Inflation
REPORT

June 2006

Banco de la República

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Inflation at June and the Outlook

- Consumer inflation declined slightly to 3.9 % in June, mainly because of the drop in food inflation. The reduction in consumer inflation during the second quarter is explained by supply factors: lower prices for a number of perishable foods and the decline in inflation in regulated goods/utilities.

- The rise in the exchange rate since April has yet to be reflected fully in the consumer price index (CPI). Depreciation usually affects consumer inflation whit a three-months lag, which means the impact would not begin to be evident until July. However, there already has been an increase in producer inflation. If it continues, this would imply pressure on costs. On the other hand, non-tradable inflation without food and regulated goods/utilities has been stable for the past year. This suggests the increase in demand is not reflected in higher inflationary pressures, or that these have been neutralized by declining inflationary expectations that are consistent with the inflation target for 2006 and the range to be defined for 2007.

- The wage hikes observed during the year to date exceed current inflation and the target. However, the unit labor cost measured for industry is down as a result of important increases in labor productivity, which were evident in other urban sectors as well. Monetary policy decisions necessitate determining if these improvements in productivity are due to cyclical factors or temporary or permanent supply factors. There is still not enough information in this respect, and the behavior of the different indicators will have to be assessed further.

- In this report, the analysis of the macro economy and its prospects for the future is not radically different from that in recent editions.

    - In real terms, the Central Bank's interest rate and interest on deposits with the financial system remain at historically low levels.

    - Use of installed capacity is at its historic average values and measurements of the output gap suggest levels near zero, even considering the uncertainty surrounding these estimates.

- Expectations of inflation for 2006 and 2007 continue to be consistent with the Bank's inflation targets.

- External conditions remain favorable: external demand and terms of trade contributed to the rise in exports and the increase in national income. High volatility on the financial and stock markets and the increase in risk perception during the second quarter did nothing to change this situation, but did affect some capital flows, especially the short-term variety. As of late, the financial and stock market indicators have seen some recovery and less volatility, while the country-risk premium has declined.

- Household and business confidence remains high, in keeping with what the surveys show. Under these circumstances, the economy continues to grow, supported by domestic demand, which has increased by an annual rate of 8%. The main items in this respect are the acceleration in household consumption and the high rate of investment.

• Given these conditions, the Board of Directors of Banco de la República (BDBR) has said the Colombian economy requires no monetary incentive to continue to operate satisfactorily. In fact, there are several reasons why the monetary incentive will have to be reduced gradually to lower inflation in the direction of the long-term goal.

- If real interest rates remain low and external and domestic factors continue to favor an increase in spending, the momentum in aggregate demand would continue, making it harder in the future to lower inflation in non-tradable goods and services.

- If part of the rise in external interest rates or in the country-risk premiums is lasting, the same will apply to a portion of the increase in the real exchange rate, and the relative price of tradable goods will tend to increase. This means tradable inflation will have less of an impact than before on lowering inflation.

- Credit accelerated, although there was no change in real lending rates; some even declined. This increased momentum probably has broadened the current impact of the monetary incentive on aggregate demand.

• At its meetings on April 28 and June 20, the BDBR ruled an increase in intervention rates based on these considerations. No changes to this effect were adopted at the May 26 and July 27 meetings. These decisions consider the fact that monetary policy operates with a relatively long lag. This means the required adjustments must be made well in advance so as not to jeopardize future targets for inflation and the credibility of the policy itself.

• These decisions also ratify the gradual nature of the changes in the stance of Colombia's monetary policy. Given the uncertainty under which monetary policy operates, a gradual approach to decisions makes it possible to include new information that helps to redefine the BDBR's perception of important macroeconomic aspects such as changes in productivity, use of installed capacity, the extent of competition in different markets and the movement of

international capital markets. These elements are crucial to a macroeconomic diagnosis, but are surrounded by a great deal of uncertainty. A gradual approach to adjustments in the stance of monetary policy also avoids excessive volatility in interest rates, output and employment. However, it is important to recognize that a gradual approach is possible due to the positive trend in inflationary expectations and the credibility acquired by the country's monetary policy.

Board of Directors
Banco de la República

INFLATION REPORT

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I. The Current Economic Situation

External conditions remain favorable for Colombia, despite financial volatility. The momentum in world demand continues, coupled with high terms of trade. At the time this report was written, there was a tendency towards less volatility.

The drop in stock and TES prices did not include other assets such as real estate. Housing prices continued to rise at a moderate pace and the prices of other domestic assets had recovered by the end of the quarter.

The Colombian economy experienced solid growth during the first half of 2006. The rise in domestic demand far outpaced the historic average, with a major increase in household consumption. Credit is playing a more important role and some interest rates are lower, despite the increase in the Central Bank's rates.

Consumer inflation was down again in the second quarter, mainly because of supply factors. The reduction was due to regulated goods/utilities and staple foods. Depreciation continued to have a limited impact on the CPI, but was important for producer prices. There were no major demand-pull pressures.

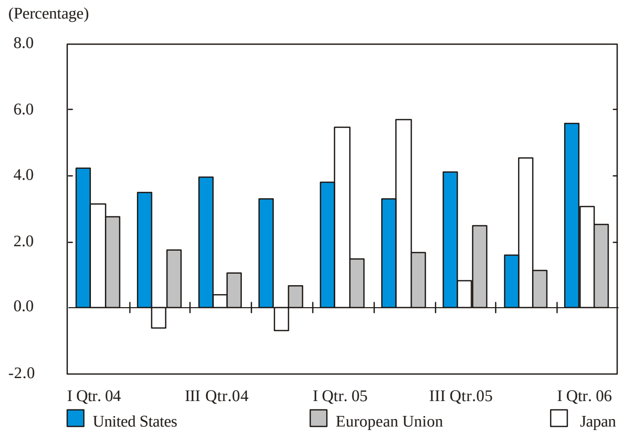
A. The External Context

The external panorama in recent months was characterized by a great deal of volatility on the financial markets associated with increases in inflation and with expectations of higher interest rates in several of the developed economies. However, this situation did not overshadow the good performance of the world economy. Its growth during the first half of the year was consistent with what was anticipated in the previous report.

The increase in the economy worldwide was lead by the United States, with 5.6% growth (annualized quarterly) during the first three months of 2006, although the latest indicators suggest this tendency is near the breaking

GRAPH 1

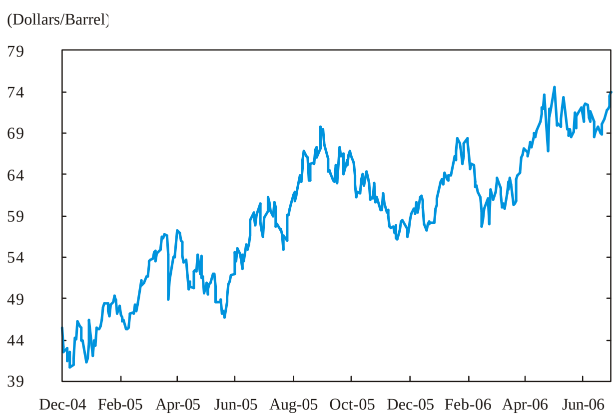
ANNUALIZED QUARTERLY GDP GROWTH IN THE UNITED STATES, THE EURO ZONE AND JAPAN



Source: Datastream.

GRAPH 2

PRICE OF OIL (WTI) ON THE NEW YORK STOCK EXCHANGE



Source: Bloomberg.

point[1]. Levels extent of employment and industrial production remained favorable, while other figures such as those on retail sales and the trade balance suggested less growth in consumption (Graph 1). Although housing prices remained high, home sales slowed. This suggests the possibility that the housing market will wind down, which analysts regard as extremely crucial to the country's economic performance.

Other developed economies, such as the Euro zone and Japan, saw positive momentum, which indicates they appear to be on a path towards sustained growth. First-quarter growth was 2.4% in the Euro zone (annualized quarterly) and nearly 3% in Japan. The improvement in the job market and in household consumption, particularly in Japan, has become increasingly important (Graph 1).

The emerging economies and especially those in Asia, such as China, continued to exhibit an upward tendency. For example, the Chinese economy saw more than 11% growth in the second quarter. Two of Colombia's major trading partners: Ecuador and particularly Venezuela, experienced a similar situation, thanks to high oil prices.

Commodity prices remained high due to the strength of world demand and some supply problems. Oil is the clearest example. It climbed to US$76 a barrel in recent days, as a result of political instability in the Middle East (Graph 2). The rise in commodity prices also extends to metals, including those exported by Colombia, such as gold and nickel (which saw respective increases of 13% and 35% between the first and second quarters). In general, prices for Colombia's basic export items ended the quarter close to their historic levels and above the predictions in previous reports.

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[1] The preliminary figure for second-quarter growth in the United States was announced at the time this report was being written. It is 2.5% (annualized quarterly), which is below what the market expected and implied a negative contribution to residential investment and public spending. The respective annual growth rate was 3.5%, which is still above that economy's potential growth.

Although the external context continues to favor the region's economies, strong economic growth and high commodity prices have begun to exert inflationary pressure on the developed economies, raising fears of a sharp reduction in international liquidity. The situation of greatest concern with respect to inflation is in the United States, where core inflation has been climbing since March and has been above the "implicit goals" set by that country's monetary authorities[2] (Graph 3). Although still moderate in the Euro zone and Japan, these pressures are growing.

These upswings in inflation prompted monetary authorities to raise interest rates more than the market had anticipated. The reference rate went to 5.25% in the United States and 2.75% in the Euro zone. Moving quicker than expected, the Central Bank of Japan upped its reference rate by 25 basis points (bp), after maintaining it at near zero levels for almost six years (Graph 4). These expectations of higher interest rates were reflected in more volatility in shares, bonds and exchange rates throughout the world, demonstrating an increased aversion to risk.

The volatility in financial markets had an important impact on the Latin American economies, particularly in Colombia where it was more pronounced there than in other parts of the region. From May to mid-June, the Colombian peso devaluated by 9%. This is more than in Brazil (3%), Chile (4.5%) and Argentina (0.6%) (Graph 5)[3]. Stocks experienced a similar situation. In Colombia, they plummeted by 25.3% during the same period, far more than in the aforementioned economies. However, it is important to point out that, as of 2004, stock prices in Colombia rose much higher than those in other Latin America markets.

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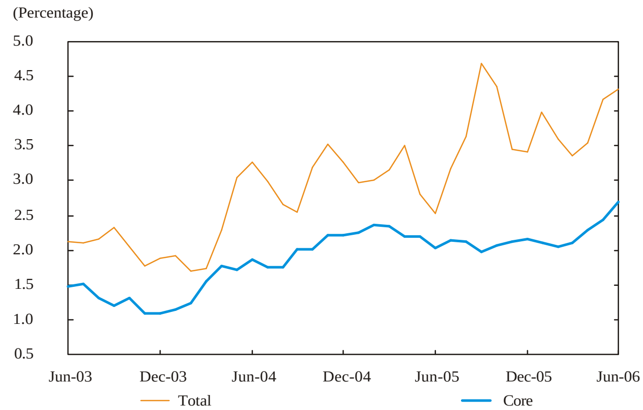
[2] Core inflation in July was 2.7% as opposed to the figure in March (2.1%), with 4.3% total inflation compared to 3.4%.

[3] By mid-June, pressure on the Colombian peso and region's other currencies was less evident and a new trend towards appreciation had begun to emerge.

GRAPH 3

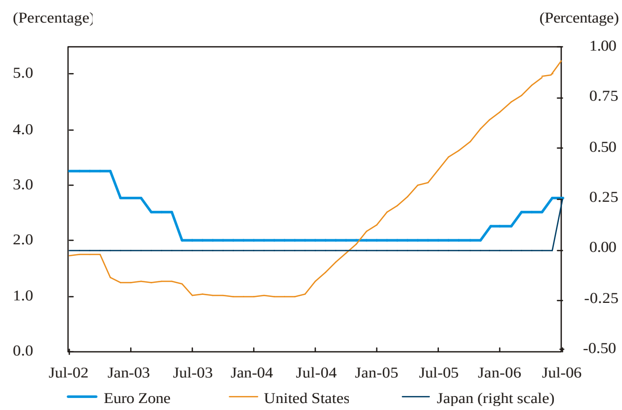
ANNUAL CONSUMER INFLATION IN THE UNITED STATES



Source: Datastream.

GRAPH 4

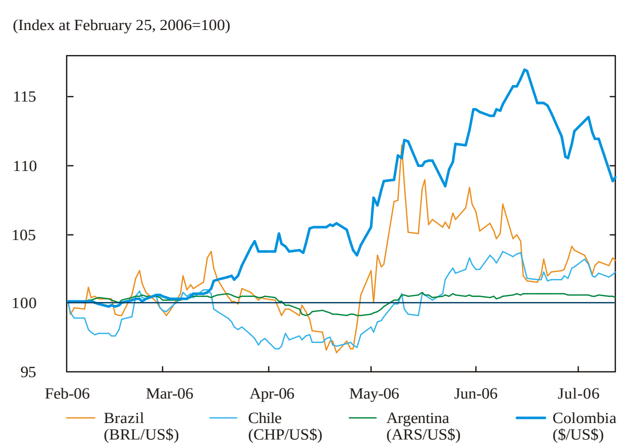
MONETARY POLICY RATE IN THE UNITED STATES, THE EURO ZONE AND JAPAN



Source: European Central Bank and Datastream.

GRAPH 5

NOMINAL RATE OF EXCHANGE FOR DIFFERENT LATIN AMERICAN CURRENCIES AGAINST THE DOLLAR



Source: Datastream.

The second quarter saw an extraordinary rise in volatility on the financial markets...

B. Financial Variables

As indicated earlier, the second quarter saw an extraordinary rise in volatility on the financial markets, along with more expectations of external interest rate hikes, a strong tendency towards peso depreciation, a rise in interest on government bonds (TES) and a sharp drop in stock prices. Also, the growth in monetary aggregates accelerated in recent months, as did the amount of credit extended by the financial system. This situation was coupled with an increase of 50 bp in Banco de la República's intervention rate: the first since April 2003.

1. The Exchange Rate

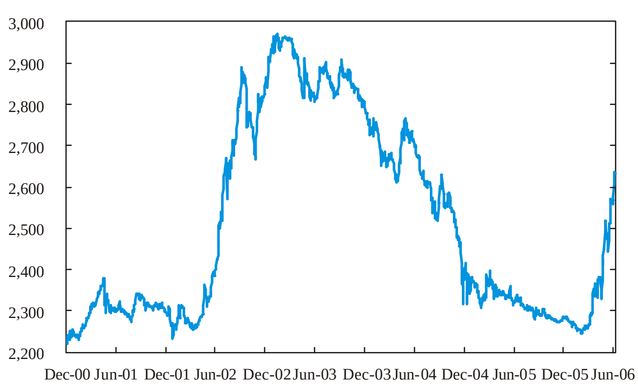
Up to the end of the first quarter of 2006, low external interest rates and the favorable external context allowed surplus liquidity to continue to be channeled towards the emerging economies, helping the currencies of those countries to appreciate (including the Colombian peso) and lowering their country-risk premiums. This situation changed during the second quarter, with the increased likelihood that that interest rates would rise. In response to this new circumstance, portfolio capital declined and domestic agents increased their capital outflows, all of which weakened the exchange rate.

