was

There now exists a highly liquid secondary market for debt securities, with participation by different agents from the financial and real sectors.

no such market in the 1990s, yet today it shows a balance of 82.3 tr pesos, with two denominations (mainly pesos and Real Value Units (UVR)). Colombia's domestic debt, unlike those of other Latin American countries, is no longer benchmarked to the exchange rate or short-term interest rates. All bonds are issued at a fixed rate.

Moreover, there now exists a highly liquid secondary market for debt securities, with participation by different agents from the financial and real sectors. The yield curve, which had a three-year maturity term in 1998, now extends to 2020 in fixed-rate pesos and to 2015 in real fixed rate. Securities with maturities of less than a year also exist, and there are two trading systems and a market-makers scheme for debt distribution. Though the market is still deficient in many ways, its depth and liquidity today can hardly be compared with what they were in the late 1990s, when it had recently begun.

As described in Chapter IV, *credit risk*, which reflects the possibility of debtors failing to repay their debts to financial intermediaries, will not be a source of instability to the system in the short term. But drastic movements in the chief macroeconomic variables may cause the balance sheets of major debtors to deteriorate and so increase the credit institutions' portfolio of non-performing loans. For instance, downturns in economic activity, higher interest rates, or pronounced changes in the economy's asset prices may increase defaults of credit responsibilities by financial-system debtors. But even so the system's soundness provides greater protection against shocks like the one that occurred in the 1998-1999 crisis.

The present financial system is also highly resistant to *liquidity risks*, that is, the possibility that a financial system becomes unable to meet is obligations because of a lack of liquid resources.

The yield curve, which had a three-year maturity term in 1998, now extends to 2020 in fixed-rate pesos and to 2015 in real fixed rate.

Exposure to *market risk* has, however, increased, given the rise in the securities holdings of financial-system institutions. Greater exposure makes the portfolio more sensitive to changes in investment interest rates, which could result in large losses if an adverse change occurs in assets prices and the capital needed to deal with the situation is lacking. The recent falls in TES and equity prices show the significance of this risk to both pension fund managers and the financial system as a whole and point to the need to introduce improvements in reasonable regulation of the sector.

E. CONCLUSION

Although local and international financial markets have been highly volatile recently, conditions still exist for Colombia's economy to maintain its momentum.

The Colombian economy's growth in the past three years has responded to both domestic and external factors. The domestic factors include easy monetary conditions consistent with inflation targets, an upturn in confidence, expanding credit, and rehabilitation of household and company balance sheets. The external factors include dynamic behavior in external demand and the terms of trade and, until a few months ago, local and international investors' great reluctance to take risks in emerging markets.

Although local and international financial markets have been highly volatile recently, conditions still exist for Colombia's economy to maintain its momentum. And a number of factors in the economy's present situation are different from those that existed in the 1990s and helped to heighten the crisis at the end of that decade. The current factors include lower inflation, a greater degree of openness, current-account and trade-balance results, sustainability, solvency and external liquidity ratios, and the current-account financing structure. There has also been a substantial recovery in confidence, grounded on real factors such as improvement in security conditions.

Similarly, the Colombian financial system is clearly stronger in several respects than a decade ago: recovery over the past three years has come with consolidation of financial institutions, higher profits and greater capital strength; portfolio-quality ratios have improved for the different types of loan; and credit and liquidity risks will not be a source of instability in the short term.

In the medium term however the Colombian economy's dynamics may be negatively affected by a number of risks including, in particular, the current increase in the financial sector's market exposure, resulting from the rise in the sector institutions' securities holdings. The recent falls in TES and equity prices show the significance of this risk and point to the need to introduce improvements in reasonable regulation of the sector. Furthermore, reforms are needed in the fields of taxes and subnational transfers to improve the central government's situation and ensure fiscal sustainability in the medium and long term.

Though external indicators have improved, the Colombian economy, like most other emerging economies, is still vulnerable to changes in the international environment, which are reflected by steep falls in the terms of trade, world demand or capital flows. In this respect, keeping a floating exchange rate and an adequate level of international reserves provides effective protection against such eventualities. Responsible management of macroeconomic policies and the credibility of monetary policy in particular are assets that contribute to macroeconomic stability, without which no progress can be made in any development agenda.

IX. INTERNATIONAL RESERVES

Management of Colombia's foreign reserves is grounded on three main principles: i) protecting the economy from possible external shocks; ii) minimizing loss risks and ensuring the timely availability of international liquidity as needed; and iii) guaranteeing the efficient provision of liquidity when conditions justify using part of the reserves for this purpose.

Management of the country's international reserves by the Banco de la República is an integral part of a macroeconomic policy designed to ensure a stable economic environment for sustainable economic growth. As reiterated in several of the Board of Directors' Reports to Congress, the administration of international reserves is grounded on three main principles, namely: i) protecting the economy from possible external shocks; ii) minimizing loss risks and ensuring the timely availability of international liquidity as needed; and iii) guaranteeing the efficient provision of liquidity when conditions justify using part of the reserves for this purpose.

Movements in some of Colombia's external-vulnerability indicators are analyzed below to determine whether the country's level of reserves is adequate for dealing with external shocks.

A. EXTERNAL VULNERABILITY INDICATORS

The analysis of the economy's external-vulnerability indicators is centered on those that measure the effect of external borrowing in terms of both its level and the payment obligations it generates in the short term. These indicators are supplemented by inclusion of the current-account deficit. International markets generally consider that a value less than one for these indicators may be a warning signal about an economy's external vulnerability, depending on each country's characteristics.

