Remarks by José Dario Uribe, Governor of Banco de la República, at the Bear Stearns 2006 Colombia Conference

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I. Introduction

It is a pleasure to be with you here in Cartagena. This morning I am particularly pleased because this meeting gives me a timely opportunity to analyze with important representatives of the business community some of the main recent developments of the Colombian economy and prospects.

Initially, I will review recent economic developments in Colombia and its determinants. Then I will focus on the policies that have been taken in Colombia, both by the Government and the Banco de la República, in order to increase the ability of the economy to adjust to changes in external conditions.

II. Recent economic developments

The Colombian economy has been exhibiting a vigorous growth momentum for the last four years. Current rates of economic growth are close to 6%, higher than the best years of the first half of the nineties. From the supply side the main factors behind this strong dynamism are a significant increase both in capital stock and total factor productivity. The investment ratio in 2006 will reach a level close to 24%, above the corresponding average for the last 25 years (17%), while total factor productivity increased about 1.5% between 2004 and 2005.

On the demand side, the strong economic growth has been supported by a significant increase in household consumption, around 5% in 2005 and 2006, a strong dynamism of private investment for more than four consecutive years, and rapid growth in exports since 2004. Growth has also been accompanied by an expansion of imports, particularly capital goods that have

Against this background, and assuming a benign external environment and the continuation of macroeconomic policies, we at the Banco de la República believe that Gross Domestic Product in 2006 and 2007 will grow more than 5.5% y 4.5%, respectively. Domestic and foreign analysts have expressed similar outlooks. These are certainly good rates of growth.

On the other hand, annual headline CPI inflation decreased from 6.5% in 2003 to 4.8% in 2005, following the declining trend that it has exhibited since the beginning of the decade. Core inflation measures and inflation expectations showed a similar pattern. Inflation is expected to continue a process of convergence towards a long run target range of 2%-4%.

III. Determinants of the current economic situation

The current favourable situation of the Colombian economy is the result of three main factors: i) the state of the global economy; ii) the macroeconomic strategy of the Government and the Banco de la República, including reforms, and iii) the security situation.

The first factor is external, and relates to the positive effects of the global economy on Colombia. As many other small open economies, Colombia is very much affected by changes in the prices of and world demand for, our products, as well as by capital flows. All these elements have moved favourably in recent years.

High growth in the global economy, in particular in Asia, has pushed up the international prices of commodities. Roughly half of total Colombian exports are commodities (oil, coal, coffee, nickel and gold), so the increases in their relative price result in gains in labour income, in corporate profits, and government revenues. This positive shock to the country's income has generated growth impulses to the Colombian economy. Furthermore, in Colombia the price of oil determines in part the Foreign Direct Investment in the mining sector (oil and coal) and the growth of some of the main markets for Colombian non-traditional exports (e.g. Venezuela and Ecuador).

Growth in the U.S. and other countries has also contributed to the remarkable performance of Colombian exports in recent years.

has induced FDI flows into sectors other than mining and has made Colombian firms attractive to international investors. In addition, the external environment has implied low sovereign risk premia and relatively stable non-FDI private capital flows.

The expansion of trade and globalization has had other beneficial consequences on the Colombian economy. Specifically, the increased degree of competition in several industries, the disciplining effect on the labor market and the adoption of more advanced technologies embodied in the surge of imported capital equipment have improved the productivity of the economy in the long run and subdued inflationary pressures.

Second, better macroeconomic management has been instrumental to the good economic performance of recent years. Between 2003 and 2005, the consolidated fiscal deficit was reduced from 2.7% of GDP to 0%, and the government expects a consolidated fiscal deficit lower than 1.5% of GDP by the end of 2006. As a result, the net public debt to GDP ratio has decreased from 44.3% in 2003 to 34.1% in 2005. This process has been crucial to make the public debt sustainable and support relatively low real interest rates in the economy.

At the same time, the government has promoted several wide-ranging economic reforms, such as those in the pension system, in the labour market and in the public sector; implemented privatization, e. g. Granbanco, Banco Granahorrar, Megabanco, Telecom; and invested in human capital and physical infrastructure, in cooperation with local governments. These steps have already borne fruit and will continue to do so in the future.