Consequently, by the end of June 2006, the nominal rate of exchange was $2,633 pesos per dollar. This meant 15.4% devaluation during the year to June and an increase of $388 pesos compared to the lowest rate, which was registered in early March (Graph 6). Other Latin American economies also saw their exchange rates increase during the second quarter; namely, Brazil, Mexico, Chile and Argentina, but with less depreciation than in Colombia. So far this year, the Colombian peso has devaluated in real terms with respect to the country's trading partners, including both the developed economies (9.4%) and the developing economies (9.6%).

Graph 6

Representative Market Rate of Exchange

(Pesos per Dollar)



Source: Banco de la República.

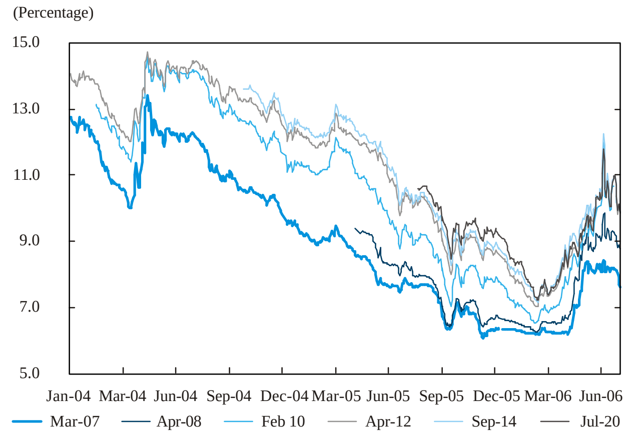
2. Public Debt (TES)

For several years, there has been a close correlation between the exchange rate and TES prices and interest rates. Recent months have been no exception. Depreciation in the exchange rate and the rise in volatility on the world's financial markets, coupled with less appetite for risk as of late March, translated into a major drop in TES prices and a subsequent rise in the interest on these bonds (Graph 7).

Initially, the increase was only in medium and long-term rates, coinciding with higher country-risk premiums and a greater perception of risk on world financial markets, which sharpened the yield curve. However, with the rate changes made by Banco de la República (25 bp on April 28 and again on June 20), plus the anticipation of further hikes, short-term rates also reacted upward, re-establishing the slope of the yield curve, but at a higher rate level.

GRAPH 7

TES INTEREST RATE a/ ON THE SECONDARY MARKET



a/ Data at July 27, 2006.
Source: SEN, Banco de la República.

Although the recent momentum in TES is associated with the external factors mentioned already, and with the change in the stance of monetary policy, the extensive rise in interest rates –more than 300 bp in the longest-term rates– also reflects a correction in what might have been an excessive price rise the year before. In effect, the reduction in rates was continuous as of May 2004 and added nearly 700 bp to those for the longest terms. Although low external rates and the confidence reining in the markets were contributing factors, this also seems to have been the result of extensive leveraging possibilities for domestic market agents.

TES rates began to decline again in recent weeks, but moderately so, and still amidst considerable volatility (Graph 7). This tendency, also observed in other local assets and in most of the emerging economies, coincided with statements by the Federal Reserve Bank (Fed) suggesting the reduced likelihood of further interest-rate hikes in that country.

3. Prices of Other Assets : Stocks and Real Estate

As with TES, the Colombian stock market also devaluated sharply and experienced considerable volatility during the second quarter. Between March and June of this year, the General Colombian Stock Exchange Index (IGBC in Spanish) dropped by 31%. In fact, the Colombian stock exchange experienced the biggest price slide worldwide. However, by the last week of June and early July, this tendency had reversed itself and the IGBC saw another major price increase, but not enough compared to the levels in March.

…however, the past month has seen prices for domestic assets recover substantially.

January figures suggest housing prices continued to rise slowly, as they have for the past two years. Apparently, Colombian real estate nationwide has yet to experience the sort of sharp price increase witnessed for stocks and TES as of mid-2004, although this might have happened to some extent in a few specific markets such as urban housing for high-income households.

4. Monetary Aggregates

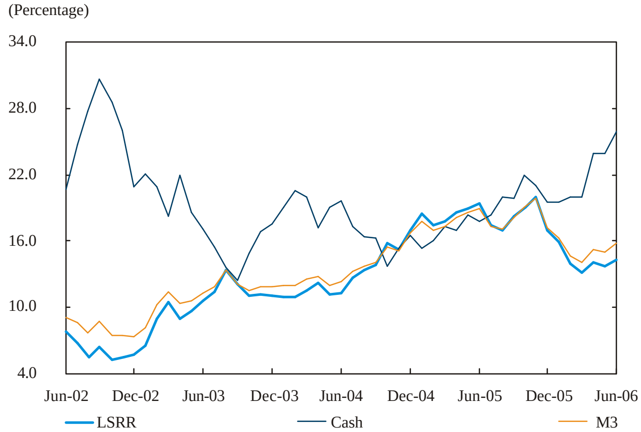
One implication of the high volatility in TES and stock prices has been an increase in market risk. This is particularly important to financial brokers, whose exposure to TES is now considerable[4] and might have affected the behavior of bank assets and liabilities.

With respect to liabilities in the financial system, the entire second quarter saw evidence of accelerated growth in the supply of funds for credit (or, from the standpoint of savers, an increase in demand for deposits). One reason might be that companies and households have not only replaced TES and stocks with assets in foreign currency, but also with liabilities subject to reserve requirements (LSRR), such as savings accounts and term deposits (CDs), among others. Graph 8 illustrates the acceleration in M3 and LSRR during the preceding months, although their nominal growth rates at the start of the year were already relatively high.

Besides the additional growth in LSRR, there has been even more of a step up in cash. Although this may be due to changes in agents' portfolios, it might also signal an acceleration in consumer spending. Until the end of the nineties, the tendency in cash was associated with consumption. However, this correlation disappeared with the shift in demand for money at the start of this decade, partly because of the tax on financial transactions. However, the fact that this tax has been stable in recent years may have opened the way for a reappearance of this correlation (Graph 9).

GRAPH 8

MONETARY AGGREGATES
ANNUAL RATES OF GROWTH
IN THE MONTHLY AVERAGE



Source: Banco de la República.

4 Figures for May 2006 show 32.0% of all TES were held by the financial system. This is equivalent to $26.4 trillion pesos. Including pension and severance funds, the share is 52.6% or $44.4 trillion.

As to assets in the financial system, indications suggest that banks have increased their supply of credit to mitigate the higher market risk resulting from the devaluation in TES. Credit establishments increased their loan portfolios considerably more during the second quarter than in the first, coinciding with a sizeable reduction in other investments (Table 1).

The substantial growth in credit includes portfolios of every type, but particularly consumer loans and recovery on mortgages. Growth with respect to the latter is in positive terrain, but still very low (Graph 10). Even so, the total portfolio and the portfolio directed to households (consumer credit, plus mortgage loans) is still a long ways from the historic highs, when measured in relation to gross domestic product (GDP).

The recent tend in interest rates supports the idea that the acceleration in credit during the second quarter is more the result of an increase in supply on the part of financial establishments than a shift in demand. Lending rates on household loans (consumer and credit card) continued to decline substantially during May and June, in both real and nominal terms. Less of a reduction also was seen in the rates on ordinary credit (Graph 11). However,

TABLE 1

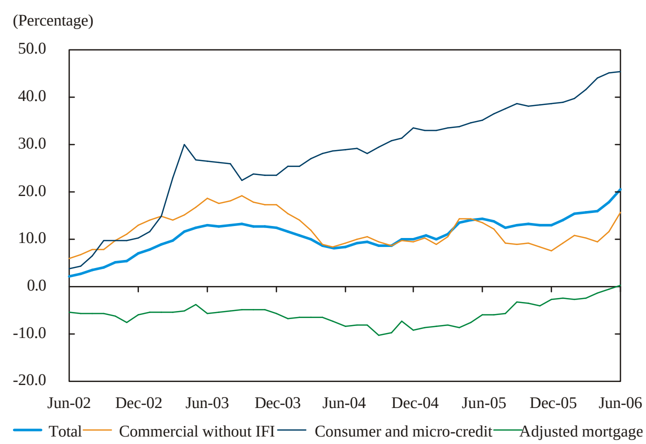
CREDIT ESTABLISHMENTS
SELECTED MONTHLY FLOWS
(BILLIONS OF PESOS)

	I Qtr. 06	II Qtr. 06
Net Portfolio	2,383.2	8,541.2
Investments	2,012.0	(4,780.4)
TES B fin. System - changes in cash		(1,561.0)

Source: Colombian Superintendent of Finance.

GRAPH 10

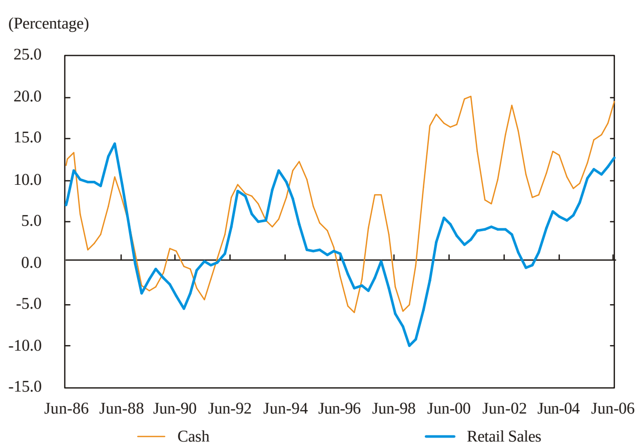
GROSS PORTFOLIO (L/C)
(ANNUAL GROWTH)



Source: Colombian Superintendent of Finance. Calculations by Banco de la República.

GRAPH 9

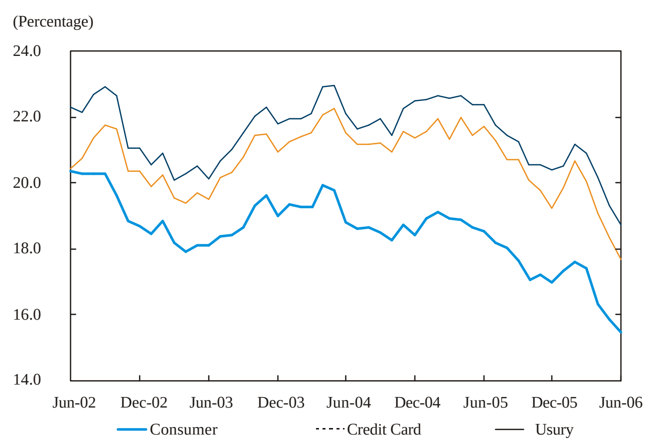
REAL ANNUAL GROWTH IN CASH
AND IN RETAIL SALES
(TENDENTIAL COMPONENTS OF THE SERIES)



Source: DANE and Banco de la República.

GRAPH 11

REAL INTEREST RATES
(MONTHLY AVERAGES)



Source: Colombian Superintendent of Finance. Calculations by Banco de la República.

The total portfolio, as a portion of GDP, remains at relatively low levels.

it is important to point out that the reduction in the usury rate might have contributed to this downturn as well.

The decline in most lending rates contrasts with the rise in the interbank rate and interest on deposits, including the rate on fixed-term deposits (DTF in Spanish). As was expected, the increase in Banco de la República's intervention rates in April and June (25 bp on both occasions) was transferred quickly to the interbank rate; transfer to the DTF began when it increased by 30 bp at the start of July. In other words, the relationship between both these nominal rates is being re-established after several years of apparent detachment.

C. Economic activity and employment

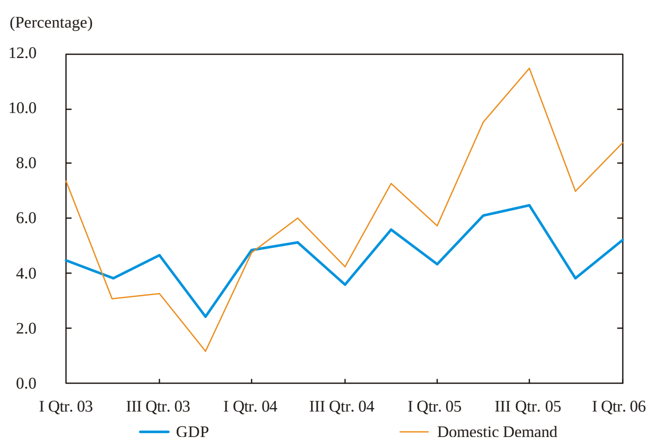
1. First-quarter Growth in 2006

The National Department of Statistics (DANE) reported 5.2% real growth in GDP for the first quarter of 2006. This was consistent with what a number of analysts had predicted and quite close to Banco de la República's projections. The current growth phase of the economic cycle has continued for 14 quarters, considering that average quarterly growth since the end of 2002 is 4.6% and has been characterized by more of an increase in domestic demand than in output (Graph 12). However, given the figures available at March, the current account in the balance of payments has not yet to show the signs of deterioration that are evident when examining the figures in constant pesos (real net external demand reached –5.0% of GDP)[5]. Part of this discrepancy could be explained by the effect higher terms of trade had on national revenue.

The force of domestic demand largely explains the growth in GDP during the first quarter of 2006 and confirms what was anticipated by the consumer and investor confidence indicators. The contribution of household consumption to GDP is a high point (Table 2), especially consumption of durable goods, which was up by an annual rate of 18% this quarter, and had increased by 20.5%, on average, since the start of 2004. The only unsatisfactory outcome continued

Graph 12

Domestic Demand and GDP



Source: DANE. Calculations by Banco de la República.

[5] DANE frequently revises the figures on foreign trade; that is, exports and imports (in constant pesos). Therefore, the current amounts should not be regarded as definitive.

to be consumption of non-durables (3.6% in the first quarter, 3.2% in the two years before).

There was a real increase of 26.8% in gross capital formation, with major growth in all items except for home and building construction, which was down by 1.2%. The reasons for this slump are not clear, considering the positive trends in the variables associated with home construction, particularly the terms on mortgage loans and credit for builders, the increase in building permits and the number of works in progress. Halted works was the only indicator that suggests some deterioration in the sector, based on the construction census for seven cities with an annual increase of 7.5%, the first since early 2000.

Imports mirrored the force of investment and were up by 23.1% in real terms. According to estimates by Banco de la República, real imports of capital goods registered an increase of 25% during the first quarter, while imports of intermediate goods rose by 17.7%. On the other hand, real imports of consumer goods increased at an annual rate of 24% during the same period, accelerating compared to the pace they exhibited in previous years (an average of 10% since 2004). Nonetheless, their share of total imports was still less than 20%.

TABLE 2

GROWTH AND CONTRIBUTION TO GDP PER TYPE OF EXPENSE
(PERCENTAGE)

	I Quarter of 2006	
	Percentage to Growth	Contribution of Growth
End Consumption	**4.6**	**3.7**
Household	5.0	3.1
Government	3.2	0.6
Gross Capital Formation	**26.8**	**5.2**
Gross Fixed Capital Formation (GFCF)	14.7	2.7
GFCF without Civil Works	14.0	2.1
Civil Works	17.8	0.6
Variation in stock	287.4	2.5
Domestic Demand	**8.8**	**8.9**
Total Exports	**6.6**	**1.3**
Total Imports	**23.1**	**(5.0)**
GDP	**5.2**	**5.2**

Source: DANE. Calculations by Banco de la República.