Accordingly, the more relevant indicators for determining sovereign country risk are:

1. *Reserves / current- or following-year debt repayments*: This indicator suffices for countries that have neither a current-account deficit nor an

over-valued currency, so that the need for international liquidity is limited to external debt repayments.

2. *Reserves / overall external debt service*: This is a useful measure when a country needs to turn to the international market to finance payments not only of principal but also of interest on the total debt.

3. *Reserves / (debt repayments + current-account deficit)*: This ratio indicates the external vulnerability of those countries with large principal and interest obligations and a current-account deficit that, upon closure of international markets, would want to make a gradual adjustment without sharp cuts in spending and output.

4. *Other reserves indicators*: Vulnerability indicators are supplemented by measures that quantify the size of reserves relative to other economic variables: i) the traditional reserves / imports ratio; ii) the ratio of reserves to GDP; and iii) the ratio of reserves to the broad monetary aggregate, M3.

Table 35 shows movements in the indicators described above, from 2002 to June 2006. Under groups A and B, debt-repayment and external-liquidity

TABLE 35

INTERNATIONAL RESERVES RATIOS

	2002	2003	2004	2005	2006 (e) 1/
Balance					
Net international reserves-NIR ($m)	10,841	10,916	13,536	14,947	14,456
Ratios:					
A. Foreign-debt repayment ratio					
Foreign-debt repayments ($m)	10,146	10,173	8,918	13,198	11,777
NIR/current-year foreign-debt repayments	1.07	1.07	1.52	1.13	1.23
NIR/following-year foreign-debt repayments	1.07	1.22	1.03	1.27	1.51
B. Adequate external-liquidity position					
NIR/current-year debt service	0.86	0.87	1.19	0.93	1.00
NIR/following-year debt service	0.86	0.96	0.84	1.03	1.17
NIR/(current-yr. debt repayments + current-yr. currt-acct. def.)	0.94	0.98	1.37	0.98	1.08
NIR/(following-yr. debt repayments + following-yr. currt.-acct. def.)	0.97	1.11	0.89	1.12	1.11
C. Other international reserves ratios					
NIR as months of goods imports 2/	10.77	9.88	10.23	8.91	8.20
NIR/M3 (%) 3/	41.85	36.47	33.31	30.33	28.99
NIR/GDP 4/	13.36	13.74	13.88	12.19	11.23

(e) Estimates.
1/ Balance of international reserves at June 2006.
2/ Value of goods imports refers to the monthly average between January and March 2006.
3/ M3 balance at June 2006.
4/ Estimated GDP value in dollars for 2006.
Source: DANE and Banco de la República; calculations by Banco de la República.

ratios improved considerably until 2004; since 2005 some of them have decreased, but in all cases the levels have remained highly satisfactory by international standards.

As stated in the March 2006 *Report to Congress*, vulnerability indicators have been influenced by the government's prepayment of external debt last year as part of its policy of substituting domestic debt for foreign debt. The indicators that consider following-year debt repayment and debt servicing weakened in 2004 but improved in 2005, while those considering current-year debt repayments and debt servicing were affected negatively. Thus the foreign-debt prepayments have had favorable repercussions on the profile and future trajectory of debt repayments; for this reason, the estimates for 2006 reveal significant improvement in the solvency and external-liquidity ratios under groups A and B.

Foreign-debt prepayments have had favorable repercussions on the profile and future trajectory of debt repayments; for this reason, estimates for 2006 reveal significant improvement in the solvency and external-liquidity ratios under groups A and B.

Section C of Table 35 shows that the reserves have continued to represent over eight months' imports of goods, a higher level than international standards for this indicator. Note also the decline in the balance of reserves in June both as a ratio of annual GDP, from 12.2% in 2005 to 11.2% in 2006, and relative to the size of deposits in the financial system (M3), from 30.3% to 29.0%.

B. INTERNATIONAL RESERVES: CURRENT LEVEL AND MANAGEMENT CRITERIA

In June 2006 net international reserves stood at $14,461.2 m, having decreased by $486.1 m since December 2005.[25] In the first half of the year reserves worth $1,196.7 m were bought through discretionary intervention, foreign exchange worth $1,000 m was sold to the government, sales of foreign exchange worth $944.3 m were made through call options to control volatility, and net return of $397.1 m was obtained on investments of reserves.

The investment tranche[26] is the major component of the reserves, making up 92.3%, or $13,345.4 m, of the total. The remaining balance is dividedbetween:

In June 2006 net international reserves amounted to $14,461.2 m, having decreased by $486.1 m since December 2005.

[25] Las reservas netas son iguales al total de las reservas internacionales. o reservas brutas. menos los pasivos externos a corto plazo del Banco de la República; estos últimos están constituidos por obligaciones a la vista en moneda extranjera con agentes no residentes, A menos de que se indique lo contrario. todas las cifras en este documento corresponden al fin de mes de June de 2006 y son cifras provisionales,

[26] El tramo de inversión se refiere a los recursos de portafolios administrados internamente. portafolios delegados y la suma que se destina a capital de trabajo,

i) reserves positions at the International Monetary Fund and the Latin American Reserves Fund, $754 m; ii) special drawing rights, $186.5 m; iii) gold, Andean pesos, and positive balances under international agreements, $176.1 m; and iv) demand deposits and cash on hand, $3 m. Short-term external liabilities stood at $3.8 m (Table 36).

