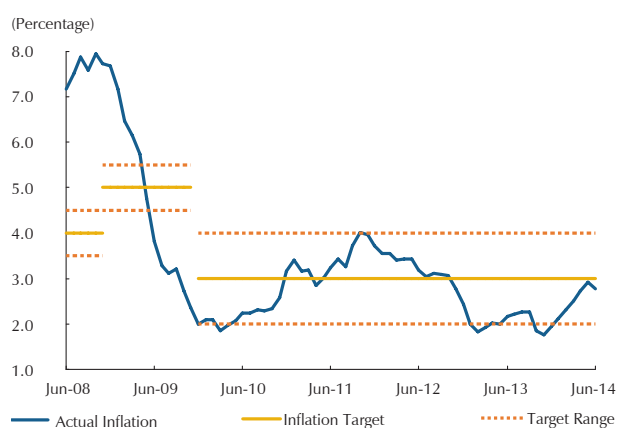


DEVELOPMENTS IN INFLATION AND MONETARY POLICY DECISIONS

Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República

Annual inflation increased in the first five months of the year and converged towards the 3% target slightly faster than expected. It declined somewhat in June to 2.79% (Chart A). A significant part of this movement is explained by the spike in prices for food and regulated items, given reversal of the favorable conditions that pushed the prices of these two baskets to unusually low levels in 2013. The average of the core inflation measures increased to a lesser degree, largely because of the behavior in tradable goods. As a reflection of this, inflation expectations increased and are now near or slightly above 3% for horizons of one year or more.

The forecasts for December suggest prices for food and regulated items will increase at a higher annual rate. The annual changes in the rest of the CPI basket would reflect relative stability. This being the case, annual inflation would end up slightly above 3%.

As for economic activity, the Colombian economy grew at an annual rate of 6.4% in the first quarter of 2014, which is higher than the rate on record for the final quarter of 2013 (5.3%) and more than was expected by the market and by the technical staff of Banco de la República. This positive outcome is due to the momentum in consumption and construction of civil works and buildings, which performed better than had been forecast. The new figures on household spending indicate it will continue to grow at a good pace. This is consistent with a persistently declining unemployment rate, good growth in retail sales, an increase in consumer confidence to favorable levels, and a growth rate in consumer lending that brought its slowdown to a halt. As for investment, this item is expected to grow at a high rate, but less so than during the first quarter.

The total growth in lending has increased due to the added momentum in commercial loans and mortgages. This situation is coupled with real interest rates on loans at levels that bolster spending.

On the external front, average growth for Colombia’s major trading partners has been weaker than was forecast earlier this year, given the sharp drop in GDP in the United States during the first quarter and less growth in some countries of the region. However, the new data suggest external demand will be more dynamic in the coming quarters.

Liquidity levels in the United States remain less expansive and foreign interest rates are still low, although higher than the average observed in 2013. Risk premiums in several emerging economies continue to be low, financial assets in local currency have gained in value, and some of their currencies have appreciated against the dollar.

This being the case, the Bank’s technical team estimates a growth range for the second quarter of 2014 between 3.6% and 5.0%, with 4.3% being the most likely figure. The forecast for growth in 2014 as a whole was revised upwards and is now within a range of 4.2% to 5.8%, with 5.0% as the most feasible figure.

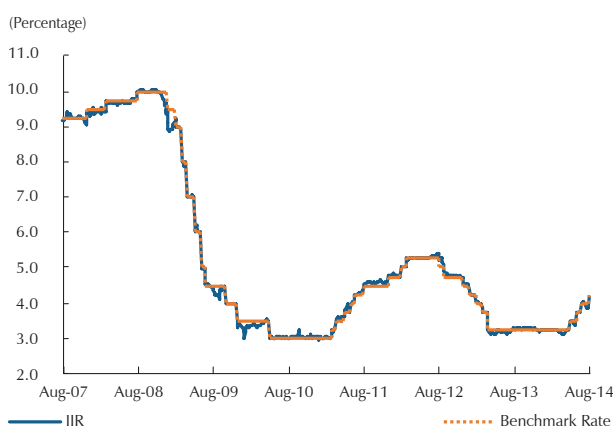
In summary, the growth of aggregate demand in Colombia remains strong and has led gradually to the use of nearly full productive capacity. Domestic spending is expected to continue to expand at a dynamic pace, accompanied by a recovery in external demand. The build-up in inflation halted briefly in June, but the short-term forecasts suggest it will be slightly above 3% by December. Inflation expectations have hovered around 3% or slightly higher. All

this is occurring in an environment where growth in lending has increased and real interest rates on loans are at levels that are driving spending.

After evaluating the risk balance, the Board of Directors of Banco de la República decided to raise the benchmark interest rate by 25 basis points at each of its meetings in May, June and July. As a result, it was increased from 3.50% to 4.25 % (Figure B). The Board felt that macroeconomic stability and the convergence of inflation towards the long-term target support these benchmark interest rate hikes.

Moreover, in June, it was decided the amount of international reserves purchased during the third quarter would be increased so as to accumulate up to US \$2 billion between July and September.

Graph B
Banco de la República Benchmark Interest Rate and Interbank Interest Rate (IIR) (2007-2014)^{a/}



a/ The figures pertain to the data for working days. The last figure is for August 4, 2014.
Sources: Financial Superintendence of Colombia and Banco de la República

José Darío Uribe
Governor