Growth during the first quarter was propelled by the non-tradable sectors….

There was a real rise of 3.2% in public spending, which contributed only 0.6% to GDP growth. The limited increase in this item during the first quarter compared to the government's goals for the year (approximately 6% real growth) might be associated with the impact of the Electoral Assurances Act on government contracting during the period. An increase in public spending within what was budgeted would have allowed for 5.8% GDP growth during the first quarter and, consequently, more of a rise in domestic demand and in the production of non-durables.

Total exports saw a real increase of 6.6% and continued to benefit from favorable external conditions. Traditional exports were not as dynamic as non-traditional exports, mainly because of the shortcomings in coffee and ferronickel exports. In March, the figures on foreign trade showed tremendous growth in non-traditional exports to Venezuela and the United States. The increase in exports to Ecuador is much slower and is leaning towards standstill, after having peaked in the last quarter of 2005.

Growth at the sector level during the first quarter of 2006 was propelled more by non-tradables than tradables (Table 3). This is consistent with the favorable trend in domestic demand and its determining factors, and with the way the exchange rate performed.

…while consumer confidence continued to grow.

The main factors in the tradable sectors include the drop in coffee production (-14.2%) due to weather problems in 2005 and the growth in manufacturing (7.3%). The latter is explained, in part, by three more working days (the effect of the Easter holiday).

Another important factor with respect to tradables is the recent stability in crude oil production, which increased a bit in the two previous quarters, even though a decline in production was anticipated a few years back. In this case, high international oil prices have made it more profitable to produce heavy crudes (which are less profitable) and prompted more exploration in Colombia.

Growth in the non-tradable sectors was responsible for nearly 70% of the increase during the first quarter of 2006. The construction of civil works was up, thanks to the telecommunications sectors and several major highway projects being developed by government agencies at the territorial level.

Conditions on the job market are still improving.

Energy generation, commerce, financial services, real estate agencies, business services and restaurants grew at a good pace, backed by industrial growth, abundant liquidity, good conditions on the job market and consumer confidence. According to the Fedesarrollo Index, consumer confidence rose throughout the first quarter.

Table 3

Sector Growth and Contribution to GDP
(Percentage)

	I Qtr. 2006	
	Percentage to Growth	Contribution of Growth
Agriculture, forestry, hunting and fishing	0.8	0.1
Mining and quarrying	1.7	0.1
Electricity, gas and water	3.2	0.1
Manufacturing industry	7.3	1.1
Construction	5.7	0.3
Buildings	(1.1)	0.0
Civil works	17.8	0.3
Commerce, repairs, restaurants and hotels	8.4	1.0
Transport, storage and communications	9.7	0.8
Financial establishments, insurance, real estate agencies and business services	6.5	1.1
Social, community and personal services	2.9	0.5
Financial brokerage services measured indirectly	13.6	(0.6)
Subtotal: Aggregate value	4.8	4.5
GDP	**5.2**	**5.2**
Taxes minus subsidies	10.3	0.7
Net FBMI financial services [a/]	4.2	0.5
Tradables [b/]	4.4	1.7
Non-tradables	5.7	3.5

a/ FBMI: financial brokerage services measured indirectly.
b/ Agriculture and livestock, mining, manufacturing, air and water transport services, both complementary and auxiliary, and certain private services for companies are classified as tradable sectors.
Source: DANE. Calculations by Banco de la República.

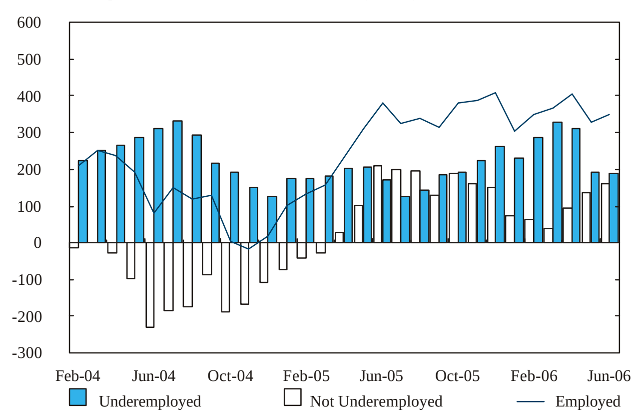
2. Employment

Available indicators show a steady improvement in conditions on the job market. The number of employed in the thirteen major cities rose by 4.3% during the second quarter of 2006, which is a sign the rate of economic growth is being maintained. In June, the unemployment rate declined by 1.3 percentage points (pp) compared to the rate in June 2005. Throughout most of the first six months of the year, the increase in employment was sustained by formal jobs (as opposed to underemployment) (Graphs 13 and 14). However, underemployment rose during May and June, particularly outside the thirteen major metropolitan

Graph 13

Job Creation

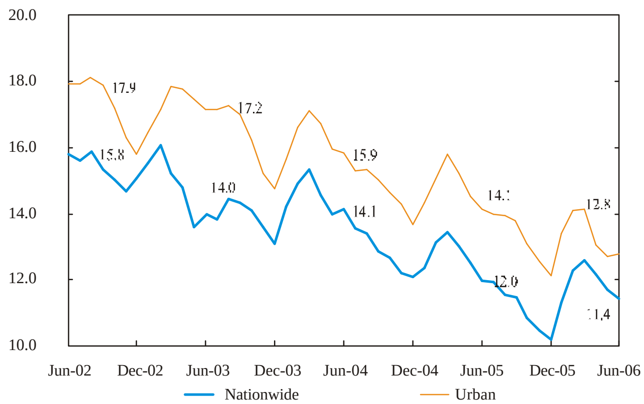
(Thousands of persons in 13 cities, three-month moving average)



Source: DANE. Calculations by Banco de la República.

GRAPH 14

UNEMPLOYMENT RATE
(THREE-MONTH MOVING AVERAGE)



Source: DANE-CHS.

areas[6]. Although the figures are too limited for a conclusive explanation, the fact that this phenomenon was seen mainly in the small cities and rural areas could be due, in part, to more demand for labor associated with temporary agricultural activities and/or with other seasonal demands such as recreation and tourism.

All considered, the figures for the first six months support the hypothesis in the last report in the sense that the job market is continuing to adjust. The decline in unemployment has occurred on par with a standstill in the global participation rate (GPR). This suggests there has been no increase in the labor supply in relative terms. On the supply side, employment is up and the rate of hourly underemployment dropped by 1.5 pp in June of this year compared to the same month in 2005.

D. DETERMINANTS OF INFLATION

1. The Exchange Rate

Consumer prices in Colombia are usually affected by a variation in the exchange rate (Box 1). For example, during the last major episode of exchange-rate instability, which occurred between 2002 and 2003, one of the results of 30% depreciation was an approximate 2 pp acceleration in consumer inflation. Normally, transmission to the CPI takes about three months. This is contrary to the effect on the producer price index (PPI), which tends to be immediate[7].

Consequently, a large portion of the depreciation registered in the second quarter would have been transferred to producer prices in recent months, but would not have had much effect on consumer prices. The impact in this respect would begin only as of the third quarter. This being the case, during the second quarter, the CPI continued to benefit from the favorable effects of exchange stability in previous quarters, with small price variations for tradable goods (or those affected by the exchange rate) and

6 Although the June underemployment rate for the thirteen major cities showed no change with respect to the same month the year before (31.4%), it was up by 3.9 pp nationwide (34.4% at June 2006).

7 It is partly because producer prices for numerous imported goods are expressed in dollars and converted into pesos at the representative market rate (RMR) in effect at the time.

with an annual rate of inflation in the sub-basket that was well below the targets set by the Central Bank.

The impact of depreciation on inflation depends on how permanent the increase in the exchange rate is.

In the future, several particular features of the current situation that can alter the extent of exchange-rate transmission will have to be taken into account:

- First of all, the extent of transmission can vary during the economic cycle. Unlike what happened in 2002-2003, the economy is now experiencing solid growth. In this context, companies are likely to be quicker about passing on the full increase in the exchange rate to prices, because the risk of losing customers is low.

- Secondly, many imported raw materials have increased substantially in price and these hikes will tend to be passed on to the local producer or consumer, magnifying the effect of depreciation.

- An opposite situation is created by the fact that the Colombian economy is now more involved with the world market. This means local companies face more competition on the domestic market and are less able to set prices. With globalization and involvement in the world market by countries with an abundant supply of manpower, the production costs and prices of many manufactured goods imported by Colombia have been reduced.

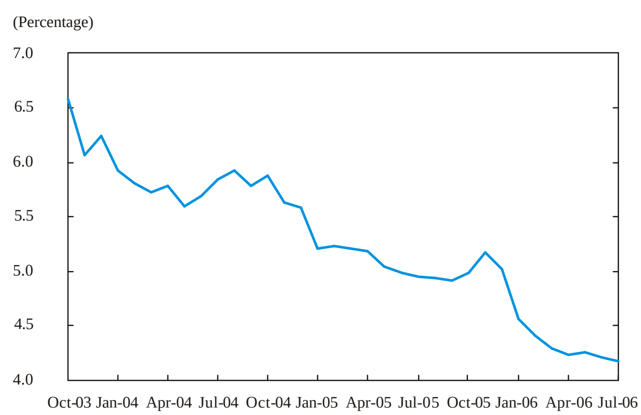
- Finally, to determine the impact on inflation, it is important to consider not only the magnitude of depreciation but also its duration, and how permanent the increase in the exchange rate is. A short hike such as the one that seems to be underway, given the change since mid-July, can have much less of an impact on prices than a longer one, as occurred in 2002.

2. Expectations

Expectations of inflation remained relevant to lowering inflation in Colombia. During the second quarter, the various measurements used by Banco de la República showed a downward tendency and were situated in the lower portion of the target range set by the Bank. Those polled for the July survey of expectations anticipate 4.2% inflation by December (Graph 15) and expect it to remain there until July 2007. Slightly less optimistic, but with an equally favorable tendency, were the findings of the Bank's quarterly expectation survey in April, which point to 4.6% inflation by December and 4.5% by March

GRAPH 15

EXPECTATIONS OF ANNUAL INFLATION ON A MONTHLY BASIS: BANKS AND STOCKBROKERS



Source: Banco de la República.

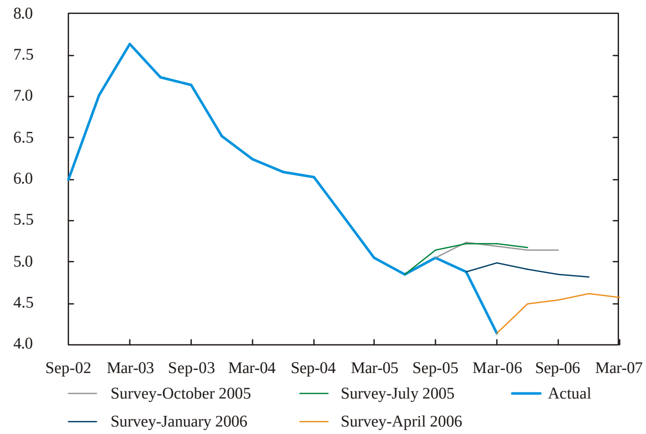
2007 (Graph 16). It is important to bear in mind that the findings of this last survey are usually higher than the other measurements and the actual figures.

In addition to the favorable trend in expectations, the inflation target continues to be regarded as highly credible. The vast majority of those polled for the quarterly survey in April (90.1%) believe the 2006 target is feasible (Graph 17). This is the highest percentage for the month of April since data became available (Graph 17).

These expectations may have offset certain inflationary pressures that might have begun to emerge with respect to costs or because of the rapid growth in demand. They also may have helped to restrain wage hikes, despite the upward signal that could have come from this year's increase in the minimum legal wage, which exceeded the inflation target by three pp.

GRAPH 16

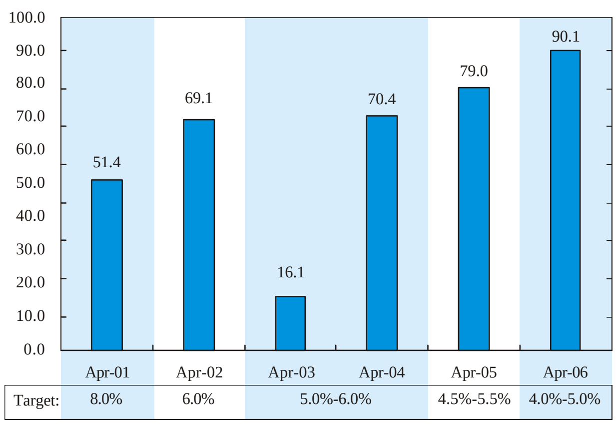
MONTHLY INFLATION EXPECTATIONS



Source: Banco de la República.

GRAPH 17

PERCENTAGE OF INFLATION TARGET CREDIBILITY: 2001 TO 2006
(SURVEY OF EXPECTATIONS DONE EACH YEAR IN APRIL)



Source: Banco de la República.

3. Surplus Capacity and Demand-pull Inflationary Pressures

The strong growth in demand during the past three years has been accompanied by a constant increase in the economy's potential supply. This has prevented the surplus production capacity inherited from the crisis at the end of the nineties from disappearing quickly. The productivity gains detected in several production sectors also contributed to this situation. Even so, as noted in previous editions of this report, the growth in demand has been high, with a tendency to exceed productive capacity, which is why these surpluses have been slow to disappear.

This tendency probably continued during the first half of 2006, as evidenced by the wide range of indicators concerning use of productive-capacity (Graph 18) and by estimates of the output gap developed with different methods. An analysis of this information suggests surplus productive capacity is now less than what was estimated at the beginning of the year and in 2005. This conclusion is possible, even with the sizeable growth in investment during the previous year and in the first half of 2006.

The view in this report is that factor use and productive capacity, in general, would be approaching a threshold as of which an accelerated increase in demand results in pressure on prices. Accordingly, the assumption is that the output gap has closed during 2006 and might even be marginally above zero, given DANE's recent upward revision of the growth figures for 2005 (Graph 19).

It is, however, important to bear in mind that various measurements of core and non-tradable inflation continue to reflect considerable stability, or have declined during the year to date. This suggests that inflationary pressures attributed to demand are being contained or are very limited. Low inflationary expectations might have been an important contributing factor in this respect, but the recently detected apparent acceleration in labor productivity gains in various sectors, such as industry and commerce, might also be exerting an influence, as will be explained later. Also, the force of globalization may have slowed price hikes in both the tradable and non-tradable sectors by reducing production costs and increasing competition for local companies.

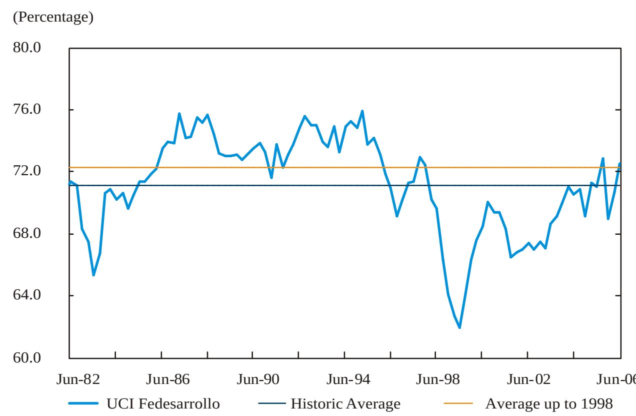
4. Costs

Second-quarter depreciation and price increases for a number of raw materials purchased on the world market have affected producer prices, especially in the imported PPI, and could spell upward pressure on costs. In effect, after a historic low in March of this year (1.5%), total producer inflation rose sharply during months that followed and was 4.8% in June. The increase in the imported PPI was even higher: 4.7% in June (Graph 20).