The criteria established by the Banco de la República for management of international reserves are, in order of importance, security, liquidity and profitability. In keeping with these criteria and to ensure that the country's external payment obligations are met, the reserves are invested in financial assets that have a large secondary market, and a part of them is held as working capital to ensure immediate availability.

In accordance with the above guidelines, a portion of the international reserves' investment tranche is administered by overseas fund managers, which are chosen through a rigorous selection process that evaluates their experience in the business, the size of the funds they administer, and the quality of their investing and risk management. As mentioned in previous

TABLE 36

COMPOSITION OF INTERNATIONAL RESERVES

Description	Dec-05		Jun-05		Jun-06	
	Millions of dollars	%	Millions of dollars	%	Millions of dollars	%
Cash	**179.9**	**1.2**	**2.0**	**0.0**	**3.0**	**0.0**
Cash on hand	2.8	0.0	0.2	0.0	2.5	0.0
Demand deposits	177.1	1.2	1.8	0.0	0.5	0.0
Investments	**13,603.9**	**91.0**	**12,650.3**	**92.2**	**13,345.4**	**92.3**
Direct portfolio	6,499.1	43.5	5,577.9	40.6	6,088.6	42.1
Portfolio under administration	7,104.7	47.5	7,072.3	51.5	7,256.9	50.2
Gold	**167.6**	**1.1**	**142.8**	**1.0**	**133.3**	**0.9**
On hand	0.0	0.0	0.0	0.0	0.0	0.0
Under custody	167.6	1.1	142.8	1.0	133.3	0.9
International Monetary Fund	**583.5**	**3.9**	**589.7**	**4.3**	**609.3**	**4.2**
SDR	175.0	1.2	173.4	1.3	186.5	1.3
Reserves position	408.5	2.7	416.3	3.0	422.8	2.9
Latin American Reserves Fund	**342.2**	**2.3**	**342.2**	**2.5**	**351.2**	**2.4**
Contributions	322.2	2.2	322.2	2.3	331.2	2.3
Andean pesos	20.0	0.1	20.0	0.1	20.0	0.1
International agreements	**79.6**	**0.5**	**3.8**	**0.0**	**22.8**	**0.2**
Total gross reserves	**14,956.6**	**100.1**	**13,730.8**	**100.0**	**14,465.0**	**100.0**
Short-term liabilities	**9.3**	**0.1**	**5.7**	**0.0**	**3.8**	**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, investments	0.0	0.0	0.0	0.0	0.0	0.0
Accrued interest on liabilities	9.3	0.1	5.7	0.0	3.8	0.0
Total net reserves	**14,947.3**	**100.0**	**13,725.1**	**100.0**	**14,461.2**	**100.0**

Source: Banco de la República.

reports, these firms have improved the yield on reserves through specialized management.

The Banco de la República itself has managed $6,088.6 m (or 45.6%) of the investment tranche, including a working capital of $867.0 m. The remaining 54.4% ($7,256.9 m) has been administered by the specialized firms: Barclays Global Investors, J.P. Morgan Investment Management Inc., Goldman Sachs Asset Management, BlackRock Financial, Wellington Management and Pacific Investment Management Co.

The investment portfolio is mainly concentrated in the sovereign-risk sector, which includes short- and long-term assets and makes up 71.9% of the portfolio. The remaining portion is distributed among the other sectors as follows: banking sector 14.0%, corporate sector 10.8%, supranational sector 1.3%, and repurchase agreements at the Federal Reserve Bank of New York 2.0%. At June 2006 the distribution by credit quality according to the ratings of specialized agencies was as follows: "P-1" 46.4%; "AAA" 46.6%; "AA" 1.5%; "A" 3.5%; and Federal Reserve Bank of New York repurchase agreements 2.0%. The distribution of credit risk reflects the strict security criterion applied in managing the international reserves.

Table 37 shows returns on the different portfolios making up the investment tranche of international reserves, compared with the yield on the benchmark index.

TABLE 37

RETURN ON INTERNATIONAL-RESERVES PORTFOLIOS
DECEMBER 31, 2005 - JUNE 30, 2006 (*)
(PERCENTAGE)

Manager	Return on portfolios		
	Portafolio	Benchmark index	Difference
Banco de la República	2.64	2.61	0.03
Barclays Global Investors	2.89	2.77	0.12
JPMorgan Investment Management	2.55	2.77	(0.22)
Goldman Sachs Asset Management	1.39	1.31	0.08
BlackRock Financial	1.60	1.31	0.30
Wellington Management	1.44	1.31	0.13
Pacific Investment Management Co.	2.96	2.77	0.19
Working capital	2.30		

(*) Provisional figures subject to revision.
Source: Banco de la República.