The Banco de la República has also played its part in the strategy, mainly by carrying out an interest rate policy coherent with the achievement of decreasing quantitative inflation targets. Moreover, the Bank has supported other economic goals, especially growth and employment, on condition that they do not conflict with the attainment of the inflation targets. In particular, Colombia has experienced a fairly long period of initially falling and thereafter stable, low real interest rates. This has been possible as far as price inflation was subdued, inflation targets were achieved, and there was idle capacity in the economy. The low interest rate level has contributed to a considerable increase in demand for goods last April the Board of the Central bank started to gradually rise interest rates. To date, Banco de la República´s key interest rate has been increased 100 basis points from 6% to 7%.

Finally, progress in the security situation have also had positive effects on the economy, in particular by increasing domestic and foreign investors´ desire to invest in Colombia. Moreover, improvement in security has improved households willingness to consume and to travel around the country.

In short, low interest rates, advances in security, strong global growth and the improvement in terms of trade have contributed to solid growth in the Colombian economy. Capacity utilization has probably reached a normal level, and the cyclical upturn is continuing. Enterprises and consumer are steadily increasing their debt to finance investments and consumption, with real wages and labor productivity growing at a similar rate and inflation running on the middle of the target range.

IV. The Way Forward

We have learned from past experience that a sound macroeconomic policy is a necessary condition to maintain high economic growth rates. It is clear for us that a low and stable inflation allows for a better allocation of resources in the economy, a better functioning of the financial system and a lower long run real interest rate. Also, a low public debt burden is essential to keep low real interest rates in the economy.

A strong macroeconomic framework not only creates a favourable environment for the economy to grow, but also make it more flexible to adjust to changing circumstances. At the Banco de la República we believe that world economic prospects remain favourable. As in many other central banks, this is our central expectation of how the world economy will unfold. However, we all know that there are downside and upside risk around this scenario. On the downside, the most important risk has to do with the way global imbalances are ultimately resolved. An inappropriate resolution may end up in a situation in which global growth slow more sharply than desired. On the upside, we can not rule out the possibility of stronger growth, especially in Asia.

In any case, we all need to be prepared for strong movements in global demand, relative prices and capital flows. By all I mean the Government, the Central Bank, and the private sector.

If commodity prices remain high or increase in the context of a dynamic global economy, the ensuing positive effects on income and aggregate demand (including demand for Colombian exports from our oil-producing trade partners) will persist. Also, in this scenario FDI will keep flowing in, especially in the mining sector, and there will not be an abrupt shift in non-FDI capital flows. Hence, the external stimulus will continue to push growth and induce an appreciation of the currency. If this situation is to continue for a while, we will be likely to observe a sectoral re-composition of the economy, in which some export or import competing industries must shrink in favour of export-booming or non-tradable sectors. This outcome may not be desirable when the external phenomena that produce it are not permanent, so it may become a challenge for policy makers.

On the other hand, a decline in global growth coupled with a fall in commodity prices and a (possibly abrupt) reduction of net capital flows will produce a depreciation of the currency and a decrease in growth of demand and output. The extent of the effects of such a shock will crucially depend on the flexibility of the economy. In particular, the structure of the labour and financial markets, as well as the reaction possibilities of the fiscal and monetary policy will be key elements of the adjustment of economy to the shock.

The challenges posed by the types of events described above require the consolidation of a strong macroeconomic policy framework and further progress in the reform agenda.

Macroeconomic policy

Regarding monetary policy, the achievement of a low and stable inflation rate is instrumental in the pursuit of a flexible economy. With it, the credibility of the inflation target in the range of 2% to 4% will be enhanced and expectations will be anchored. This will reduce the pass-through of the exchange rate to prices and monetary policy will not have to be pro-cyclical, especially in the case of the shock that depreciates the currency and reduces growth. In fact, with anchored expectations and credibility of the

In this context, the flexible exchange rate regime is more beneficial for the economy, since the exchange rate may play more easily its shock-absorber role, producing a more efficient adjustment of the economy in the face of changing economic conditions. As a result, the inflation-targeting strategy of monetary policy may get closer to a program to stabilize output around its potential or trend level, as deemed desirable by the Central Bank and society.