Prices for petroleum, its by-products and possible substitutes were among the external prices most responsible for higher producer inflation and costs.

GRAPH 18

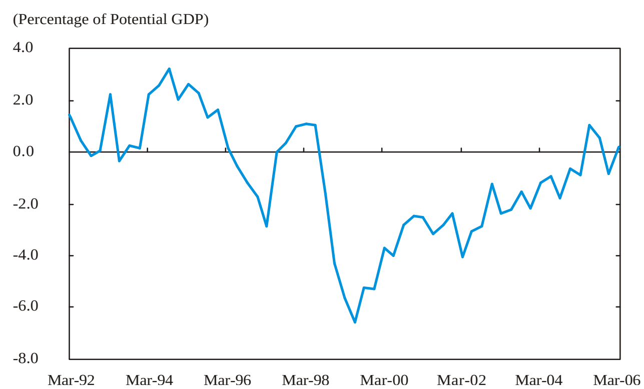
USE OF INSTALLED CAPACITY: FEDESARROLLO SURVEY (SEASONALLY ADJUSTED SERIES)



Source: Fedesarrollo.

GRAPH 19

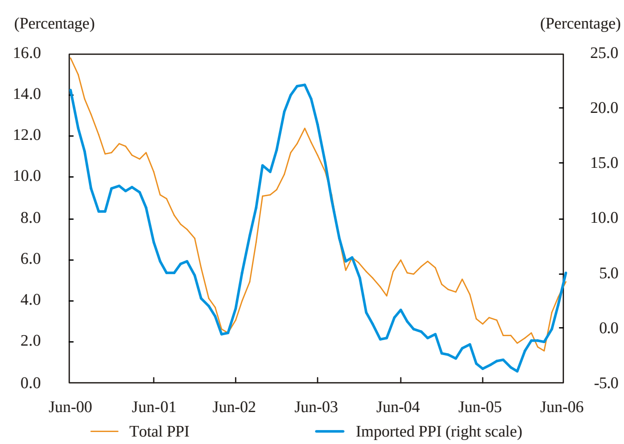
OUTPUT GAP



Source: Banco de la República.

GRAPH 20

TOTAL AND IMPORTED PPI INFLATION



Source: Banco de la República.

High prices for oil and its by-products have pushed up costs and producer inflation.

This last group includes various products of agricultural or agro-industrial origin, such as corn, sugar cane and sugar. Until not long ago, the link between their price cycle and fuel was limited. However, as a result of technological progress and the limited supply of crude oil, they are beginning to be regarded as an important energy alternative. Aside from energy, price increases have been reported for metals, including gold, given the surge in demand due to strong growth in Asia.

In the case of petroleum, its by-products and metals, the price hikes appear to be the result of a permanent adjustment based on new market conditions. This poses a new situation for the Colombian economy, which will have to be translated into higher production costs. As to depreciation, it is less clear if it will have a sustained impact on costs, volatility and the downward revisions observed since July.

5. Wages and Productivity

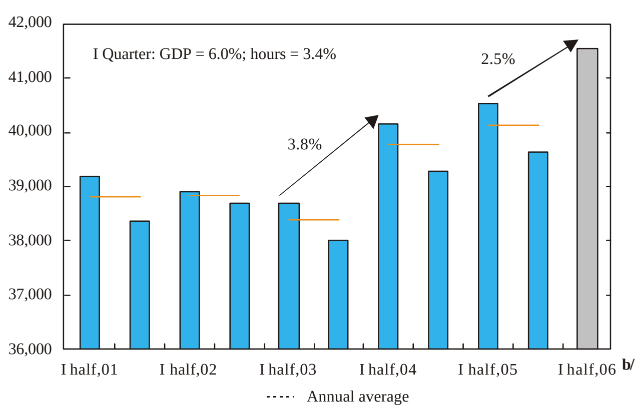
Productivity has increased in both the tradable and non-tradable sectors.

The pattern of productivity is a key variable for analyzing non-inflationary growth and surplus production capacity in the economy. As noted in previous reports, the only way to obtain indicators of this measurement is indirectly, through other variables. Consequently, based on the strategy defined in the September 2005 *Inflation Report*, the following is the trend in output per hour worked, as the best indicator of work productivity.

GRAPH 21

URBAN OUTPUT PER HOUR WORKED a/

(1994 pesos)



a/ GDP without government services, agriculture and mining.
b/ a projection by Banco de la República.
Source: Banco de la República.

Based on the national accounts, the continuous home surveys (CHS) and assuming an increase of 6.0% in urban GDP during the first half of the year, without government services[8], it is estimated that productivity per worker at the urban level (Y/L) would have increased by 1.5% in the first half of the year and that labor productivity (Y/H) was up by 2.5% (where H is the total number of hours worked) (Graph 21).

There have been labor-productivity gains in both the tradable and non-tradable sectors. In the case of industrial manufacturing, the rate of growth in output

[8] This assumption is consistent with the growth forecast for the second quarter, which is outlined in Chapter II of this report.

per hour worked has increased, leaving behind the temporary reduction seen in the second half of 2005 and noted in the March edition of this report. On the other hand, the growth in sales per worker in the retail trade also accelerated throughout the year, indicating headway in the sector's productivity (Graph 22).

The added gains in labor productivity and the moderate industrial wage hikes have had an influence on the stability of the nominal unit cost of labor. Based on figures available in April, the annual increase was only 0.6%. In recent months, wage hikes in non-tradable sectors such as construction and commerce have been moderate as well. Consequently, labor costs should have generated no major inflationary pressure during the first half of the year.

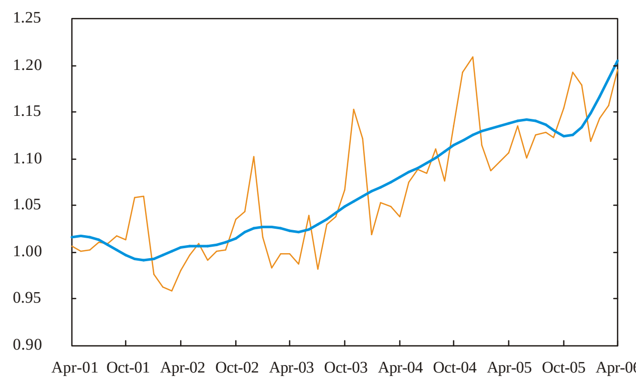
Nonetheless, decisions on monetary policy necessitate identifying whether or not these improvements in productivity are due to cyclical factors or to temporary or permanent supply factors. The data available is still insufficient in this respect, and the pattern in the various indicators will have to be evaluated further.

E. Inflation at June

Consumer inflation dropped to 3.9% during the first half of 2006 (as opposed to 4.9% in December and 4.1% in March. This is below the bottom of the range of the target set by the Bank for the current year (Graph 23). The favorable pattern in total inflation also was evident in the measurements of core inflation: CPI without food was 3.6% at June (Graph 24), which is well below the bottom of the target range. The other two indicators of core inflation (nucleus 20 and CPI without staples, fuel and public utilities) have declined on par with non-food inflation, despite a few recent increases. In all, the three indicators averaged 3.6% at June.

Graph 22

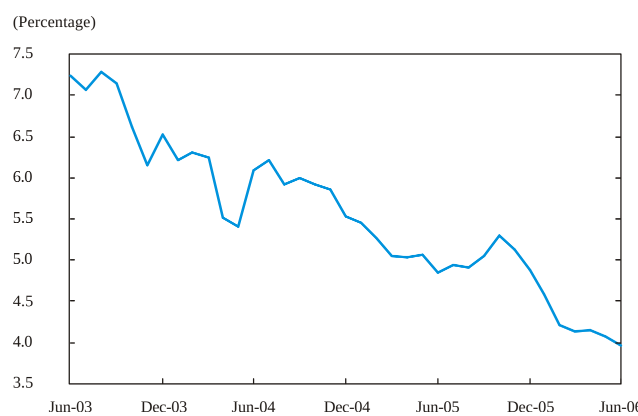
Output per Hour Worked in Industry
(Tendential Component)



Source: DANE. Monthly Manufacturing Sample.

Graph 23

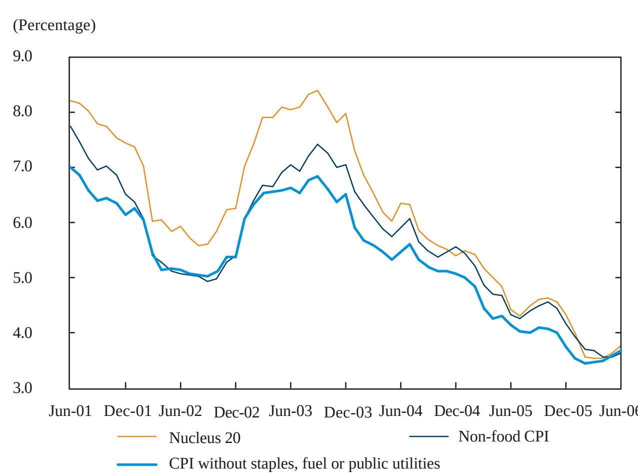
Annual Consumer Inflation



Source: DANE. Calculations by Banco de la República.

Graph 24

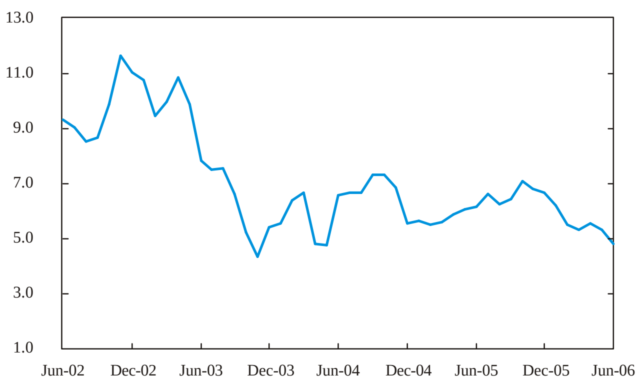
Core Inflation Indicators



Source: DANE. Calculations by Banco de la República.

GRAPH 25

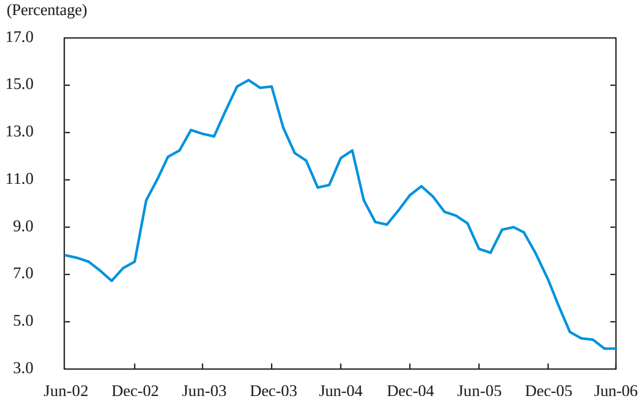
ANNUAL FOOD INFLATION



Source: DANE. Calculations by Banco de la República.

GRAPH 26

ANNUAL INFLATION IN REGULATED GOODS/UTILITIES (ANNUAL VARIATION)



Source: DANE. Calculations by Banco de la República.

Although core inflation indicators for the first half of the year were good, the bulk of their reduction and most of the decline in total inflation was due to supply factors with a possible temporary effect. This could have had a positive impact on two CPI sub-baskets: food and regulated goods/services.

Food inflation decreased to 4.7% (Graph 25) in June, compared to 6.5% in December, thanks to the slow adjustment in the price of perishables. The supply of perishables was boosted by an increase in the amount of area under cultivation and by favorable rains. Processed foods did not perform as well as perishables. Their prices tended to increase faster than during the previous year, due to rising international prices and depreciation in the exchange rate.

On the other hand, the increase in June for prices on regulated goods/utilities (fuel, transport and public utilities) was only equivalent to an annual rate of 3.7% (as opposed to 6.6% in December and 4.2% in March). This is the lowest rise since 1982 (Graph 26) for a sub-basket that has all but declined steadily since September 2003 (Graph 26).

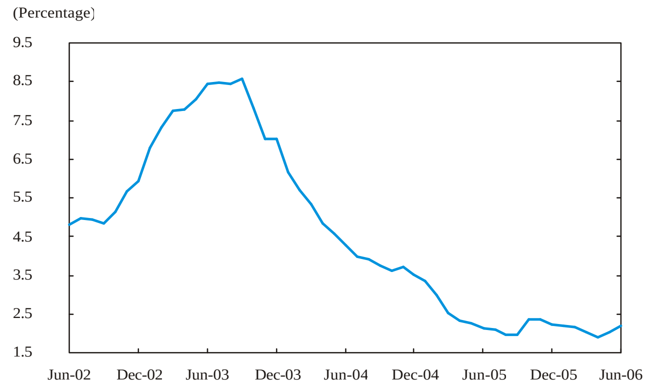
As part of regulated goods/utilities, the CPI for public transportation CPI (the most important one in the group) is the component that has done the most to lower inflation. By June, public transportation rates had increased at an annual rate of just 3.1%. In several urban areas, including Bogotá, these rate hikes have been postponed for up to 18 months, even though fuel prices soared during the same period. Public utilities were a contributing factor as well (2.9% at June). Their good performance was coupled with new regulations on water introduced at the start of the year and with an abundance of rainfall. This helped to lower the price of hydroelectric energy, which is the main source of energy in Colombia. The third component (fuel) has kept price increases relatively high. These, in turn, exerted an upward effect on inflation, particularly during the second quarter. Even so, the hikes in domestic gasoline prices have yet to reflect the entire rise in external prices and in the exchange rate.

The first half of the year saw no major changes in the pace of price increases with respect to the "rest" of the CPI components (tradables and non-tradables without food or regulated goods/utilities). As a result, tradable inflation without food or regulated goods/utilities was 2.2% at June, a figure similar to the one in December and only slightly above the figure at March (Graph 27). Inflation in this group does not appear to reflect the recent surge in the exchange rate, and the small increase witnessed in recent months may be due to the effect of higher prices for precious metals such as gold and silver and their impact on the CPI for merchandise such as jewelry.

Inflation in non-tradables (without food and regulated goods/utilities) fluctuated within a range of 4.4% to 4.6% during the last six months. This was similar to the pattern observed in the second half of 2005 (Graph 28). The behavior of the CPI for rentals, as part of this sub-basket, was an important factor, having grown more than expected at the start of the year, even though these hikes declined during the second quarter (Graph 29). This pattern may be associated with the reduction in interest rates on home loans, which has sparked increased competition among banks to extend mortgage loans. Lower interest rates make it less attractive to rent a home than to buy, thereby reducing the demand for services of this type. Added to this is the extensive supply of real estate originating with the recovery in construction during previous years.