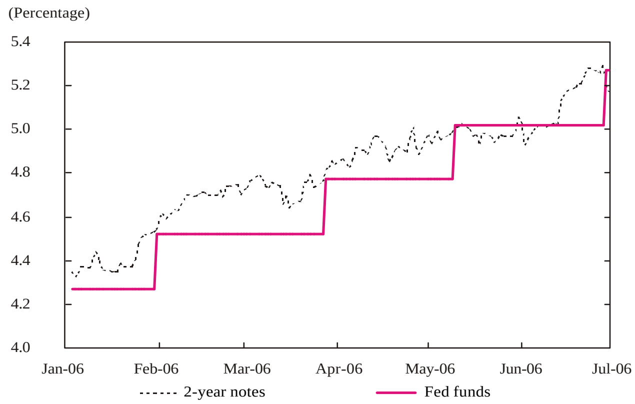
27 Standard & Poor's. Moody's y Fitch Ratings

28 En la escala de las calificaciones de corto plazo. "P-1" representa la mejor,

CHART 54

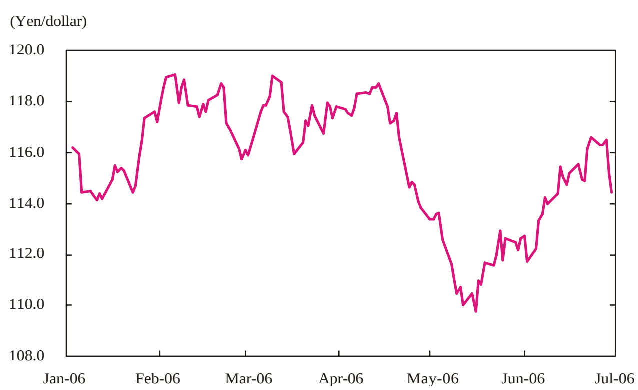
MOVEMENTS IN US TREASURY RATES AND THE DOLLAR AGAINST THE YEN AND EURO

TWO-YEAR US TREASURY NOTES AND US FEDERAL FUNDS, 2006 1/



EURO AGAINST THE DOLLAR, 2006 2/

YEN AGAINST THE DOLLAR, 2006 3/



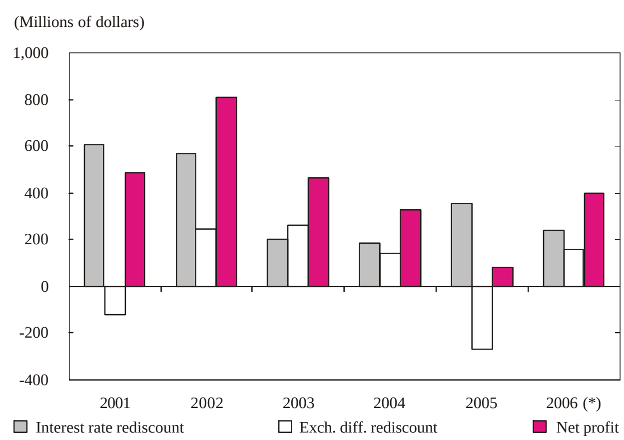
1/ The inverse ratio between price and rate of return implies that, as the rate of return increases, the fixed-income asset price decreases.
2/ The direct quotation euro/dollar implies that the euro loses value as it moves away from zero.
3/ The inverse quotation dollar/yen implies that the yen loses value as it moves away from zero.
Source: Bloomberg LP.

The yield earned on the investment tranche was considerably higher in the first half of 2006 than a year earlier. This was basically because of valuation gains from the euro's and yen's appreciation against the dollar, by 8.4% and 3.2%, respectively, in contrast to their declining trend in the first half of 2005 (Chart 54). Also worth noting is the net positive effect between: higher accrued interest, and valuation losses on bonds resulting from successive increases in benchmark rates in the United States (federal funds rate) and Europe (refinancing rate). In addition, reserves have benefited from a 17% rise in the price of gold.

Net yield on total international reserves at June 30, 2006 was $397.1 m. Gains from interest-rate movements and exchange-rate differentials totaled $216.7 m, with accrued interest yields amounting to $180.4 m (Chart 55).

CHART 55

RETURNS ON INTERNATIONAL RESERVES, 2001-2006



(*) To June 30, 2006.
Source: Banco de la República.

X. BANCO DE LA REPÚBLICA'S FINANCIAL SITUATION AND USE OF ITS FUNDS

A. RESULTS AT JUNE 30 2006

The biggest source of revenues for the first half of 2006 was returns on international reserves, produced in particular by positive exchange-rate differentials from appreciation of the euro and yen. Returns on reserves made up for valuation losses on the Bank's TES portfolios and for other corporate and monetary outlays. Overall revenues of 1,300.6 bn pesos and expenditures of 661.3 bn pesos gave a profit of 639.3 bn pesos, the results exceeding those obtained in the same period last year (Table 38).

The operating result for the first half of 2006 is basically attributable to returns on investments, which amounted to 934.0 bn pesos, up by 958.6 bn pesos

The operating result for the first half of 2006 is basically attributable to returns on investments, which amounted to 934.0 bn pesos, up by 958.6 bn pesos on the first half of 2005, when returns were negative.

TABLE 38

BANCO DE LA REPÚBLICA'S SUMMARIZED INCOME STATEMENT
(BILLIONS OF PESOS)

	Execution		Absolute annual change
	June 2005 A	**June 2006 B**	**(B - A)**
Income	448.2	1,300.6	852.4
Monetary	384.7	1,218.5	833.7
Corporate	63.4	82.1	18.7
Expenditures	438.6	661.3	222.7
Monetary	281.4	347.9	66.5
Corporate	130.7	138.9	8.2
Pensioners	26.5	174.5	148.0
Result for the period	9.6	639.3	629.7

Source: Banco de la República.

on the first half of 2005, when returns were negative. The exchange-rate difference also provided a positive effect, rising by 141.3 bn pesos relative to June 2005, largely because of movements in the peso/dollar exchange rate, which favored valuation gains on foreign-currency assets other than international reserves (Table 39).[29,30]

Those results offset: i) lower income (349.0 bn pesos) from valuation of the Bank's TES portfolio, as a result of the net sale of TES to the market in the amount of 1,500.2 bn pesos between July 2005 and June 2006 in sterilizing exchange-market intervention, and valuation losses of -47.8 bn pesos at June 2006 on the portfolio, owing to higher TES trading rates; and ii) higher outlays, concentrated largely in valuation losses on the portfolio built with pension liability funds, which together with pensioners' expenses gave a net result higher than the amount executed in the same period of 2005.

