

INTRODUCTION

In the first quarter of 2010, the global economy reached an annualized growth above 5%, showing a significant response to the fiscal and monetary stimuli given in 2008 and 2009. The robust expansion of the Asian economies has led this dynamic, mainly due to the performance of China and India. In this context of world recovery, the Colombian economy, with an annual growth of 4.4% in the first quarter of 2010, was together with Brazil and Peru, one of the countries with the highest growth in Latin America.

In the first quarter of 2010, the global economy reached an annualized growth above 5% showing a significant response to the fiscal and monetary stimuli given in 2008 and 2009. Because of this better than expected result, the International Monetary Fund (IMF) revised their growth projection for 2010 upward by 0.4 percentage points (pp) which placed it at 4.6% and kept the one for 2011 unchanged at 4.3%. The global indicators for real activity continued their recovery in April and May with high increases in industrial production and in world trade which could confirm the better outlook for this year despite the problems that still exist in many countries.

However, the recovery of the global economy has been, unequal from one region to another. The robust growth of Asia has led that dynamic, mainly due to the performance of China and India, whose annual growth rates were 11.9% and 8.6% respectively in the first quarter of 2010. Among the emerging economies apart from those in Asia, the strong recovery of several countries in Latin American such as Brazil, with an annual growth in the first quarter of 8.9%; Peru, 6% and Colombia, 4.4% stands out. However, among the developed countries, the US economy, which had achieved an annualized quarterly growth of 5.6% in the last quarter of 2009, had a lower one in the first quarter of 2010 (2.7%). This is in line with the expectations of a sustained but moderate recovery. Finally, the economies in the euro zone continued to show a slow and unequal recovery, pointing to an average growth of around 1% in 2010.

The initial recovery of the world economy has been over-shadowed by the financial turbulence product of the markets' concern about the fiscal sustainability of some European economies and the effectiveness of their policy responses to deal with the situation. This uncertainty was caused by the problems Greece had in covering its public debt and the fears that this would spread to other vulnerable economies in the euro zone such as Portugal, Italy, Ireland and Spain. The loss of confidence in the sovereign debt of some European countries was reflected in the hike in their risk premiums and in the drop in the value of the euro. This situation had a negative impact on the stock market indexes and on commodity prices and reached the point where it generated doubts about the strength of the recovery of the global economy.

Even if the uncertainty about the potential effect this financial tension in Europe could have on the global economy continues, what has occurred so far indicates that its contagion to other regions around the world has been limited and, except for temporary fears, capital flows towards emerging economies have continued. Under these conditions and even recognizing the risks in a scenario of turbulence where additional financial deterioration is possible, the IMF did not modify their growth estimate for 2011. Nevertheless, much of this depends on the success of the new European stabilization mechanism that was created in order to preserve financial stability and to effectively coordinate the policies intended to rebuild confidence in the banking system.

In this context of world recovery, the Colombian economy, which had an annual growth of 4.4% in the first quarter of 2010, was one of the countries together with Brazil and Peru with the highest growth in Latin America. This result was higher than expected by the analysts and by the Banco de la República due to both methodological changes and better performance. From the demand side, this positive surprise was explained by the trend of gross fixed capital formation, which grew 8% (the highest number since 2007). Government consumption with a rise of 6.1% was another important factor that simulated domestic demand. Finally, although it is still in the process of recovery, the 3.5% upswing in household consumption during the first quarter of the year compares favorably to its poor performance in 2009 (1.1%). The improved trend in consumer confidence makes it possible to expect that household consumption will continue to strengthen.

With respect to the different branches of activity, the performance of the mining and quarrying sector which had an annual growth of 13.2% should be highlighted as well as that of construction which grew 15.9% in the first quarter of the year. Like in 2009, this latter sector continues to lead by public works projects, an area that surged 37.5% in the first quarter. The industrial manufacturing sector, in turn, showed growth of 3.9% during the same period, which is positive performance if compared to last year's drop of 5.9%. The most recent data from the monthly manufacturing sample (MMS) of the National Bureau of Statistics (DANE in Spanish) show that industrial activity is becoming stronger and had an annual growth of 7.5% in May.