GRAPH 27

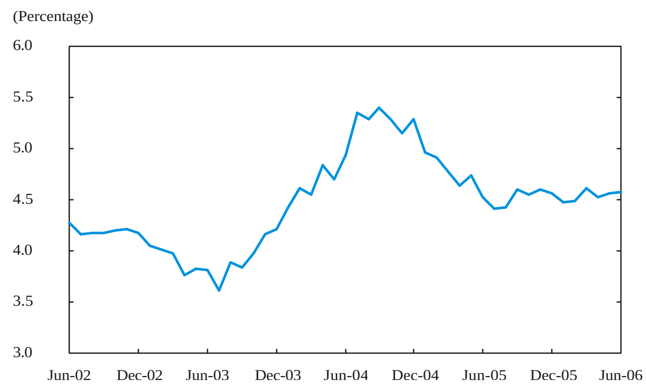
TRADABLE INFLATION
(ANNUAL VARIATION)



Source: DANE. Calculations by Banco de la República.

GRAPH 28

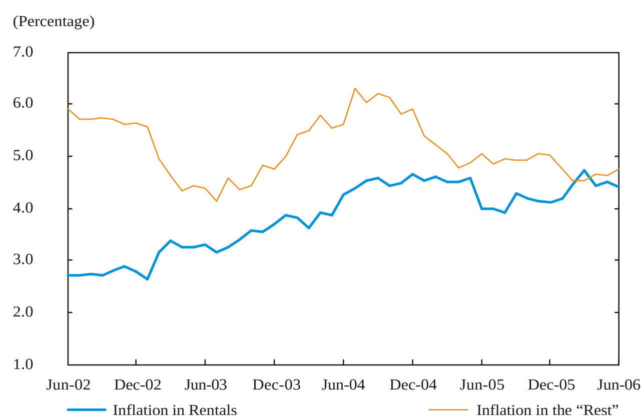
NON-TRADABLE INFLATION WITHOUT FOOD OR REGULATED GOODS/UTILITIES
(ANNUAL VARIATION)



Source: DANE. Calculations by Banco de la República.

GRAPH 29

INFLATION IN RENTALS AND THE "REST"
(ANNUAL VARIATION)



Source: DANE. Calculations by Banco de la República.

The Impact of the Exchange Rate on Prices

Edgar Caicedo G.*

Recent peso depreciation has sparked new concern about how it might affect consumer prices[1]. Therefore, this article is intended as a review of domestic and international literature on how and to what extent the exchange rate can affect price dynamics.

What does theory say about the impact of the exchange rate on prices?

In Anglo-Saxon economic literature, the response of domestic prices to changes in the exchange rate is referred to as the pass-through effect (hereinafter PT) or transmission of the exchange rate to prices. One of the principal approaches, known as the unitary price law, indicates the prices of an item - measured in the same currency - is the same in any country, regardless of where the item might be produced or sold[2]. Consequently, the PT in a small and open economy would be equal to 100%, which means exchange rate pass-through to prices would be complete. Other approaches consider the effects of depreciation on production costs and on demand.

How big is the PT in Colombia and how far does it lag?

There have been a number of studies in Colombia that quantify the PT calculation by estimating the direct association between the exchange rate and the CPI, or indirectly through the impact of import prices on the CPI (Table B1.1). In the mid-nineties, using a static approach with an input-product matrix, Leibovich and Caicedo (1996) concluded that an increase in the exchange rate equivalent to 10% was transformed into an acceleration of 1% in consumer inflation. Later studies, such as those by Rincón (2000) and Rowland (2003) with different econometric techniques, concluded that 80% to 84% of peso devaluation with respect to the dollar is transferred in the long run to producer prices on imported goods, 28% to 61% to producer prices as a whole, and between 8% and 15% to

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1 The peso lost 13.8% of its value with respect to the dollar between March 1 and July 18, 2006.

2 This law applies under the assumption of a perfect arbitrage and mobility of goods at domestic and international level, without measuring the differences in homogeneity and substitutability of products with the rest of the world.

Table R1,1
Comparison of Several Pass-Through Studies in Colombia

Authors	Long-term Pass-Through [a]			Period Analyzed
	Imported Prices	Total PPI	Total CPI	
Leibovich and Caicedo (1996)			10.0%	n.a.
Rincón (2000)	84.0%	61% [b]	11.0%	1980-1998
Rolawd (2003)	80.0%	28%	8%-15%	1983:01 - 2002:10
Banco de la República Economic Models Department (2003)			4.0% - 5.5% [c]	1984 - 2002
Rosas (2004)	50% - 100% [d]			1991:01 - 2002:09
Rincón, Caicedo and Rodríguez (2005)	10% - 80% [d]			1995:01 - 2002:11
Deutsche Bank (2006)			4.4%	

a/ The pass-through coefficients are the percentage of exchange rate devaluation transmitted to price inflation.
b/ On export prices.
c/ On core inflation.
d/ PT range for the different industrial sub-sectors analyzed.
n.a. Not applicable.

consumer prices. Other studies that directly calculated the total CPI response to an exchange rate shock (DMM-BR, 2003 and Deutche Bank, 2006) also found long-term effects between 4% and 6%[3].

According to the aforementioned literature, the effect of depreciation on consumer inflation in Colombia is limited and incomplete. The reasons are varied and include the existence of imperfect competition and substitutability among tradable goods, the heterogeneity of goods, the different ways agents perceive the transmission of depreciation and, above all, the relatively low participation of marketable or tradable sectors in the Colombian consumer basket (35%).

The speed with which pass-through occurs depends on the basket of goods in question. With the PPI, especially imported goods, PT is almost immediate. For the CPI, various studies coincide in that full pass-through can take up to a year, but important effects begin to be felt after a quarter, especially on the tradable CPI.

Has the pass-through effect declined in Colombia?

According to the BR-EMD study (2003), the two previous decades saw a decline in imported inflation PT on core inflation in Colombia from 8.6% in the mid-eighties to levels between 4% and 5% at the end of 2002. On the other hand,

[3] Sector estimates such as those by Rosas (2004) and Rincón et al. (203) found a broad range of PT coefficients that go from 0% to 100%.

the study by Rincón *et al.* (2005) found the PT for various industrial sectors can be less during periods when inflation is low and the exchange rate is flexible. These are precisely the conditions found during the last seven years.

How do we compare to the rest of the world?

The recent study by Deutsche Bank (2006) shows Colombia is the country with the least exchange rate pass-through to consumer prices (Table 1.2). It also found PT in the Latin American economies has declined to levels found in the developed countries (G7). Argentina is the exception, with a PT coefficient similar to those of the emerging economies in Europe, the Middle East and Africa. Except in Mexico and Argentina, where pass-through occurs after one year, in the other countries of the region it is complete within twelve months. Even so, consumer prices respond faster to an exchange-rate shock in Latin America than in other regions. According to the study by Edwards (2006), the drastic drop in PT in Latin America is due to decontrol of foreign exchange and the use of inflation targeting schemes.

Does the PT differ according to the type of exchange shock and the phase of the economic cycle?

There is little evidence of how the impact of sharp depreciation in the exchange rate varies compared to appreciation[4]. A recent study in the United States showed

Table B1.2
Pass-Through international comparison
(Percentage)

Country	1 month	3 months	12 months
Argentina	-	13.1	23.9
Brazil	1.1	6.3	9.7
Chile	-	5.5	5.3
Colombia	1.1	3.1	4.4
Mexico	3.5	7.5	13.6
Latin America average	1.0	7.1	11.4
Latin America average without Argentina	1.4	5.6	8.3
Latin America since 2000	10.0	20.0	69.0
Group of Seven (G7) without EE.UU.	n,a,	2.0	11.0
EMEA	10.0	17.0	25.0

Source: Deutsche Bank (2006).

4 There are no studies in Colombia on the possibility of asymmetries in exchange rate pass-through.

depreciation has more of an impact than appreciation on prices in the economy (Ye, Zyren, Shore and Burdette, 2005). In contrast, Mendoza (2004) concludes the PT in Venezuela is greater when the currency appreciates than when it does not. In the case of Peru, the PT of considerable depreciation is 8% to 10% greater than with limited depreciation (Winkelried, 2003).

Finally, the PT in Peru doubles when changes in the exchange rate occur in a context of economic growth, as opposed to a recession. A finding common to many economies is that the PT also tends to be greater when inflation is high, than when it is low (Mendoza, 2004).

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II. Macroeconomic Perspectives

The Colombian economy should continue to be propelled by a favorable external context during the remainder of the year and in 2007. Moderate cooling in the United States is expected and would be offset by increased momentum in other developed economies and Asia.

Projections on the balance of payments indicate stable oil production and revenue in the next few years. The current account deficit will be financed easily with foreign direct investment.

The base scenario in this report contemplates little pressure towards depreciation in the coming quarters. The exchange rate is unlikely to remain at the levels observed in May and June, but neither is it expected to return to the low levels seen at the start of the year.

No major changes in the pace of economic growth are anticipated for this year and the next. There might be a slight slowdown in the second quarter, due to temporary events. The credit channel is expected to play a more important role in the future.

The economic climate points to a slight acceleration in inflation, particularly during 2007. The inflation target for 2006 will likely be met. However, surplus capacity eventually will be depleted, heightening the risk of inflation. Fuel and transportation probably will generate pressures that could become permanent if they filter into expectations and wages.

A. External Context, Balance of Payments and Exchange Rate

1. General Aspects

The prospects for world economic growth during the second half of this year and the next remain favorable. Less of an increase in the US economy is not expected to seriously effect world growth, which will be boosted by further momentum in the Euro zone, Japan and China. On the other hand, the expectations of growth for Colombia¢s trading partners in the region are better than they were three months ago.

The slowdown in growth in the United States economy would be particularly evident in 2007 (2.8% as opposed to 3.0% anticipated three months ago). This would be due to the hikes in interest rate during the last two years. There will be less of an increase in household consumption, thanks to cooling of the housing market and higher interest rates. Growth will continue to be lead by investment (Table 4).

The growth predictions for the Euro zone and Japan in 2006 are 2.2% and 2.9%, respectively, with an equally favorable tendency for 2007. This is more than in the five previous years (Table 4). In both cases, the increase will be lead by investment and consumption, which is gaining force. Domestic demand would compensate for the reduction in external demand resulting from a cooler US economy.

As for the emerging economies, expectations of growth have increased substantially compared to what they were three months ago. The Chinese economy is expected to expand by 9.6% in 2006 and by 8.9% in 2007. Growth will continue to be spearheaded by investment, even though an increasing improvement in consumption is expected. Although the country's monetary authorities have taken steps to control investment in certain sectors

Table 4

Growth Forecasts for Colombia's Main Trading Partners
(Percentage)

	Actual 2005	Forecast fora			
		2006 at:		2007 at:	
		Apr-06	Jul-06	Apr-06	Jul-06
Principal Partners					
United States	3.6	3.3	3.4	3.0	2.8
Ecuador	3.9	3.2	3.2	3.0	3.1
Venezuela	9.4	6.8	7.9	4.6	5.3
Other Partners					
Euro zone	1.4	2.1	2.2	2.0	2.1
Japan	2.7	2.9	2.9	2.1	2.2
China	9.3	9.1	9.6	8.7	8.9
Peru	6.1	4.9	5.5	4.6	4.9
Mexico	3.1	3.6	4.1	3.4	3.4
Chile	5.9	5.6	5.4	5.2	5.3
Argentina	8.9	7.1	7.6	4.5	5.3
Brazil	2.5	3.4	3.6	3.7	3.6
Bolivia	3.7	3.1	3.1	3.1	3.1
Developed economies	3.1	3.1	3.2	2.8	2.7
Developing economies	6.3	5.2	5.8	4.1	4.5
Total Trading Partners	**4.8**	**3.9**	**4.0**	**3.2**	**3.1**

Source: Datastream - Consensus. Calculations by Banco de la República.

and high real estate prices, the anticipated impact on growth will still be quite limited.

In the case of Venezuela, our main trading partner in the region, the expectations are better than they were three months ago, thanks to higher oil prices. This report lists a substantial increase in the growth forecast for 2006 and 2007, which is up from 6.8% and 4.6%, respectively, to 7.9% and 5.3%. However, growth in Ecuador's economy will remain at around 3% because of less investment, which has been affected by political instability. Given the foregoing, in our basic scenario, the amount of growth anticipated for our trading partners, according to the estimated balance of payments, is 4.0% in 2006 and 3.1% in 2007 (Table 4).

The current situation with respect to inflation in the United States is one of the most complex in recent years. On the one hand, inflationary pressure originating with high prices for raw materials remains a factor and is even increasing at a time when the economy is growing at relative high rates, despite some signs of a slowdown, and when indications of higher inflationary expectations are beginning to emerge. On the other, the indicators show productivity appears to have continued to expand a good pace, suggesting that potential non-inflationary growth is still significant.

The tendency among analysts has been to increase their inflation forecasts for the United States, given the recent upswing in prices, the new hikes in prices for raw materials and the inertia that comes with economic growth. Accordingly, the analysts' consensus forecasts[9], which are part of our basic scenario, rose from 2.9% to 3.5% for 2006 in the case of total inflation, and from 2.4% to 2.7% for core inflation. For 2007, the forecast increased from 2.3% to 2.7% for total inflation and from 2.4% to 2.6% for core inflation.

This outlook is associated with an increase of 25 to 50 bp in interest rates, which places them somewhere between 5.5% and 5.75% by the end of 2006. This is more than anticipated three months ago (5.25%). However, we still believe the Fed's response will depend on new information with respect to both inflation and growth.

In the case of the Euro zone and Japan, the forecasts for interest rates are up as well, although marginally so, and are expected to end the year at 3.25% at 0.5%, respectively.

The forecasts for commodity prices have increased as a result of strong growth worldwide and low surplus production capacity for certain primary goods. *The Economist Intelligence Unit* estimates oil will be US$71.62

[9] JP Morgan, Deutsche Bank, Goldman Sachs, Credit Suisse and Dresdener Kleinwort W., among others.

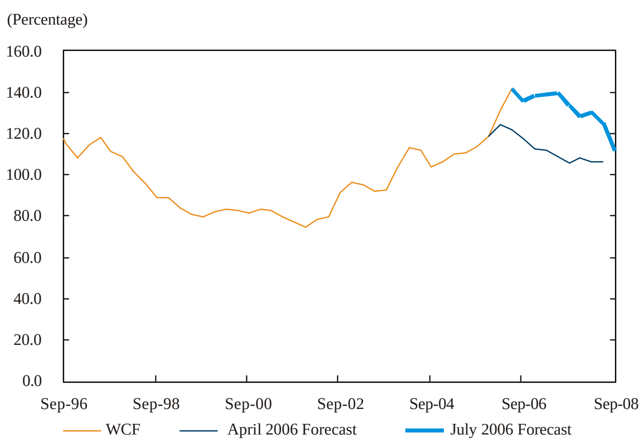
a barrel in 2006 and US$67.56 in 2007, which is US$10 more than the forecasts three months ago. In the short term, continuous geopolitical problems continue to exert pressure on prices. The current war in the Middle East is a case in point.

The prices forecast for commodities (without energy) are much higher as well, particularly in the case of metals. According to the World Commodity Forecast (WCF), prices will be up by 21.1% in 2006; the step up forecast three months ago was 5.0%, with a drop (1.2% in 2007; 9.4% previously). This should be an incentive to production in the years ahead; however, whether or not this is the case will be clear only as of 2008 (Graph 30). For the long term, strong growth in several Asian countries, such as China and India, might keep up prices for oil and other commodities in high nucleuses. On this basis, the prices for Colombia's major exports have increased for the base scenario of this report, compared to what they were three months ago (Table 5).