Returns on reserves stemmed essentially from the positive impact of exchange-rate differentials and higher prices for gold. The euro and yen depreciated against the dollar in the first half of 2005 (by 10.9% and 7.5%, respectively) but appreciated against it in the first half of 2006 (by 8.4% and 3.2%, respectively). The fix price per troy ounce of gold rose from $436.8 in June 2005 to $600.4 a year later.

First-half corporate income in 2006 was higher by 18.7 bn pesos than in 2005, the main item being 8.6 bn pesos in fees from the sale of call options through Bank intervention in the foreign-exchange market.

Monetary expenses were higher by 66.5 bn pesos than in the first half of 2005, largely because of: i) exchange-rate differences on deposit accounts, and ii) remuneration on government deposits made through the Ministry of Finance's Treasury Office.

The Bank's corporate expenditures (138.8 bn pesos) rose by a nominal rate of 6.3%, equivalent to a real rate of 2.2%. But leaving aside taxes and contributions, which are beyond the Bank's direct influence and represent 5.1% of corporate expenditures, real growth in corporate expenditures came to 0.6%, as a result of continued application of the spending-control program (Table 40). In real terms, personnel costs grew by 0.5%, despite the increase

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29 The exchange rate difference account for contributions to international organizations showed monetary income up by 140.0 bn pesos in the first half of 2006 relative to a year earlier and monetary expenses down by 12.4 bn pesos.

30 Valuation gains on the balance of international reserves, from the rise in the peso-dollar exchange rate, are reported in the equity exchange-adjustment surplus account and do not affect the income statement.

BANCO DE LA REPÚBLICA'S INCOME STATEMENT, JUNE 2005 - JUNE 2006
(BILLIONS OF PESOS)

		Execution			Annual change	
		Dec. 05 A	Jun. 05 B	Jun. 06 C	Percentage C / B	Absolute C - B
1. Income		1,174.0	448.2	1,300.6	190.2	852.4
1.1 Monetary income		1,031.9	384.7	1,218.5	216.7	833.7
1.1.1 Interest and returns		912.5	332.2	1,007.1	203.2	674.9
International reserves		184.1	(24.7)	934.0	n,a,	958.6
Credit portfolio and other	1/	10.3	1.4	9.7	578.3	8.2
Liquidity Repos & transitory support		115.4	49.8	112.1	125.0	62.3
Valuation gains/losses on TES		593.0	301.2	(47.8)	(115.9)	(349.0)
Valuation gains/losses on other securities	2/	9.8	4.4	(0.8)	(118.9)	(5.3)
1.1.2 Exchange difference		42.9	17.7	159.0	800.2	141.3
1.1.3 Coins		54.5	15.5	25.6	64.8	10.1
1.1.5 Other	3/	22.0	19.3	26.8	38.4	7.4
1.2 Corporate income		142.1	63.4	82.1	29.5	18.7
1.2.1 Fees		124.6	57.0	75.4	32.3	18.4
Banking services		58.0	25.5	28.6	12.1	3.1
Trust business		66.5	31.4	38.2	21.6	6.8
Foreign-exchange management, & option sales		0.1	0.0	8.6	n,a,	8.6
1.2.2 Other	4/	17.5	6.4	6.7	4.5	0.3
2. Expenditures		848.8	438.6	661.2	50.8	222.7
2.1 Monetary expenditures		640.6	281.4	347.9	23.6	66.5
2.1.1 Interest and returns		446.4	188.9	213.0	12.8	24.2
Deposit-account reserve requirements		110.3	52.5	55.1	4.8	2.5
Deposit accounts, Finance Ministry Treasury Office		308.0	123.3	148.7	20.6	25.4
Monetary contraction Repos		0.0	0.0	0.0	n,a,	0.0
International reserves management expenses		28.1	13.1	9.3	(29.1)	(3.8)
2.1.2 Exchange differences		63.0	36.7	69.0	88.1	32.3
2.1.3 Cost of issuing and distributing bills & coins		124.7	53.3	62.6	17.4	9.3
2.1.4 Other	5/	6.6	2.5	3.3	30.8	0.8
2.2 Corporate expenditures		275.8	130.7	138.8	6.3	8.2
2.2.1 Personnel expenses		174.5	87.8	91.6	4.4	3.8
2.2.2 Overhead		42.3	17.8	18.6	4.9	0.9
2.2.3 Tax		7.0	3.2	4.4	37.2	1.2
2.2.4 Insurance		7.6	3.8	3.7	(1.8)	(0.1)
2.2.5 Contributions and membership dues		3.5	1.6	2.9	73.9	1.2
2.2.6 Cultural expenditures		7.2	2.5	1.9	(26.3)	(0.7)
2.2.7 Depreciation, provisions, debt repayments & other	6/	33.6	14.0	15.8	12.8	1.8
2.3 Pensioners' expenses	7/	(67.6)	26.5	174.5	558.3	148.0
3. Operating result (1 - 2)		325.2	9.6	639.3	6,573.2	629.8

1/ External and government credit lines and valuation gains on non-monetary gold
2/ Law 546 TES and valuation gains/losses on other securities.
3/ Other monetary, operating and non-operating income.
4/ Profit from sale of silver and platinum, and other corporate income.
5/ Loan-portfolio management, precious-metals refining and other monetary expenditures.
6/ Including other corporate, operating and non-operating expenses
7/ Return on resources, less expenses.
n.a. Not applicable
Source: Banco de la República

established in the collective bargaining agreement, while overhead expenses rose by 0.9%.

