Introduction

Low inflation contributes to more an effective use of productive resources and encourages investment. It also avoids an arbitrary redistribution of income and wealth, which jeopardizes those who have fewer resources and cannot protect themselves against the negative effects of inflation, and promotes macroeconomic stability, which is a requirement for elevated and sustained growth.

The 1991 Constitution and Law 31/1992 order the Board of Directors of Banco de la República (BDBR) to stabilize prices, in coordination with the general macroeconomic policy. A flexible inflation targeting strategy was adopted as a result. This means the primary quantitative goal of the country's monetary policy is to keep inflation low, while attempting to stabilize the long-term trend in aggregate output. Accordingly, the Bank's objectives are price stability combined with maximum sustained growth in output and employment.

The monetary strategy adopted by BDBR is often misinterpreted. Some think the only purpose of BR policies is to control inflation, to the detriment of growth in output and employment or a better distribution of wealth and income. This is far from true. Low inflation contributes to more an effective use of productive resources and encourages investment. It also avoids an arbitrary redistribution of income and wealth, which jeopardizes those who have fewer resources and cannot protect themselves against the negative effects of inflation, and promotes macroeconomic stability, which is a requirement for elevated and sustained growth. In short, stable prices do much to improve the well being of all Colombians by raising income and reducing uncertainty and arbitrary distribution of income and wealth.

Taking advantage of the credibility of the inflation target, the Bank's policies have helped to soften the economic cycle by making the economy more resistant to negative external shocks and easing temporary fluctuations in the exchange rate.

The monetary policy also can make important short-term contributions. To the extent that inflation in Colombia remains near its long-term target, and inflationary expectations are consistent with the immediate quantitative targets, both monetary and exchange policy instruments have been used intensively, keeping real intervention interest rates low, supplying the necessary liquidity and allowing for active intervention in the exchange market, without jeopardizing the inflation target. In this way, and taking advantage of the credibility of the inflation target, BR policies have helped to soften the economic cycle by making the economy more resistant to negative external shocks and easing temporary fluctuations in the exchange

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rate. Monetary policy credibility is, therefore, a tremendously valuable asset for the country, one the Bank and the government must preserve.

Banco de la República has kept intervention interest rates at levels that it believes are coherent with the targets for inflation and will boost short-term economic growth. These levels pertain to historically low real interest rates at which the Bank has supplied all the primary liquidity required by the financial system. This has been accomplished through repo operations, supplemented with large purchases of international reserves. In an atmosphere of increased confidence in the economy, this broad monetary policy stance has helped companies and households to recover financially and is behind the renewal in credit and domestic spending.

Private investment has been the most dynamic component of domestic demand since 2002, and investment as a share of gross domestic product (GDP) reached 19.3% in 2004. This surpasses the historic average for the last fifty years. Even more important is the fact that the force of private investment has remained steady during the course of 2005 to date, as illustrated by indicators such as the strong growth in imports of capital goods and the results of business surveys. The increase in investment has been accompanied by growth in productive capacity and improvements in the productivity and competitiveness of domestic production. Although the rise in household consumption was less that the increase in output, it is expected to improve in the coming quarters, as suggested by the rising volume of commercial sales, the growth in consumer credit and the better consumer confidence indicators announced by Fedesarrollo. By the same token, the strong economic recovery experienced by Venezuela in recent years, more growth in the United States and better terms of trade have allowed for a sharp increase in Colombian exports. Based on an analysis of these and other indicators, Banco de la República expects growth of the Colombian economy in 2005 to be similar to what is was in the last two years (around 4%).

The trend in consumer and producer prices is equally important. So far this year, inflation is in keeping with the target set by the Bank for 2005, which is between 4.5% and 5.5%. Annual consumer inflation went from 5.5% in December to 4.8% in June. The drop in non-food inflation was even more pronounced: from 5.5% to 4.3% during the same period. This was made possible by underused of productive capacity, peso appreciation, and growth in the monetary authority's credibility. The latter is reflected in declining expectations of inflation that are near in the target announced by the Bank. Therefore, the inflation target for 2005 is likely to be met and inflation should continue to decline during the remainder of the year.

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In short, private investment and exports are behind the growth in the Colombian economy (in spite of real peso appreciation during the last two years). Also, public investment is expected to improve in 2005, after last year's slump. Labor productivity is increasing at a high rate and almost every sector of the economy is performing well, especially consumer durables and semi-durables. Consumption of non-durables does not appear to be growing as quickly, but is doing better. Inflation is on a downward course and moving gradually towards the long-term target. In other words, the basis for Colombia's economic growth is broad and sustainable.

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However, this does not mean the economy is immune to changes in the external environment, particularly in capital flows and terms of trade. All emerging economies are vulnerable in this respect. Also, some productive sectors face legal and illegal competition from foreign goods. The spreads are much narrower than they were a decade ago, but are still high for certain kinds of credit. No less important are the macroeconomic risk factors to be addressed in due course. The most important is the fiscal situation, as reflected in the size of the government deficit and the levels of public borrowing. These have declined as a share of GDP but are still high.

Nevertheless, the Colombian economy is gaining force. International reserves have increased and the financial system is sounder. There are major differences with respect to the second half of the nineties. For example, the current account deficit in the balance of payments is 1.1% of GDP (as opposed to 5.4% in 1997). Single-digit inflation has been a fact of life for several years and is converging gradually with the desired long-term levels. Congress recently approved legislation to reduce the nation's pension liability and to eliminate special pension plans. This was an important step towards guaranteeing fiscal sustainability. These factors generate confidence in the economy, as illustrated by the increase in foreign investment flows.

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Colombian needs consistently higher rates of economic growth if it is to lower unemployment and alleviate the poverty that affects broad sectors of the population. A substantial improvement in the distribution of wealth and income is required if the most vulnerable sectors of society are to have more opportunities. Accomplishing these objectives demands more than macroeconomic policies; it necessitates additional mechanisms and policies as well. These include measures for security, stable rules of the game and respect for property rights, public spending targeted on high-risk groups, and more efficient use of the resources society has provided, at enormous sacrifice, to ensure education and health for all Colombians. Nevertheless, policies to promote development and equity cannot and must not go against macroeconomic stability.

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The present report is divided into seven chapters. The first contains a summary of economic activity and employment during the course of the year to date, together with an analysis of prospects for the second half of 2005. The pattern and outlook for inflation are discussed in Chapter II; the trend in interest rates and monetary aggregates, in Chapter III, which also contains an analysis of the developments in credit and the solvency indicators for the financial system. The same chapter includes three sections that explain the new liquidity supply scheme adopted by Banco de la República in May 2005, recent changes in interest rate spreads among credit institutions, and the credit channel and the policy interest rate transmission. In Chapter IV, there is an explanation of the exchange policy. Its coherence with the monetary policy is analyzed, and the principal results of the balance of payments for the first quarter are presented. A section on the recent trend in foreign direct investment flows is included as well. The change in public finances and the outlook in this respect for 2005 are analyzed in Chapter V. The balance of international reserves and the how they are managed is described in Chapter VI, while Chapter VII contains a review of the financial position of Banco de la República for the year to date and projected income for 2005.