Although the base scenario for the external context remains favorable, the financial markets could become highly volatile in the months ahead, given reining uncertainty and less liquidity worldwide. The crucial part of the external context for the countries in the region, including Colombia, will be strong world growth, which makes prices for our products less vulnerable. Better terms of trade will continue to boost foreign direct investment, especially investment to tap natural resources.

GRAPH 30

TOTAL COMMODITY PRICE INDEX, WITHOUT OIL (WCF)



Source: The Economist Intelligence Unit.

TABLE 5

INTERNATIONAL PRICES

	Average			Projection for 2006		Projection for 2007	
	2003	2004	2005	Current a/	Previous b/	Current a/	Previous b/
Coffee (ex-dock) (dollars/pound)	0.7	0.8	1.1	1.2	1.1	1.0	1.0
Oil (dollars/barrel)	29.0	37.3	49.8	59.0	53.5	61.8	52.9
Coal (dollars/ton)	28.2	36.1	47.9	47.9	47.5	50.2	48.8
Ferronickel (dollars/pound)	1.4	2.3	2.4	2.4	2.4	2.2	2.2
Gold (dollars/troy ounce)	362.5	409.3	445.0	560.2	560.2	590.2	590.2

a/ Balance of payments estimated in July 2006.
b/ Balance of payments estimated in April 2006.
Source: Banco de la República.

Therefore, even with the persistence of high volatility on financial markets, the exchange rate is not expected to remain at the levels observed in May and June. The adjustment since July verifies this tendency. On the other hand, it also is unlikely the exchange rate will return to the levels witnessed at the beginning of the year. In all, it is important to emphasize that any exchange-rate forecast is surrounded by a great deal of uncertainty, even the short-term forecasts.

2. Balance of Payments Prospects for 2006 and the Medium Term

The current account deficit estimated for 2006 is US$1,589 million (1.2% of GDP as opposed to 1.6% in 2005), basically due to less of a deficit in factor income (down from 4.5% to 4.% of GDP) and in non-factor services (from 1.7% to 1.4%). This would more than compensate for a smaller merchandise trade surplus, which is expected to drop from US$1,595 m in 2005 (1.3% of GDP) to US$1,050 m (0.8% of GDP) (Table 6). The improvement in factor income is due to less interest paid by the government, because of the way it has managed its liabilities.

The deficit in the current account is expected to be financed with resources from net foreign direct investment[10], which should remain dynamic in the oil,

[10] This takes into account US$1,162 million (m) in resources scheduled to originate with the privatization of Telecom, ISA, Granbanco, Ecogas, Propal, and Monómeros Colombo Venezolanos, among other companies.

TABLE 6

BALANCE OF PAYMENTS FORECAST FOR COLOMBIA

	Millions of Dollars			Percentage 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. Goods and non-factor 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. Non-factor 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 a/	3,046	(319)	(2,799)	3.1	(0.3)	(2.2)

(proj) Projected.
(pr) Preliminary.
a/ Includes operations in the public and private sectors, errors and omissions, plus the variation in gross international reserves.

coal and manufactured goods sectors. The flow of direct foreign investment would partially offset outflows of private capital. The forecasts in this report assume there will be no additional capital outflows during the second half of the year.

Finally, the Bank´s mid-term projections show the current account deficit in the balance of payments will continue to average around 2.5% of GDP during the next five years, given the gradual reduction in terms of trade, growing world demand (2.8% per year) and approximately 4% economic growth in Colombia. This forecast also takes into account the possible change in sources of external financing.

In this scenario, revenue from exports of oil, its by-products and coal should remain relatively stable at around 4.5% and 2.2% of GDP, respectively. This projection is based on no decline in crude oil production during the period and on international prices that should remain relatively high.

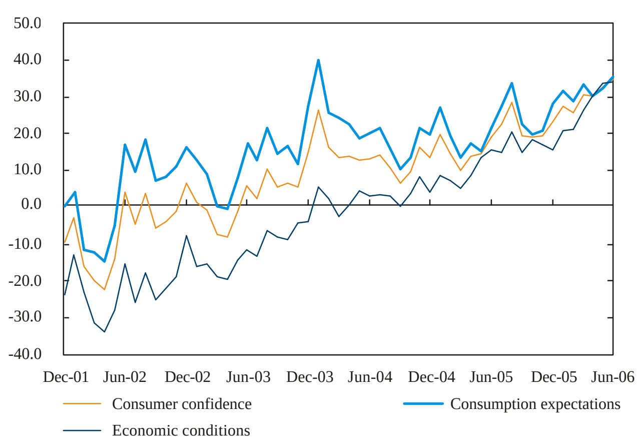
B. The Domestic Context

1. The GDP Short-term Forecast

Available figures for domestic demand show the momentum in earlier quarters has continued during the year to date. In June 2006, indicators of consumer confidence, consumption expectations and economic conditions were still on the rise and reflected levels above those registered during the same period the year before (Graph 31).

Graph 31

Fedesarrollo Consumer Survey Indexes



Source: Fedesarrollo.

In addition to the confidence indicators for household consumption, there also are signs that private investment should continue to grow at a good pace. The figures announced by DANE in May and those provided in June (preliminary) by the National Department of Customs and Revenue (DIAN) show a solid situation with respect to imports, most of which were comprised of intermediate and capital goods. Coupled with the portfolio data, investor confidence, the continued improvement in employment conditions and the favorable external context, this suggests growth in domestic demand will remain the driving force of GDP growth.

Despite the continuance of good domestic and external conditions for growth, the central scenario in this report forecasts an increase of 3.7% in GDP during the second quarter of 2006 due to several supply shocks (Table 7). The poor coffee harvest, in particular, is expected to have somewhat of negative impact on growth. The same can be said of the strike against the coal company Drummond, the heavy rains that jeopardized harvests for some perishables, and the fewer number of working days in the second quarter of the year (three), together with the effect of the Electoral Assurances Act on some government services and the possible impact of financial volatility on brokerage services in the financial system.

The same central scenario also indicates the pace of growth will recover during the third quarter of 2006, with an increase of 5.2% compared to the same quarter in 2005. The prediction is that coal exports will be reinstated entirely during that period and there will be a moderate drop in coffee production, although output for the 2005/2006 coffee year is expected to be down by nearly 6.0%, on average.

Public spending is likely to increase sharply during the third quarter and generally throughout the second half of the year, the reason being that this demand was curbed during the first six months of the year by the Electoral

TABLE 7

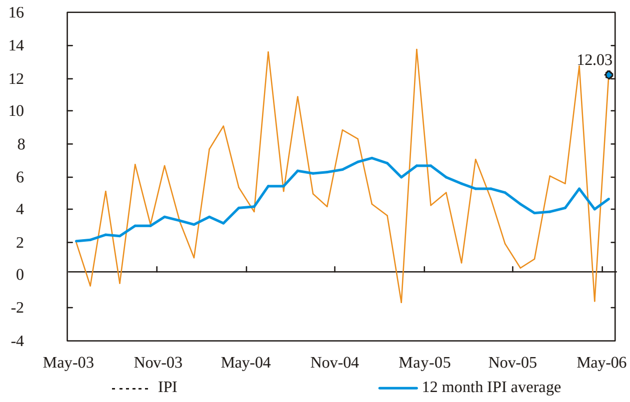
REAL ANNUAL GDP GROWTH BY SECTORS
(PERCENTAGE)

	2005	2006		
		I Qtr.	II Qtr. a/	III Qtr. a/
Agriculture and livestock, forestry, hunting and fishing	2.9	0.8	1.2	2.5
Mining and quarries	3.0	1.7	(4.6)	6.7
Electricity, gas and water	3.2	3.2	1.2	3.1
Industrial manufacturing	3.9	7.3	2.8	3.6
Construction	11.9	5.7	11.2	3.9
Buildings	4.3	(1.1)	2.4	2.2
Civil works	28.1	17.8	30.0	6.8
Commerce, repairs, restaurants and hotels	9.4	8.4	6.4	6.3
Transportation, storage and communication	5.1	9.7	5.8	5.1
Financial establishments, insurance companies, real estate agencies and business services	3.5	6.5	(2.9)	(0.4)
Social, community and personal services	4.0	2.9	1.9	9.1
Financial brokerage measured indirectly	8.5	13.6	(17.6)	(7.1)
Subtotal: aggregate value	4.6	4.8	3.1	5.0
GDP	**5.2**	**5.2**	**3.7**	**5.2**
Taxes, minus subsidies	13.3	10.3	11.6	8.3
Net financial services -FBMI b/	1.9	4.2	2.3	2.0
Tradables c/	4.0	4.4	2.9	4.4
Non-tradables	6.0	5.7	4.1	5.7

a/ Projection.
b/ FBMI: financial brokerage services measured indirectly.
c/ Agriculture and livestock, mining, manufacturing, air and water transport services, including those of a complementary and auxiliary nature, and certain private services for businesses are regarded as tradable sectors.

GRAPH 32

ANNUAL GROWTH IN THE INDUSTRIAL PRODUCTION INDEX (IPI) OF THE DANE MONTHLY MANUFACTURING SAMPLE



Source: DANE-MMM. Calculations by Banco de la República.

Assurances Act. Consequently, the third and fourth quarters would have to witness an increase of almost 10.0% in public spending to comply with the budget for 2006.

In view of the foregoing, the non-tradable sectors should expand by 4.9%, on average, between the second and third quarters, while growth in the tradable sectors would be only 3.7%. However, when these projections were made, there was no information available on industrial growth in May (12% according to the DANE monthly manufacturing sample), which turned out to be more than predicted. According to Banco de la República's calculations, with a revision for working days and seasonality, growth in the tendential component of industrial manufacturing might exceed 4.0% (Graph 32), which would surpass the forecasts contemplated in the central scenario of this report.

2. GDP Forecast for 2006 and 2007

The external context and the various elements in the domestic context that support the short-term central forecast for GDP guarantee good growth during 2006, which is already expected to be 4.8% for the year as a whole. Household consumption should climb to 5.3%, accelerating compared to 2005 and making an important contribution to growth (Table 8). Total investment will continue to boost growth, even though the annual variations anticipated for the second half of 2006 are expected to be less dynamic than in the first half of the year. The growth forecast for gross fixed capital formation (GFCF), without civil works, is 12.7%, according to what has been budgeted by the government. This being the case, the end of the year should see a level of investment near 24% of GDP, which is well above the historic average (17.4%).

In 2007, the economy is expected to continue to grow at a good pace, with no major shocks. The primary external fundamentals, particularly high terms of trade and solid external demand, should allow for 4.3% to 5.2% GDP growth.

C. INFLATION FORECASTS

1. Forecasts

The inflation forecasts based on the Bank's central model (TMM) are shown in Table 9. They were developed according to the assumptions outlined in the two preceding sections. As usual, the results of the model contemplate an interest rate that adjusts itself endogenously to ensure the long-term inflation targets are met. Therefore, when interpreting a rate of this type, it is important to bear in mind that changes in the stance of monetary policy have a significant impact on inflation only after a time horizon of more than three quarters.

According to the TMM central path, no major changes in inflation are expected during the second half of 2006, with respect to the levels registered at June.

TABLE 8

REAL ANNUAL GDP GROWTH BY TYPE OF EXPENDITURE
(PERCENTAGE)

	2004	2005	2006 a/
End 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 without 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**
GDP	**4.8**	**5.2**	**4.8**

a/ Projection by Banco de la República.
Source: DANE. Calculations by Banco de la República.

TABLE 9

CENTRAL MODEL FORECASTS

	Total inflation	Food inflation	Non-food inflation				Output Gap
			Total	Non-tradables	Tradables	Regulated	
Jun-06	3.9	4.7	3.6	4.6	2.2	3.8	0.3
Sep-06	3.9	4.2	3.8	4.6	2.5	4.2	0.6
Dec-06	3.9	3.9	4.0	4.7	2.6	5.1	0.9
Mar-07	4.6	4.3	4.7	4.8	3.5	6.0	1.0
Jun-07	4.5	4.0	4.7	4.9	3.3	6.2	0.8
Sep-07	4.1	3.7	4.3	4.8	2.9	5.8	0.6
Dec-07	4.0	4.0	4.0	4.7	2.5	5.6	0.4
Mar-08	4.1	4.1	4.1	4.7	2.3	6.4	0.1
Jun-08	4.1	4.1	4.1	4.6	2.6	6.3	(0.1)

Source: Banco de la República.

Major reductions in inflation during the second half of the year are ruled out.

Total inflation should stay near the bottom of the target range as a result of a decline in food inflation, which would offset a slight rise in non-food inflation. Thus, these forecasts rule out major reductions in inflation during the second half of the year, contrary to what occurred during the first six months. They also signal a break in the downward trend in non-food inflation, which would have hit bottom at mid-year.

For a longer time horizon, the model again envisages an upward tendency for total and non-food inflation, at least while the changes in monetary policy endogenous to the forecast begin to take effect. Even when compared to the results published for the March report, the new forecasts suggest slightly higher inflationary pressures within a mid-term horizon (from three to six quarters). One example would be the rise in the non-food inflation forecast at March 2007, which is up from 4.3% in the last report to 4.7% herein.

The increase in mid-term forecasts is explaines by the exchange-rate depreciation during the second quarter, which was underestimated in the March report. When included in the model, that episode added nearly 100 bp to the annual rate of tradable inflation anticipated for the first half of 2007 (excluding non-regulated foods). As usual, this outcome obeys to the direct impact of the increase in the exchange rate and its indirect effect through the impact on inflationary expectations and inertia.

However, the anticipated increase in inflation is moderate compared to the situation during other episodes of depreciation: no more than 40 bp on non-food inflation and even less on total inflation, even after considering the likely increases in prices for imported foods. This is possible because the recent weakening in the peso would be largely temporary. Hence, pressure towards depreciation would be much less in the second half of this year and in 2007, as was explained earlier in this chapter.

Nevertheless, with the model, tradable inflation is determined not only by the exchange rate, but also by the course of expectations, by past inflation and by growth in demand with respect to available productive capacity. In the long run, these factors cause it to converge towards the targets, even if the exchange rate remains stable. In view of this fact, the current forecasts also reflect an underlying upward trend for tradable inflation associated with its currently low level compared to the Bank's long-term targets and with the continued force of domestic demand anticipated for the coming quarters.

The new forecasts suggest slightly more inflationary pressure at mid-term.

Together with the revised forecasts for tradable inflation, this report also envisions a slight increase for inflation in regulated goods/utilities during 2007. The TMM still expects an upward tendency in this indicator during the next four quarters, for several reasons. The most important one concerns high fuel prices on today's world market and the extreme likelihood that they will remain at the current levels for quite some time. This would necessitate an increase in domestic prices during the remainder of 2006 and in 2007, above and beyond the inflation targets, to close the gap that now exists with respect to international prices. The recent increases in external prices and depreciation during the second quarter make this scenario even more feasible.