Lastly, pensioners' expenses amounted to 174.5 bn pesos at June 2006, having increased from a year earlier because of: i) valuation losses on the portfolio built with funds from the actuarial estimate, caused by lower prices for TES-B securities (which make up some 85% of this portfolio), resulting in an income reduction of 135 bn pesos relative to the first half of 2005; and ii) higher actuarial provisions under the regulations in force.

B. BANCO DE LA REPÚBLICA'S FINANCIAL STRUCTURE

This section explains changes in assets, liabilities and equity at June 30, 2006 relative to December 31, 2005.

1. Assets

The Banco de la República's assets amounted to 52,805.9 bn pesos, up by 6,188.9 bn pesos (or 13.3%) on December 2005, when they totaled 46,617.0 bn pesos. The main changes are explained as follows:

TABLE 40

RESULTS AT JUNE 2006
(BILLIONS OF PESOS)

	Execution to		Annual change	
	June 2005 A	June 2006 B	Percentage (B / A)	Absolute (B - A)
Personnel costs	87.8	91.6	4.4	3.8
Overhead	17.8	18.6	4.7	0.8
Insurance	3.8	3.7	(1.8)	(0.1)
Cultural expenditures	1.8	1.1	(38.8)	(0.7)
Scholarships to non-employees	0.7	0.8	5.3	0.0
Depreciation, provisions, debt repayments & other	14.0	15.8	13.0	1.8
Subtotal	125.9	131.6	4.6	5.8
Tax	3.2	4.4	37.2	1.2
Contributions and membership dues	1.6	2.9	73.9	1.2
Total corporate expenditures	130.7	138.8	6.2	8.2

Source: Banco de la República.

TABLE 41

BANCO DE LA REPÚBLICA'S BALANCE SHEET, DECEMBER 2004 TO JUNE 2006 (*)
(BILLIONS OF PESOS)

	December 2005		June 2006		Variation	
	Balance	%	Balance	%	Absolute	%
Assets	**46,617.0**	**100.0**	**52,805.9**	**100.0**	**6,188.9**	**13.3**
Gross international reserves	34,164.2	73.3	37,306.5	70.6	3,142.2	9.2
Contributions at international organizations	2,834.0	6.1	2,968.0	5.6	134.0	4.7
Investments	2,606.7	5.6	2,634.0	5.0	27.3	1.0
Credit portfolio	2.4	0.0	1.6	0.0	(0.8)	(32.2)
Resale agreements - transitory liquidity support	4,050.4	8.7	6,909.2	13.1	2,858.9	70.6
Other net assets	2,959.3	6.3	2,986.6	5.7	27.3	0.9
Liabilities and equity	**46,617.0**	**100.0**	**52,805.9**	**100.0**	**6,188.9**	**13.3**
Liabilities	**30,196.9**	**64.8**	**32,169.7**	**60.9**	**1,972.8**	**6.5**
Monetary base	22,804.6	48.9	21,835.3	41.4	(969.3)	(4.3)
Government: Finance Ministry Treasury Office	3,724.4	8.0	6,825.3	12.9	3,100.9	83.3
Obligations to international organizations	2,284.6	4.9	2,301.1	4.4	16.5	0.7
Other liabilities	1,383.3	3.0	1,207.9	2.3	(175.4)	(12.7)
Total equity	**16,420.1**	**35.2**	**20,636.3**	**39.1**	**4,216.1**	**25.7**
Capital	12.7	0.0	12.7	0.0	0.0	0.0
Reserves reqd. by bylaws	1,867.7	4.0	1,397.7	2.6	(470.0)	(25.2)
Capital surplus	13,387.6	28.7	17,758.7	33.6	4,371.1	32.7
Special Foreign-Exchange Account settlement	453.5	1.0	453.5	0.9	0.0	0.0
Foreign-exchange adjustment from 1993 on and surplus	12,679.1	27.2	17,047.9	32.3	4,368.9	34.5
Other	255.1	0.5	257.3	0.5	2.2	0.9
Property valuation gains/losses (works of art, cultural artifacts, real estate)	829.2	1.8	827.8	1.6	(1.3)	(0.2)
Results	322.9	0.7	639.3	1.2	316.4	98.0

(*) Figures subject to revision.
Source: Banco de la República.

- At the end of June this year gross foreign reserves valued at market prices totaled 37,306.5 bn pesos, equivalent to $14,465 m, having increased in pesos by 3,142.2 bn pesos but decreased in dollars by $492 m over the first half of the year.

