Inflation at September and the Outlook

- Consumer inflation during the year to September was coherent with the goal set for 2005 by the Board of Directors of Banco de la República (BDBR). The annual variation in prices at September was 5%, which is the middle of the target range (between 4.5% and 5.5%). The various core inflation indicators were between 4.0% and 4.6%.

- The third quarter saw a surge in prices for several major items in the family basket of goods and services. For example, the annual change in food prices went from 6.1% in June to 6.4% in September. Public utility rates and rental prices increased from respective annual rates of 7.9% and 4.0% to 8.8% and 4.3% during the same period.

- Nevertheless, this change in prices still appears to be isolated and limited. In the case of food inflation, the models predict a decline in the first quarter of 2006. On the other hand, the long-term upward trend in annual inflation in the price of rentals was curbed in August 2004 and is now slightly below 4.5%. As to public utilities, the rise in annual inflation is associated primarily with water rates. This is explained by the basis for comparison, due to the reductions that took place in July and August 2004.

- External conditions continued to be favorable for the Colombian economy. The country's trading partners experienced a good rate of growth, terms of trade remained high, and the country-risk premium stayed at a low level.

- In this context, the year to date has seen the consolidation of an economic growth cycle in Colombia that is fueled by domestic demand, which rose by 5.9% on average in the last ten quarters. Gross domestic product (GDP) increased by 4.6% during the first half of 2005 (4.2% on average in the last ten quarters). The strength of investments warrants special mention. They accounted for 22% of GDP in 2005, which is the highest rate since 1995 and exceeds the historic average (18%).

- The course of inflation in the next four to eight quarters will be determined primarily by the trend in the exchange rate and the output gap, expectations of inflation, and the presence or absence of inflationary pressures generated by costs and wages.

There is a great deal of uncertainty surrounding these variables, either because they are unobservable (e.g. the output gap and expectations of inflation), because available information is piecemeal (e.g. costs and wages), or because they depend on an external situation that is changing and difficult to predict. Therefore, trying to determine how these variables will behave in the future and considering alternative scenarios is fundamental to setting policy and identifying risks.

- The external outlook for 2006 suggests better terms of trade than those predicted in earlier reports. No significant reductions in capital flows to the emerging economies and Latin America in particular are anticipated, despite the gradual rise in interest rates ruled by the U.S. Federal Reserve Bank (Fed). These circumstances should be reflected less pressure towards depreciation of the average exchange rate during in 2006, as opposed to the forecast in earlier reports.

- The Colombian economy should continue to grow during 2006 at the same rate as in 2005. This prediction is based on several circumstances. One is the fact that real interest rates have been low with respect to their historic averages. Another is the favorable outlook for the external context and the increase in employment, investment and productivity.

- Although there is still a great deal of uncertainty about the actual size of the output gap and how fast it is closing, an analysis by the BR technical team, which is included in this report, points to evidence that the gap is narrower than what was estimated in earlier reports.

- Therefore, the main risk to inflation in the future would come from possible demand-pull pressure. However, this could be mitigated by several factors; namely, a healthy growth in productivity and a sizeable increase in the rate of investment, especially in machinery and equipment. Moreover, the information that is available shows no evidence of inflationary pressures originating with the trend in costs or wages.

- The expectations of inflation at one year continued to decline and are slightly below the top of the 2006 target range for inflation set by the BDBR (between 3% and 5%). However, temporary food supply shocks (or more demand) have increased the risk of inflationary expectations being influenced at times when wages and various price agreements are being negotiated for the economy. This highlights the importance of understanding that the negative shocks to inflation anticipated for the end of the year are temporary and inflation should continue to fall in the near future.

- In point of fact, the new short-term forecast for consumer inflation at December 2005 is 5.1%. This is more than what was anticipated in the last report (4.7%) and is explained by an increase in the food inflation forecast (from 5.4% to 6.8%), plus a higher inflation forecast for non-tradables (up from 4.5% to 4.8%). Total inflation is expected to decline to 4.5% by March 2006, owing to a quick decline in food inflation. However, it is important to emphasize the high degree of uncertainty associated with the food forecasts, even in the short term.

- At its meeting on 28 October 2005, the BDBR took these factors into account and agreed to leave the interest rate on expansion repos at 6%.

- Furthermore, based on an assessment of the exchange situation and the forecasts for the balance of payments, the BDBR decided to continue its discretional intervention in the exchange market.

Board of Directors
Banco de la República