Inflation in regulated goods/utilities is expected to increase…

By the same token, fuel-price hikes that exceed the targets are likely to have an effect on the price of public transportation in Colombia, particularly because transportation rates do not seem to reflect the major increases accumulated in recent years. Within the sub-basket of regulated goods/utilities, fuel and public transportation account respectively for 11% and 50% of the total CPI, which means their tendency largely determines the behavior of prices in this group.

Another reason to expect more of an increase in prices for regulated goods/utilities is the currently low annual rate of inflation for this sub-basket. So far this year, there has been very little change in public utility rates (the annual increase at June was 2.9%). These minimal adjustments were possible thanks to special circumstances, such as abundant rainfall, which lowered the prices of energy on the exchange. This situation is not likely to repeat itself in 2007. Consequently, for the next 18 months, it is prudent to anticipate increases that are closer to the goals than is now the case.

As to the three components of the non-food CPI, only non-tradables –with the closest link to demand– have a slightly lower forecast in this report, compared to the forecast in March. This is because the results in the first half of the year tended to be less than anticipated. Even so, with the assumptions for growth (4.8% in 2006 and around 4.7% in 2007) and the actual size of the gap (0.5% on average for 2006) non-tradable inflation is expected to increase during 2007, as indicated in earlier reports. Convergence towards the long-term targets for inflation would begin only as of the third quarter in 2007, once the changes in monetary policy begin to have an impact.

Although the change in non-tradable inflation depends primarily on the anticipated growth in demand compared to the increase in potential or non-inflationary output, there are other factors that affect these forecasts. The course of expectations and past inflation are the most important ones, considering the inertia still shown by inflation in Colombia. Thus, temporary price hikes due to supply shocks (in foods or in regulated goods/utilities), or to short increases in the exchange rate have a permanent effect on inflation through these channels. In the current situation, this implies that actual depreciation during the second quarter, plus actual and anticipated increases in fuel and transportation prices, also affect the upward tendency in the forecast for non-tradables. The exchange rate can have a direct

… tradable inflation is expected to move higher in 2007.

The forecasts point to less food inflation during the second half of this year.

influence on non-tradables as well (via costs or prices of tradable substitutes).

The food CPI forecasts show less inflation during the second half of 2006. This tendency takes into account two factors that exert upward pressure on food prices; namely, depreciation in the exchange rate and higher international prices (for sugar, cereals and edible oils) during the year to date and those anticipated for the next two quarters. Although it is difficult to determine the individual importance of these two factors, the assumption in this report is that more lasting pressure would originate with high external prices and the possibility of new increases, as explained at the beginning of this chapter. Depreciation during the second quarter also would exert an upward effect during the second half of the year; however, it would be moderate if the peso again recovers part of its value, as is expected.

The reduction in food inflation during the second half of 2006 would originate primarily with prices for unprocessed or staple foods. Although this tendency is contradictory, given the pressures mentioned earlier, its explanation lies with the currently high relative prices for staple foods, due to the constant increases observed since early 2004. In the past, a quick drop in food prices has been preceded by periods when prices were relatively high and provided a strong incentive to supply. This is the sequence of events being detected by the models, with the added ingredient that ample rainfall during the second quarter would further increase the productivity of crops and, hence, the supply in the coming months.

The impact of recent depreciation on inflation would be limited.

In summary, the forecasts in this report indicate the possibility of some inflationary pressure at mid-term, if domestic credit and demand continue to grow as expected, and particularly if the increase begins to exceed growth in the economy's productive capacity and in productivity. According to the model, this situation would begin to be evident at some point between the remainder of 2006 and the start of 2007. Although actual depreciation of the exchange rate would have a certain upward impact on prices, it would be limited, since the remainder of this year and 2007 are expected to see a return to stability in the exchange rate, with less of a tendency towards depreciation compared to the situation in May and June. The high forecast for external prices would have a more permanent effect on future inflation. This is particularly true of fuel prices, given their effect on transportation and the impact they can have on expectations and wage bargaining. Finally, staple food prices are expected to be influenced by short-term downward pressure attributed to reasons associated with their production cycle.

The increases in fuel and transportation rates could have a permanent impact via expectations and wages.

2. Risks

The fan chart (Graph 33) shows the central path of the total inflation forecast and the probability of its distribution, which illustrates the uncertainty surrounding this projection. The primary risk factors that can steer inflation away from its central or most probable forecast are considered when calculating this distribution.

The following are the main factors that could result in an inflation forecast superior to the central scenario.

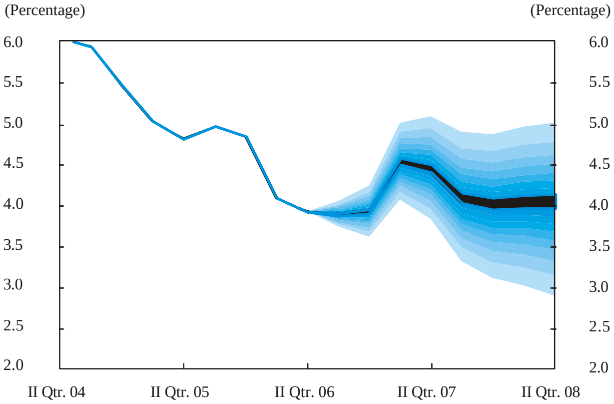
- More growth during the second quarter than contemplated in the base scenario[11]: this risk is supported by the positive trend in industrial production for May, which was not fully included in the forecasts. Also, the effect of the supply shocks anticipated during the second quarter might be less than envisioned in the base scenario, given the latest indicators for several sectors. On the demand side, consumer confidence at June remained on the rise and, by May, imports of capital goods had climbed more than expected. Finally, the anecdotal evidence collected at the consultative committee meetings held by the Board of Directors with members of the business community indicates their perception of current economic conditions is more favorable than it was last year.

- More depreciation transmitted to consumer inflation than contemplated in the forecast, inasmuch as the economy is in a growth stage. The

[11] In addition, the possibility of an upward revision of first-quarter growth figures by DANE is not ruled out.

GRAPH 33

PROBABILITY DISTRIBUTION OF THE INFLATION FORECAST (FAN CHART)



ACCUMULATED PROBABILITY OF ACTUAL CONSUMER INFLATION WITHIN THE INDICATED RANGE

Inflation ranges (%)	Probability (%)							
	2006		2007				2008	
	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Above 5.5	0.0	0.0	0.2	0.8	0.5	0.5	0.8	1.2
Below 5.5	100.0	100.0	99.8	99.2	99.5	99.5	99.2	98.8
Below 5.0	100.0	100.0	91.5	88.6	94.9	95.6	94.2	93.2
Below 4.5	100.0	99.5	40.2	49.9	75.4	79.2	76.9	76.3
Below 4.0	77.7	57.6	2.4	10.0	38.4	46.7	46.5	48.2
Below 3.5	0.0	0.9	0.0	0.5	9.2	16.1	18.4	21.8
Below 3.0	0.0	0.0	0.0	0.0	0.9	2.8	4.4	6.6

Source: Calculations by Banco de la República.

Certain risks to inflation originate with higher costs, particularly because of their impact on food prices

extent of this transmission can vary with the economic cycle, which is not detected by the central model.

- Higher oil prices in the future, given the geopolitical risks weighing on this market. The result would be increased pressure on domestic fuel costs, on transportation fares and on inflation in general.

- Higher frequency of wage hikes that exceed the targets for inflation due to a tighter labor market. The recent, more-than-expected rise in employment, the increased rate of work factor utilization, and good prospects for growth would raise the demand for labor faster than in past years. In contrast to this risk, the labor supply might not expand as quickly in the mid-term, especially among workers who are not household heads. This would be the result of more family income and job stability.

- Higher prices for processed and staple foods, due to pressure from costs that were not fully contemplated in the base scenario. These increases would be the result of higher prices for imported raw materials or tradables (cereals, edible oils, sugar, and fertilizers) associated with higher fuel prices and with a higher exchange rage.

- The possible first and second round effects of an extension in the value-added tax (VAT) to include a number of family market-basket items that have been exempt up to now, plus the impact of an increase in existing rates. None of these events have been included in the central path of the forecast. Moreover, experience shows that changes in VAT are quick to affect the CPI and considerably so, and can influence the creation of expectations, thereby having a more lasting impact on inflation.

- The last factor underscores a risk common to a number of transitory supply shocks (such as increases in the price of staple foods and regulated goods/utilities). It is the possibility of transmission to inflation through an increase in inflationary expectations. In this case, its transitional nature becomes less important in terms of inflationary processes and monetary-policy implications.

The following are the more important factors that would explain less inflation than in the base scenario.

The effects of a possible extension in VAT also pose risks.

- The beneficial impact compliance with the inflation target has on expectations and on the price-formation process for 2007.

- More gains in productivity than contemplated in the calculation for potential GDP and the gap: the growth in investment and the sharp rise in imports of capital goods can encourage technical change and favor growth in productivity. By the same token, increased competition from imports of consumer goods can spark gains in productivity by acting as a "disciplinary mechanism" for the market.

The gains in productivity could be greater than those envisioned in this report.

- The negative impact on exports and growth that would result from failure to extend the tariff advantages provided under the Andean Trade Promotion and Drug Eradication Act (ATPDEA) and Venezuela's departure from the Andean Community of Nations (CAN). Although these events could also speed the pace of depreciation, with an upward impact on prices, the downward effects due to less demand should prevail.

- The effect recent financial volatility could have on real activity, and specifically on domestic demand. The drop in stock and TES prices could lower the collateral value (wealth) households and businesses use to leverage loans for spending[12]. As to companies, the financial volatility also could imply fewer financing and investment possibilities, by discouraging stock and bond issues.

Finally, developments in the external context and especially the situation in the United States pose a major risk with an uncertain effect on inflation, because of their various implications. Controlling inflation in the United States might require more changes in interest rates than those anticipated in this report and/or a more abrupt landing for that economy. If so, world demand could be hurt if other major economies fail to offset the slowdown. Our terms of trade would be affected, as would the economic growth of various trading partners.

In view of the foregoing, the risk analysis indicates that, with an active monetary policy, inflation is likely to end the current year below the ceiling of the target range announced by the BDBR. The fan chart shows 42.4% probability that inflation will be between 4.0% and 5.0% at the end of 2006. There is even a high probability (57.6%) that it will be less than 4%.

It is highly probable that inflation will end 2006 below the ceiling of the target range.

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[12] If this is to be important, the assets in question must account for a relevant share of wealth, which does not appear to be the case with Colombian households. According to several estimates developed by Banco de la República, stocks account for only 1% of household assets. The amount of TES (including pension and severance funds) in the hands of private individuals is low (no more than 17%). These estimates show the bulk of the wealth would be in housing

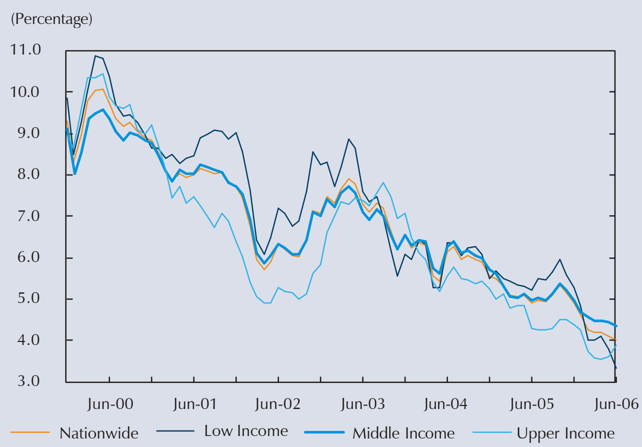
Much of the distribution in 2007 will be concentrated in the 4.0%-to-5.0% range (48.9%). Also, the likelihood that inflation will be within the announced range (3% to 4.5%) is high (76.4%) and is more than it was three months ago (62.4%). These results assume an active monetary policy that tends to be less accommodating than the current one.

Inflation and Buying Power Among the Low-Income Population in Colombia

Alejandro Reyes[4]

Consumer inflation was 3.9% at June. However, this rate differs according to the income bracket of the population. At June, inflation in the low-income bracket was 3.3%, as opposed to 4.5% in the middle-income bracket and 4.3% in the upper income bracket (Graph B2.1).

Graph B2.1
Consumer Inflation by Income Bracket
(Annual variation)



Source: DANE. Calculations by Banco de la República.

What explains these differences and how have they changed?

The differences are due to the fact that the items in the basket are of different importance to each income group. For example, food represents 41% for those in the low-income bracket, as opposed to 15% for the high-income bracket (Table B2.1). This makes changes in the price index for the entire basket different for each group. If food inflation accelerates, that increase will be reflected more in inflation for the low-income brackets than in inflation for the high-income brackets.

These differences are not always the same. Sometimes one bracket experiences higher inflation than another, and vice versa. During the year to date, inflation for the middle-income bracket has been higher than the rest, because this group has been affected the most by rising fuel prices and because inflation in rentals has been

[4] An expert with the Inflation Section of the Programming and Inflation Department in the Economic Studies Unit. The opinions expressed in this article are solely the responsibility of the author and do not necessarily reflect those of Banco de la República or its Board of Directors.

Table B2.1
Consumer Spending Basket [a/]

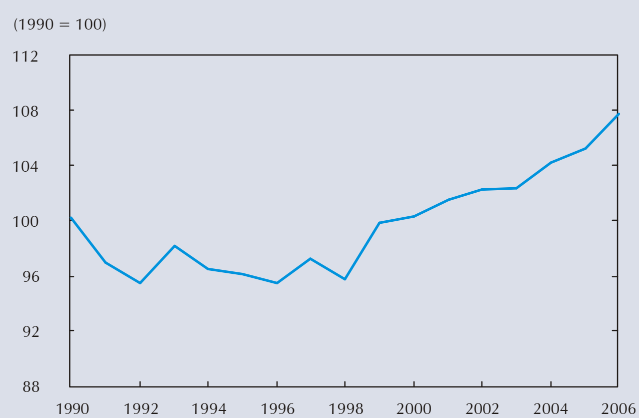
	Income		
	Low	Medium	High
Food	41.42	30.18	14.70
Housing	28.31	29.12	31.37
Clothing	7.29	7.92	5.78
Health	4.26	4.06	3.39
Education	3.57	5.30	4.95
Entertainment, culture and recreation	2.25	3.77	4.69
Transport and telecommunications	7.29	12.17	23.67
Other expenses	5.60	7.48	11.46

a/ Percentage of spending with respect to total expenditure.
Source: DANE. Calculations by Banco de la República.

higher than in the upper and lower brackets. On the other hand, inflation for the low-income bracket has declined during 2006, thanks to the drop in food inflation and the slight increases in public transportation fares, which are more important to consumers in this group than to those in the middle and upper income brackets.

Past years have seen more of an increase in inflation in the low-income brackets. This is mainly because of the tendency in prices for regulated goods/utilities and particularly the elimination of subsidies that were more important to the spending basket for this group. However, although inflation in regulated goods/utilities might have increased, this segment of the population has benefited considerably from the decline in total inflation. As illustrated in Graph B2.2, the real minimum wage provided for by law in the nineties – deflated with the consumer price index at the low-income level – lost buying power. However, since the year 2000, it has recovered considerably as a result of major hikes in the nominal minimum wage, accompanied by declining inflation rates.

Graph B2.2
Real Minimum Wage [a/]



a/ The wage was deflated by the average annual CPI for the low-income bracket.
Source: DANE and Banco de la República. Calculations by Banco de la República.

