

EVOLUTION OF THE INFLATIONARY SITUATION, AND MONETARY POLICY DECISIONS

In 2010, the annual CPI variation was 3.17%, this figure being close to the midpoint of the inflation target range (between 2% and 4%) fixed for this year by the JDBR, the Board of Directors of Banco de la Republica, the Central Bank of Colombia.

In the past quarter, the so-called “La Niña” event, along with an increment in the international prices of some commodities, caused an impact on those of food and some regulated goods and services, these groups being largely responsible for inflation acceleration.

The highest increase in food prices as recorded between September and December 2010, was seen in perishable products affected by a very intense rain period. Although to a lesser extent, the consumer price index (CPI) of processed foods did also increase its annual growth rate. This behavior took place in a context of peso depreciation accompanied by a rise in the international quotations for some basic products of agricultural origin. In addition, the highest world oil prices have moved to the regulated-item CPI.

In the last quarter of 2010, acceleration was shown by all core inflation indicators estimated by Banco de la Republica. Nevertheless, their average annual growth still remains at the lower part of the target range.

In the CPI without foods and regulated items, tradable continued to exhibit negative annual increase rates in the past quarter, though in an upward trend. On its side, the non-tradable group remained stable; likely, this behavior reflects low demand pressures relating to a still negative gap in the product, a still high unemployment rate, and the presence of some excess production capacity in some sectors like industry.

One-year-ahead inflation expectations rose and reached the mid upper part of 2011 target range, while long-long term (five to ten-year) prospects, as measured with public debt papers, exceeded its ceiling. This behavior can be explained in good part by the temporary food-price shock.

With regard to economic activity in the third quarter of 2010, the CPI annual growth was 3.6%, this figure being lower than the range projected by the technical team. The weak performance of investment and exports was in part explained, in that order, by the falls registered in building and civil works construction, as well as climate factors affecting external sales of some primary products of agricultural and mining origin. Again, household's consumption was accelerated and became the main engine of domestic demand in the same quarter.

By the end of 2010, the rain period intensity could have had negative effects not only on agriculture but also on the gross fixed capital formation and certain exports of mining origin that could not be attended to due to extraction or transportation problems. Thus, by the last quarter of 2010, a performance of the economy similar to that recorded in the third quarter is expected, *mainly driven by household consumption*.

For 2011, several factors make it possible to estimate growth acceleration, the rate of which may be around 4.5%. This would consolidate the convergence of economic activity towards its long-term sustainable levels, and the conditions for monetary policy to adopt a less expansive stance would appear. In the first place, consumption and investment would continue to be driven by historically low real interest rates as well as by an accelerated credit being reflected on increased household and business indebtedness. Surveys on the perception of credit supply and demand indicate that credit availability will continue, even with some acceleration for certain sectors.

The labor market, continuing to recover since the beginnings of the previous year, would be another encouraging factor for household consumption. In 2010, employment acceleration was seen in both the so-call self-employment/freelance ("*por cuenta propia*") and formal jobs, the latter mainly focused on workers with higher education levels.

As per the external outlook, a more favorable but slowly recovering demand after the intense international crisis would also help improve our country's balance of trade. Trading terms being likely to remain at historically high levels in 2011, would encourage exports of basic products, thus improving the economy's disposable income.

Finally, and despite the fact that the climatic phenomenon might affect the GDP again, the Government's additional spending to confront the rainfall-related emergency may mitigate the impact. On the other hand, local public administrations happen to expire and generally, the implementation of budget spending by the regions tends to accelerate in these periods,

In this macroeconomic context, according to the technical team forecast there is a high probability that inflation will end in 2011 within the target range

(between 2% and 4%) defined for the present year. Although it may be accelerated in the first semester of the year by temporary supply shocks, this tendency is likely to revert by the second half of 2011

In the light of the above, at its meetings of November and December 2010 and January 2011, the JDRB, decided to keep its reference interest rate unaltered, and announced in their last session that whether the economy remains on the expansion path as expected or there are signs of *deviations in inflation expectations* from the goals established, then the proper conditions will be made available to start withdrawing the monetary incentive in a gradual way, in order to consolidate a sustained growth of production and employment.

Banco de la Republica Board of Directors