- The peso change in reserves was the outcome of: i) the peso's 12.91% depreciation[31] against the dollar between January and June, giving an exchange adjustment increase of 4,369 bn pesos; ii) the yield from external interest-rate changes, producing in pesos an increase of 279.8 bn pesos in reserves; iii) movements in other reserve currencies against the dollar, producing an exchange-adjustment increase of 373.4 bn pesos; and iv) the net sale of reserves worth $747.6 m (1,880 bn pesos) in the first half of the year, the outcome of sales of foreign exchange worth $1,000 m to the government and of reserve-decumulating call

[31] Tomando como base de cálculo la tasa representativa del mercado (TRM) contable. de acuerdo con lo reglamentado por la Superintendencia Financiera,

Repo operations, for providing transitory liquidity, showed a balance of 6,909.2 bn pesos at the end of June 2006, up by 2,858.9 bn pesos on December 2005, signifying a greater supply of funds to the financial system.

options worth $944.3 m, less purchases amounting to $1,196.7 m through discretionary intervention in the foreign exchange market.

- Repo operations, used to provide transitory liquidity, showed a balance of 6,909.2 bn pesos at the end of June 2006, up by 2,858.9 bn pesos on December 2005, signifying a greater supply of funds to t he financial system.

- The local-currency investment portfolio, valued at market prices, stood at 2,634 bn pesos, higher by 27,3 bn pesos than in December 2005. The increase came largely from definite TES-B purchases worth 201.8 bn pesos in the first half of the year, which exceeded maturities amounting to 143 bn pesos and the portfolio's valuation losses caused by higher TES trading rates in the second quarter of 2006 (47.9 bn pesos).

2. Liabilities

The balance of liabilities at June 30, 2006 was 32,169.7 bn pesos, an increase of 1,972.8 bn pesos (or 6%) over December 2005. The chief sources of variation in liabilities were as follows:

- Government deposits at the Banco de la República, made through the Ministry of Finance's Treasury Office, showed a balance of 6,825.3 bn pesos at the end of June, up by 3,100.9 bn pesos (or 83.3%) on December 2005. This increase was brought about by the new liquidity-management scheme, under which the Treasury Office's excess liquidity is deposited in its entirety at the Banco de la República.

- At the end of June the monetary-base balance stood at 21,835.3 bn pesos, lower than in December 2005 by 969.3 bn pesos because of the usual contraction in cash that occurs in the first half of any year.

3. Equity

The Bank's equity amounted to 20,636.3 bn pesos in June, up by 4,216.1bn pesos on December 2005 mainly because of an increase of 4,368.9 bn pesos (or 34.5%) in foreign-exchange adjustment, resulting from the peso's depreciation to June, which raised the peso value of international reserves.

C. 2006 PROFIT FORECAST

Profit for 2006 is forecast at 1,231.0 bn pesos, an increase of 905.8 bn pesos with respect to the actual result for 2005 (Table 41). The forecast assumes that: i) there will be no effect from exchange-rate movements in reserve-portfolio currencies between July and December; ii) TES trading rates will remain at the same level as at the end of June; and iii) coupon maturities will be a major determinant of income from TES securities.

The projection of higher income from the reserve portfolio is based on two points: i) external interest rates will be higher, because of the expected Fed

TABLE 42

BANCO DE LA REPÚBLICA'S INCOME STATEMENT, 2005-2006
(BILLIONS OF PESOS)

	December 2005 (A)	Projected 2006 (B)	Variation Percentagel (B/A)	Variation Absolute (B - A)
I. Total income	1,174.0	2,369.5	101.8	1,195.5
1. Operating income	1,160.3	2,353.8	102.9	1,193.5
Interest and returns	912.5	1,995.7	118.7	1,083.2
International reserves	184.1	1,651.4	797.2	1,467.4
Valuation gains/losses on TES in monetary-expansion operations	593.0	67.7	(88.6)	(525.3)
Transitory securities purchases and allocations	115.4	271.2	135.0	155.8
Other 1/	20.1	5.4	(73.3)	(14.7)
Fees	124.6	115.7	(7.2)	(8.9)
Exchange differences	42.9	159.0	270.3	116.1
Other 2/	80.3	83.4	3.9	3.1
2. Non-operating income	13.7	15.8	15.1	2.1
II. Total expenditures	848.8	1,138.5	34.1	289.7
1. Operating expenditures	843.6	1,131.3	34.1	287.6
Interest and returns	446.4	409.0	(8.4)	(37.4)
Reserve-requirements and Treasury Office deposit accounts	418.3	385.2	(7.9)	(33.1)
Transitory sale of securities	0.0	0.0	n,a,	0.0
International reserves management expenses	28.1	23.8	(15.3)	(4.3)
Exchange differences	63.0	69.0	9.5	6.0
Cost of issuing and distributing bills and coins	124.7	117.8	(5.5)	(6.9)
Personnel costs	174.5	185.8	6.5	11.3
Pensions	(67.6)	235.3	n,a,	302.9
Overhead	42.3	43.9	3.8	1.6
Other 3/	60.3	70.5	16.9	10.2
2. Non-operating expenditures	5.2	7.3	39.9	2.1
III. Profit or loss for the year	325.2	1,231.0	278.5	905.8

1/ Lines of credit, valuation gains/losses on non-monetary gold, interest and returns, other operations and valuation gains/losses on Law 546 TES and other securities.
2/ Coins issued, other monetary and corporate operating income.
3/ Tax, insurance, contributions and membership dues, cultural expenditures, depreciation, provisions, debt repayments and other monetary and corporate operating expenditures.
n.a. Not applicable.
Source: Banco de la República.