Macroeconomic Projections by Domestic and Foreign Analysts

The following are the latest projections by domestic and foreign analysts concerning the main variables of the Colombian economy in 2006 and 2007. They were developed with information available at June 2006.

I. Projections for 2006

Table A1 shows the predictions for 2006. On average, the domestic analysts expect 4.8% economic growth, which is 34 bp more than the forecast during the previous quarter. The foreign analysts anticipate 4.7% (4 bp more). Apparently, expectations continue to improve. This would be consistent with the good performance displayed by industry, the acceleration in credit and the fact that Fedesarrollo's consumer confidence index in June reached a new historic high. This indicates growth could continue at a good pace, backed by private consumption.

Table A1
Projections for 2006

	Real GDP Growth (Percentage)	CPI inflation (Percentage)	Nominal exchange rate (end of)	Nominal TDR (Percentage)	Fiscal deficit (GDP percentage)	Unemployment rate (13 cities) (Percentage)
Domestic Analysts						
Revista *Dinero*	4.5	4.4	2,600	6.8	1.3	11.5
Corredores Asociados	4.8	4.2	2,450	6.5	1.6	9.5
BBVA Ganadero	4.8	4.2	2,400	6.8	1.5	n.a.
Bancolombia and Suvalor	4.8	4.2	2,660	6.8	1.0	11.5
Corficolombiana-Corfivalle	5.0	4.5	2,647	7.4	1.2	12.0
Fedesarrollo	4.7	4.5	2,450	7.0	1.8	10.7
Average	**4.8**	**4.3**	**2,535**	**6.9**	**1.4**	**11.0**
Foreign Analysts						
C. S. First Boston	5.3	4.5	2,550	6.7	1.0	11.4
Bear Stearns	5.2	4.2	2,250	6.8	(0.1)	10.0
Merrill Lynch	4.2	4.6	2,350	7.7	1.5	n.a.
JP Morgan Chase	4.5	4.3	2,400	6.8	1.0	n.a.
Economist Intelligence Unit	4.8	4.2	2,551	6.5	1.3	11.1
Deutsche Bank	4.2	4.1	2,440	7.3	1.0	11.6
Average	**4.7**	**4.3**	**2,424**	**7.0**	**1.0**	**11.0**

n.a. Not available.
Source: *Dinero.*

The domestic analysts reduced their 2006 inflation forecast by 2 bp; the foreign analysts lowered theirs by 4 bp. Both placed inflation at 4.3%. As has been the case for the past seven quarters, all the analysts are confident the inflation target will be met (between 4% and 5% for 2006), and eleven of the twelve predict it will be slightly below the middle of the range.

With respect to the exchange rate, the domestic analysts raised their forecasts by Col$200 (to Col$2,535); the foreign analysis increased theirs by Col$91 (to Col$2,424). . In other words, the former expect 10% appreciation in foreign exchange and the latter, 6%, on average, compared to the price at the end of 2005. Therefore, the maximum appreciation anticipated by these analysts is 14% and the minimum, -1.5%. This is the first time in 18 months the forecasts have been revised upward, probably influenced by the volatility of the markets in the second quarter. In contrast, downward revisions can be expected hereinafter, following the sizeable reduction in aversion to risk on international markets, as mirrored by a build-up in the Latin American currencies

The analysts expect interest on term deposits (DTF in Spanish) to be 7% by the end of 2006. This might denote expectations of additional rate hikes by the BDBR during the remainder of the year. Also, the consolidated deficit is expected to be around 1.2%, which is 20 bp below what it was last quarter (70 bp less than two quarters ago) and slightly less than the CONFIS projection (2% for the consolidated public sector). Finally, the forecast for unemployment in 13 cities was adjusted downward to 11%. This amounts to an average reduction of 20 bp.

II. Projections for 2007

The domestic analysts expect 4.4% growth in 2007; the foreign analysts anticipate 4.3% (Table A2). The domestic analysts predict inflation will be 4.1% and the foreign analysts, 4.3%, which is near the ceiling of the target range set by the Board of Directors for that year (3% to 4.5%). As to the exchange rate, 2.3% average annual devaluation is anticipated; this is compared to the forecasts for the end of 2006. Therefore, by the end of 2007, the representative market rate (TRM in Spanish) would be Col$2,535, which is similar to what it was in July 2002.

When compared to the end of 2005, these forecasts imply 11% accrued nominal peso devaluation between 2006 and 2007. On average, 76% of this devaluation is expected to occur in 2006 and the other 24% in 2007 (although two analysts expect the exchange rate to appreciate next year, while another anticipates some appreciation in 2006).

Table A2
Projections for 2007

	Real GDP Growth (Percentage)	CPI Inflation (Percentage)	Nominal Exchange Rate (end of)
Domestic Analysts			
Revista *Dinero*	4.1	4.3	2,782
Corredores Asociados	4.5	4.0	2,400
BBVA Ganadero	4.6	3.9	2,472
Bancolombia and Suvalor	4.4	4.0	2,424
Corficolombiana-Corfivalle	4.4	4.5	2,820
Fedesarrollo	4.5	4.0	2,500
Average	**4.4**	**4.1**	**2,566**
Foreign Analysts			
C. S. First Boston	**4.8**	**4.5**	**2,570**
Bear Stearns	5.0	4.0	2,332
Merrill Lynch	3.6	5.0	2,475
JP Morgan Chase	4.0	4.5	2,450
Economist Intelligence Unit	4.4	3.9	2,655
Deutsche Bank	4.2	4.0	2,536
Average	**4.3**	**4.3**	**2,503**

Source: *Dinero*.

Monetary Policy Decisions in the Last Three Months

Monetary Policy Decisions in the Last Three Months

Background Information: The March 2006 *Inflation Report*

Economic growth remained good during the first quarter of 2006, propelled largely by domestic demand. Expectations of consumer spending continued to rise at a fast pace and consumer credit was dynamic. The same can be said of private investment; for the most part, its growth was reflected in imports of capital goods and in industrial production of machinery and equipment. Good prices for several major export products have allowed for more accelerated growth in national income than in production. Besides the rise in domestic demand, a dynamic world economy in the first quarter increased beyond expectations.

The exchange rate and TES interest rates have been climbing since early March, due to higher interest rates expected in the United States and in other developed countries. Nevertheless, the central scenario in the March edition of the *Inflation Report* assumed that part of this tendency towards peso depreciation was temporary. This was because of high prices for exported raw material, the strong increase in demand worldwide, and the stability of FDI flows would have helped the Colombian economy, and other emerging economies, to adjust more easily to a situation with less international liquidity. However, it was acknowledged that changes in the exchange rate were subject to a great deal of uncertainty. Depending on their magnitude and duration, the short- and mid-term inflation forecasts might have to be revised upward

With a currently dynamic world economy and a favorable external context, the BDBR decided the Colombian economy did not require the same monetary incentive to maintain its growth, which rests on a solid foundation explained by domestic and external elements that should remain in play during the coming quarters. This fact, coupled with the changes in interest rates on domestic and international financial markets, necessitates a change in the country's monetary policy to help maintain the force of output and employment in the future, in an atmosphere of low and stable inflation.

Based on these considerations, the Board of Directors decided at a meeting on April 28, 2006 to raise its money market intervention rates by 25 bp. This increased the base expansion-auction rate from 6% to 6.25%.

Monetary Policy Decisions in the Second Quarter of 2006

The most important development in the external context during the second quarter was the growing expectation of further interest rate hikes by the Fed and by other developed economies. The result was a shift in portfolios towards investments in foreign currency and implied considerable exchange-rate movement in the regional economies. These factors also raised interest rates on government bonds and the country-risk premium on the sovereign debt. These variations were particularly important in Colombia. Between March and June, the interest rates on short-term TES (maturing in March 2007 and April 2008) registered approximate increases of 200 bp to 250 bp, while the long-term rate was up by 300 bp. At the same time, the exchange rate was Col$2,633 at the end of June. This is equivalent to 15.4% depreciation during the year to date and an increase of Col$388 pesos compared to the lowest price, which was registered at the beginning of March.

In this context of high volatility, the BDBR decided not to change its monetary stance and to wait for new information that might suggest how the financial markets, the exchange rate and prices on domestic assets would behave. This decision was reached at the Board's meeting on May 20. On six occasions during the second quarter, increases in the exchange rate during short periods activated the automatic auction of call options to control volatility. Accordingly, Banco de la República's intervention in the exchange market during this period implied the sale of US$944.3 m in foreign currency (Table A).

Although, given the reduction in international liquidity, peso depreciation came as no surprise, particularly compared to the levels during the first quarter, an assessment of the external context showed no deterioration in the fundamental

Table A
Foreign Exchange Purchase-Sale Options, Banco de la República
(Millions of dollars)

	2005	2006							
		January	February	March	April	May	June	July	Accumulated Jan-jul
Purchases	4,658.4	454.7	655.9	86.1	0.0	0.0	0.0	180.0	1,376.7
Put Options	0.0	0.0	0.0	0.0	0.0	0.0	0.0	180.0	180.0
To accumulate international reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
To control volatility	0.0	0.0	0.0	0.0	0.0	0.0	0.0	180.0	180.0
Discretionary Intervention	4,658.4	454.7	655.9	86.1	0.0	0.0	0.0	0.0	1,196.7
Sales	3,250.0	600.0	400.0	0.0	168.5	608.0	167.8	0.0	1,944.3
Call Options	0.0	0.0	0.0	0.0	168.5	608.0	167.8	0.0	944.3
To control volatility	0.0	0.0	0.0	0.0	168.5	608.0	167.8	0.0	944.3
National Government	3,250.0	600.0	400.0	0.0	0.0	0.0	0.0	0.0	1,000.0
Net Purchases	1,408.4	(145.3)	255.9	86.1	(168.5)	(608.0)	(167.8)	180.0	(567.6)

Source: Banco de la República.

factors of the Colombian economy that would explain a larger adjustment than the one observed in other economies of the region at that point in time. For this reason and based on projections for the balance of payments, the central macroeconomic forecasts developed by the technical team for May and June assume a partial reversal of the exchange rate with respect to the actual levels during those months. However, the uncertainty surrounding future changes in this variable and the persistence of shocks made it necessary to consider various alternative scenarios in which the exchange rate increased more and/or remained high for a longer period of time, in order to assess its implications on the required stance of monetary policy.

Other elements of the macroeconomic scenario were not substantially different from those presented in the March edition of this report:

- The Bank's interest rates and the deposit rates in the financial system remained at historically low levels, in real terms.

- The use of installed capacity was at historic average levels and measurements of the output gap remained near zero, although there was a great deal of uncertainty surrounding this last estimate.

- Expectations of inflation in 2006 and 2007 continued to be in line with the inflation targets.

- External demand and terms of trade continued to favor export growth and an increase in national income, while household and business confidence remained high, according to the results of the surveys. In this context the economy retained its momentum, with growth based largely on domestic demand, which was up by an annual rate of more than 8%. Household consumption ad investments were the high points in this respect.

Consideration given to the possible negative portfolio effects associated with the depreciation in TES and stocks did not change the growth forecast for the Colombian economy in 2006, at least not fundamentally. Existing indicators and the expectation surveys indicated as much, having shown no significant negative impact on economic growth or agent confidence. Moreover, asset prices underwent an upward change at the end of the quarter, following the reductions during the previous months.

Under these circumstances, the reasons given in the March report for reducing the monetary incentive and making it compatible with long-term price stability are still valid.

- To the extent that real interest rates remain low and external and domestic factors continue to favor more spending, aggregate demand could continue to grow at a rate that would make it difficult to lower inflation in non-tradable goods and services, especially if limitations in productive capacity were to become evident. Several estimates of the output gap suggest this could occur in the near future. However, as indicated earlier, these estimates are highly uncertain.

- On the other hand, if part of the rise in external interest rates or risk premiums were to last, some of the increase in the real exchange rate would as well, and the relative price of tradables would increase. To this extent, tradable inflation would do less to reduce inflation than during the last two years.

- Recent depreciation implied higher domestic prices (after a certain lag), through its direct impact on tradable prices and on the growth in net exports. This would be different from depreciation originating with a current account shock (e.g. terms of trade or external demand), where the shock itself would offset the inflationary effect of depreciation by slowing down economic activity.

- The accelerated growth in credit witnessed in recent months probably enhanced the effect of the existing monetary incentive on aggregate demand. The increased supply of bank credit, in response to more market risk, would have been a contributing factor. This hypothesis was consistent with the trend in prices and quantities on that market, which showed declining interest rates on loans (in real and nominal terms), coupled with an increase in the loan approval and disbursement rate, especially for ordinary and consumer loans, and a recovery in mortgage loans.

Based on these considerations, the BDBR decided, at its meeting on June 20, to add 25 bp to its intervention interest rates, for a total increase of 50 bp during the year to date. This placed the interest rate for expansion auctions at 6.5% (Table B). These decisions take into account the relatively long lag in monetary-policy transmission. In other words, changes in the stance of monetary policy must be made far in advance, so as not to jeopardize future inflation targets or the credibility of the policy itself.

Finally, at its meeting on July 27, the Board of Directors agreed not to change its interest rates. This decision took into account that an analysis of the financial situation and the inflation forecasts, including the partial reversal predicted for the exchange rate, allowed for a cautious approach to lowering the monetary incentive. In effect, given the climate of uncertainty in which monetary policy operates, the gradual nature of these decisions makes it possible to include new information that helps the Board of Directors to enhance its perception of important macroeconomic aspects, such as changes in productivity, use of installed capacity, the extent of competition in different markets, and movement on international capital markets. These elements, which are central to a macroeconomic diagnosis, are also the subject of considerable uncertainty. Gradual adjustments in monetary stance also minimize costs derived from changes in interest rates and help to avoid sharp adjustments in the future that often lead to a loss of growth in output and employment. Finally, it is important to bear in mind that this gradual approach is possible thanks to the positive trend in inflationary expectations and the credibility acquired by the country's monetary policy.

Table B
Modificaciones de las tasas de intervención del Banco de la República
(Porcentaje)

Date [a/]		Contraction		Expansion	
		Lombard	Auction	Auction	Lombard
2001	17 Dec.	6.25	7.50	8.50	12.25
2002	21 Jan.	6.00	7.00	8.00	11.75
	18 Mar.	5.25	6.25	7.25	11.00
	15 Apr.	4.25	5.25	6.25	10.00
	20 May	3.75	4.75	5.75	9.50
	17 Jun.	3.25	4.25	5.25	9.00
2003	20 Jan.	4.25	5.25	6.25	10.00
	29 Apr.	5.25	6.25	7.25	11.00
	23 Feb.	5.00	6.00	7.00	10.75
2004	23 Mar.	4.75	5.75	6.75	10.50
	20 Dec.	4.50	5.50	6.50	10.25
	22 Dec.	n.a.	n.a.	6.50	10.25
2005	19 Sep.	n.a.	n.a.	6.00	9.75
2006	02 May	n.a.	n.a.	6.25	10.00
	21 Jun.	n.a.	n.a.	6.50	7.50

n.a. Not applicable. The Bank suspended all monetary contraction operations (auction and Lombard) as of 22 December 2004.
(*) The working day immediately after the decision by the BDBR.
Source: Banco de la República.