The performance of the Colombian economy in the first quarter, as well as the positive indicators for economic activity in the second quarter and the vigorous recovery of consumer and business confidence reflected in the most recent surveys suggest that the upward turn that was predicted in the initial projections has materialized. As a consequence, the technical staff at the Banco de la República has modified their forecast for the gross domestic product (GDP) for 2010 from a range of 2% to 4% to a new one of 3.5% to 5.5%.

The economic recovery in Colombia and the return of consumer and investor confidence is appearing in a context of low inflation which ensures that it will remain within the long term target range (2% to 4%). With respect to this, it is worth mentioning that in the initial forecast for 2010, consumer inflation was expected to rise as a result of the El Niño phenomenon and its effects on the prices for food and for some regulated utilities such as electricity. However, the low pressure from domestic and foreign demand (the latter is partly due to the trade restrictions with Venezuela), together with an exchange rate that has appreciated and more favorable prices abroad than were predicted, offset the effects of the climatic phenomenon. Thus, at the end of the first half of the year, annual consumer inflation was at 2.3% and the predictions for the end of the year place it around the middle of the target range (3%).

In this context of low inflationary pressure in an economy that is growing at a pace that is below its potential capacity, the Board of Directors of the Banco de la República (JDBR in Spanish) believed that there is enough space to carry out a more expansionary monetary policy that would stimulate growth without jeopardizing the inflation target or macroeconomic stability. Because of that, in their meeting on April 30, 2010 the Board reduced the policy interest rate by 50 basis points (bp) which left it at 3%. This latest decision, which is added to the monetary stimulus policy that was carried out in 2009, has been almost completely transmitted to the market interest rates. In fact, between January and June 2010, the DTF interest rates and CD deposit rates declined 50 bp and 40 bp respectively. Something similar has happened to the interest rates for the different types of credit such as commercial, consumer and mortgages which saw reductions of 80 bp, 196 bp and 116 bp respectively since the beginning of this year.

In response to this stimulus and the improvement in the levels of confidence, credit has begun to react. Thus, the pace of growth of the consumer loan portfolio has seen a significant recovery and at the end of June 2010, its balance had increased 8.9% in annual terms. This was 6.1 pp above what had been seen for the same month in 2009. For the same date, the nominal annual rise for the micro-credit loan portfolio reached 11.7% while the mortgage portfolio that had been adjusted through securitizations grew 22.2% in nominal terms, which was 8.2 pp more than the pace registered the year before. Only the commercial loan portfolio continued to show weak performance as it registered an annual change of 0.9% this past June compared to 18.3% a year ago.

Along with this economic recovery, signs of stabilization in the labor market conditions began to appear. First of all, the unemployment rate began fall since December 2009, especially in the large urban areas. This was associated with a labor supply that had diminished possibly as a result of the better situation of households, at the same time as the quality of employment has been improving. Nevertheless, some facts that are worrying still persist, mainly all the duration of unemployment, which indicates that the improvements in labor conditions still need to become stronger.

As a complement to these positive developments on the fronts of economic recovery and inflation, market confidence has risen because of the recent fiscal policy announcements that have cleared up doubts about the sustainability of public finances in the medium term. On one hand, the Medium Term Fiscal Framework (MTMF) shows that starting in 2011, the fiscal stimulus that temporarily drove the economy during the crisis years will begin to be reduced. As a result, the national central government (NG) deficit is expected to go from 4.4% of the GDP in 2010 to 3.9% in 2011. Likewise, the deficit of the non-financial public sector (SPNF in Spanish) will drop from 3.6% to 3.1% of the GDP during these same years. In addition the government proposal to adopt a fiscal rule starting in 2011 which was well-received by the market. As is explained in this Report, the fiscal regulation is a policy plan that commits the authorities to a disciplined management of public finances. The purpose is to ensure a sustainable level of public debt, allow for a counter-cyclical management of fiscal policy and facilitate coordination in the design of economic policy. The fiscal rule will be an essential instrument in ensuring a prudential macroeconomic management of the mining-energy bonanza at the same time as it improves the fiscal indicators that will allow the country to recover its degree of investment.

This Report has four chapters. In the first one, the global economic recovery and the public debt crisis in Europe is described. The second chapter discusses the results of the Colombian economy during the first quarter and the outlook for 2010. A new section that has an analysis of the performance of the regional economy in Colombia is also included there. The third chapter describes the management of the international reserves and the fourth evaluates the financial situation of the Banco de la República. In addition, five that delve into analyze technical topics considered current and important are included.