Obtaining the forecast profit of 1,231.0 bn pesos will depend chiefly on return on international reserves, …

rate increase;[32] and ii) the possible effects of exchange-rate movements in the currencies making up the reserve portfolio are not taken into account. Such movements, however, are liable to affect expected income, since the operating result is directly related to the portfolio currencies' exchange-rate behavior.

Corporate fee income is forecast to decrease by about 8.9 bn pesos compared with the actual figure reported for 2005, because of the lower charges to be applied in the second half of the year.[33]

Higher expenditures are largely attributable to net pension expenses, projected to increase by 302.9 bn pesos relative to last year, as a result of: i) a decrease of 190.4 bn pesos in returns on the portfolio built with pension liability funds, projected by taking into account the securities' trading-rate behavior at close of June 2006; and ii) higher actuarial provisions of 100.2 bn pesos, estimated on the actuarial calculation for 2006, since no provisioning was required to be made in 2005.[34]

Lastly, projections for other important items are: i) personnel expenses of 185.8 bn pesos, showing with respect to the inflation target a real growth of 1.9% that reflects commitments under the collective bargaining agreement; and ii) overhead costs of 43.9 bn pesos, showing no growth in real terms and thus ratifying the policy of rationalizing expenditures the Bank has been committed to for a number of years.

To sum up, obtaining the forecast profit of 1,231.0 bn pesos will depend chiefly on return on international reserves, hence the reserve currencies' movements against the dollar will be a variable to consider in profit distribution.[35] In this connection, the Bank should set aside, in addition to other reserves, a currency-fluctuation reserve.[36]

…hence the reserve currencies' movements against the dollar will be a variable to consider in profit distribution.

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32 Income from international reserves is projected at the current rate of return (on the investment portfolio as a whole), which is higher than the rate observed in the past three years.

33 Growth in trading, trust and custody volumes and values, coupled with lower information-technology costs, has made it possible to pass on to users of such services part of the profits obtained from the previous schedule of charges.

34 Under Constitutional Amendment Number 1 of 2005, which modified the pension system.

35 The exchange differential result was positive for the first half of 2006 but may not necessarily be so for the second half and may even be wiped out.

36 Funds set aside to cover possible losses from fluctuations in the dollar against the other currencies making up the reserves.

BANCO DE LA REPUBLICA'S CONTRACTING REGIME

The National Constituent Assembly of 1991 confirmed the Banco de la República as an organ of the State exercising the functions of a central bank, with legal capacity under public law, enjoying administrative, capital and technical autonomy and governed by a legal regime peculiar to it (Articles 371 and 372 of the Colombian Constitution).

The Bank's legal regime, laid down in Law 31 of 1992 and in the Bank's Bylaws -issued as Decree 2520 of 2993-, recognize its special nature as a central bank and its functions as the executor of monetary, exchange-rate and credit policy, entrusted to its Board of Directors. The regime therefore provides that the Bank's organization, structure, functions and powers and the contracts it is a party to shall be governed exclusively by the provisions of the Constitution and said Law and Bylaws.

Accordingly, Law 31/1992 has established a special contracting regime providing that contracts entered into by the Bank shall be in compliance with the Bank's own contracting regime drawn up by the Board of Directors and, in cases not contemplated by this contracting system, in compliance with the common provisions of private law.[1] The reason for this lies in the special functions performed by the Bank, including among others regulating the currency, foreign exchange and credit, issuing legal tender, being lender of last resort and banker to banks, administrator of the international reserves, and fiscal agent to the government.

The existence of a contracting regime peculiar to the Bank is further justified by the multiple, diverse and special nature of its functions and activities, including among others the following:

a. The Banco de la República as executor of monetary, foreign-exchange and credit policy undertakes contracts with financial-sector institutions to regulate liquidity in the economy or intervene in the foreign-exchange market.

b. The Bank as administrator of international reserves undertakes contracts in international markets to ensure that investment of these resources is in accordance with the criteria of security, liquidity and profitability. Such contracts are characterized by their complexity and changing nature, depending on best practice in financial markets. It is worth mentioning that a visit from the Office of

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1 Law 31/1992, Article 52; and the Bylaws, Articles 34, 66, 67 and 68.

the Attorney General has found that contracting processes in these cases are carried out in accordance with the provisions of Law 31/1992.

c. The Banco de la República as banker to banks provides the financial sector with services designed to facilitate the normal operation of payment systems, such as management of the Central Securities Deposit and the Electronic Trading System (SEN), the interbank clearing service, deposit accounts, payment and reciprocal credit agreements with other countries, and the monitoring and registration of international foreign-exchange operations.

d. The Banco de la República as issuer of legal tender produces bills and coins at its bill-printing works and mint. For this purpose it needs to keep its industrial plants up to date and to purchase raw materials of special characteristics-as in the case of paper-and incorporate security elements into them. The same goes for the ink used in printing and the metals used in minting, which must be of the proper specifications to obtain the required alloys.

In making contracts the Bank in every case follows the applicable internal procedures, based on the principles of administrative morality, equality, economy, celerity, impartiality, efficiency, effectiveness, publicity, accountability and transparency.

The application of contracting procedures depends on the nature of the goods and services required by the Bank. Without exception, however, previous planning and study stages are carried out to analyze the advisability and timeliness of making the contract as regards budgetary, technical and market considerations, risk analysis, commercial conditions, inviting several bids, objective selection of a supplier, legal, technical and economic evaluation of bids, and other necessary elements to determine the Bank's needs and the best way of meeting them.