

INFLATION SITUATION AND OUTLOOK IN JUNE

- Inflation in June confirms the main trends observed since the start of the year: lower core inflation, lower inflation expectations and a great likelihood of meeting the 2005 target.
- The drop in nonfood inflation (from 4.8% in March to 4.3% in June) occurred in tradables and nontradables. As in the first quarter, the fall in tradables inflation reflected exchange-rate behavior. Nontradables inflation decreased mainly as a result of excess capacity and gradually declining inflation expectations.
- Moreover, the Colombian economy continued to expand over the first half of the year. This is confirmed by first-quarter GDP growth (adjusted for fewer working days) and most economic indicators available to date. Growth was chiefly driven by exports and investment.
- The main factors determining price behavior in the next four to eight months will be developments in inflation expectations, the existence or not of inflationary cost and wage pressures, exchange-rate behavior and size of the output gap.
- Inflation expectations continued to decrease. The credibility of meeting the 2005 target is at a record high, and expectations for June 2006 stand at 4.9%, according to the Bank's monthly surveys. But expectations derived from the rate differential of over three-year indexed and non-indexed bonds still remain at 5%.

- The recent months' fall in the producer price index (PPI) suggests the absence of inflationary pressures from prices of raw materials and intermediate goods. In contrast, the first half of the year has seen some significant rises in real wages in the retail trade and for skilled construction workers. These real-wage rises have probably been partially offset by faster labor-productivity growth, so that unit labor costs may have remained stable. But the emergence of bottlenecks in the near future in some sectors and some segments of the labor market is not ruled out.
- Though future exchange-rate movements are highly uncertain, no major change is expected in external conditions over the next few quarters. External conditions should remain favorable for emerging economies, even with gradual rises in the US Federal Reserves' interest rates. Demand from Colombia's main trading partners is expected to continue buoyant, with various export products retaining high prices or even higher than forecast in the previous report. Given these conditions, the peso is expected to undergo little devaluatory pressure over the rest of 2005.
- There is greater uncertainty about the exchange rate for 2006. Though commodity-price projections have increased, there are risks that might involve faster exchange-rate rises. Such risks are connected with elections in several Latin American countries, the effects of the oil-price increase on the global economy, and persistent macroeconomic imbalances in the United States.
- There are good prospects of available-income growth over the rest of the year and in 2006, thanks to gradually decreasing unemployment, higher employment in general and greater formalization of employment. Moreover, as stated earlier, the terms of trade continue to be favorable to Colombia. Despite the recent months' drop in the price of coffee, coffee growers' real income grew by 50% from January to May relative to the same period last year. In terms of national income, these factors should offset the negative impact of the peso's appreciation on remittances from abroad.
- Consumer- and business-confidence levels, as revealed by available surveys, provide further reasons for expecting economic buoyancy in the coming quarters. There is also

evidence of asset revaluations, which should stimulate private spending. Given these conditions, the pace of economic growth in 2005 is expected to remain at around 4%, with domestic demand growing at much the same rate as in the first half of the year. Growth would be driven by satisfactory investment behavior (including public investment) and by acceleration of household consumption relative to the first quarter. The expansionary monetary-policy stance, as reflected by low real interest rates, will contribute to this buoyancy.

- The different measures of output gap show that it will continue to be negative but has narrowed in recent quarters. However, some indicators, such as capacity utilization and the percentage of industrialists seeing demand as a major problem, do not suggest that the gap has been closing any faster recently. Contributing factors to this development would be the expansion in production capacity resulting from the economy's high investing rate for almost three years, and, possibly, recovery of growth in total factor productivity.
- Based on the above elements, we may conclude that demand should present no major inflationary pressures in the second half of 2005. For 2006, the factors currently driving economic growth are expected to remain in play as long as there are no sudden changes in the external context and real interest rates stay low. Given these conditions, the output gap may continue to narrow, causing inflationary pressure to arise from demand.
- The findings of the inflation-forecasting models and the central monetary-policy simulation model show there is a great likelihood of meeting the 2005 inflation target (4.5% - 5.5%) and of lowering inflation down to the target range announced for 2006 (3% - 5%). Assuming a moderate devaluation in 2006, this inflation behavior will be consistent with maintaining a short-term interbank rate at around current levels.
- In this context, taking into account the following elements, the Banco de la República's Board of Directors decided to leave the Bank's current interest-rate structure unchanged:

- Last month the DTF deposit rate fell by some 20 basis points (bp) to 7.05%, further narrowing the margin between it and the interbank rate. Other, longer-term interest rates also dropped considerably over the first quarter. For instance, since March the rate for Treasuries (TES) maturing in 2014 has fallen by some 200 bp in real terms (240 bp in nominal terms), to a record low. To the extent that this rate affects aggregate demand (for example, as a measure of the opportunity cost of investment funds), its recent movements provide an additional impetus to economic activity.
- There is considerable uncertainty about the output gap's current level and the pace at which it may be closing. The previous quarter's faster growth in credit and private deposits may indicate that the economy is in better shape than was anticipated in the base scenario. Consumer credit has become more dynamic, growing now at a nominal rate of some 35%. Commercial credit has been registering nominal rises of around 15% in recent months, though part of this growth may reflect a reduction in external borrowing by the real sector. Acceleration in the monetary aggregates may have resulted from portfolio adjustments by agents, and also from a higher level of economic activity.
- Expected inflation more than a year ahead is still above or at the top of the target range for 2006. Nonfood nontradables inflation is forecast to run close to 5.5% in December 2005 and possibly remain around this level for part of next year. A potential rise in the exchange rate would therefore make it difficult to keep headline inflation on a declining path relative to current levels, because of its likely impact on tradables inflation. This is particularly relevant given the uncertainty about future exchange-rate movements, especially in 2006.
- Central simulation models show that the recent months' expansionary monetary-policy stance should be replaced in the medium and long term by a neutral position. For this reason, reduction of the intervention rates in force today would be transitory and would need to be reversed in the coming quarters, assuming there is no change in

the fundamentals that determine inflation behavior. In these circumstances, such a policy would make short-term interest rates more volatile, and this volatility, transmitted to TES rates, might produce adverse effects on financial stability. This is particularly relevant, because over-reactions may occur in the public-debt market, given the high share of public-debt securities in the financial system's assets and their importance to financing government.

- Furthermore, based on assessment of the exchange-rate situation, balance-of-payments projections and recent information on foreign direct investment (FDI), the Bank's Board of Directors have decided to retain the scheme of discretionary intervention in the foreign-exchange market, with the aim of contributing to its gradual adjustment and averting over-appreciation of the peso.

Board of Directors, Banco de la República