Having said so, however, we think that intervention of Banco de la República in the foreign exchange market may be granted for a number of reasons, under the conditions that no explicit or implicit target on the exchange rate is pursued and that the inflation targets are not compromised. Specifically, we believe that holding an adequate level of international reserves is a key element to reduce the vulnerability of the economy to external shocks. Banco de la República has intervened in the for-ex market with this purpose, starting from low initial stocks of reserves and during periods of currency appreciation.

Moreover, we consider worthwhile to limit excessive short term volatility of the exchange rate in a market that is still relatively shallow and subject to speculative movements. Also, given the characteristics of the for-ex market in Colombia, we think that sometimes intervention may be a useful complement of interest rate policy to meet the inflation targets. That is why for-ex intervention and interest rate policy have been consistent since the inception of the managed floating exchange rate regime in September of 1999. Finally, with well anchored inflation expectations and as long as it is effective, intervention may be a valid instrument to mitigate a transitory appreciation that would harm tradable sectors.

Turning to fiscal policy, the government will continue to operate within a framework of budget targets, with the intention of reducing public sector debt levels relative to the size of the economy (the debt/GDP ratio). Let me recall some important reasons for this policy:

- Reducing the debt/GDP ratio will increase the economy's robustness and enable it to respond to negative external shocks such as changes in liquidity and interest rate abroad.

account by the rating agencies when they assess the economies resilience to shocks. A reduction in the ratio will help to improve Colombia's rating. This will reduce the interest rate that government and the private sector pay in the capital markets to finance their activity.

- A lower debt/GDP ratio will enable the government to operate a countercyclical fiscal policy.
- A lower debt/GDP ratio will reduce the exposure of the public sector to foreign exchange risk and the exposure of the financial system to domestic market risk. Hence, a decrease in the public debt will enhance financial stability.

Two Structural Reforms

The flexibility of the economy will also be enhanced by the adoption of reforms in the financial sector. It has been recognized that domestic financial systems generally amplify and propagate external shocks to emerging economies, rather than helping smooth their effects. The build-up of internal and external imbalances and the subsequent recession and financial crisis of nineties in Colombia attest to the perils of a pro-cyclical behaviour of the financial system.

The Central Bank and the Financial Superintendency have been working jointly to improve credit, market and liquidity risk regulation and supervision for the financial system and the capital market. This effort is not only aimed at strengthening the solvency and the liquidity of the financial intermediaries, but also at perfecting risk management along the guidelines of Basle II. In particular, market risk regulation, which is very important in Colombia nowadays, is being improved. Also credit risk regulation is under reform, with some counter-cyclical features being introduced.

Moreover, the Government plans to submit to Congress a financial reform. It has two main objectives: to increase the depth and scope of the financial system in the economy and to improve its risk management practices. To do so, it enhances creditors' rights and information to achieve a wider access to credit and reduces transaction and intermediation costs for credit institutions. It also moves towards a universal banking approach. Furthermore, it addresses some specific aspects of the pension and insurance system, to improve their risk management and the decumulation

Another area of structural reform in the Colombian economy is trade. A FTA with the USA is underway, and agreements with other countries or blocks of countries are under study. By consolidating external markets for Colombian products and increasing the degree of openness of the economy, adverse shocks may be easily absorbed. An adjustment of the current account may not be borne so heavily by domestic expenditure, but by rapidly expanding exports to already open markets. By the same token, trade and investment agreements may provide more stable FDI flows and, as a result, less volatile capital accounts.

V. Concluding remarks

Let me now conclude. The Colombian economy has been displaying vigorous growth momentum for the past four years and inflation has been declining towards its long term target. This auspicious situation is not something that the Colombian economy attained by chance. It has been the result of several things: A monetary policy based on inflation targeting, a sustainable fiscal policy, structural reforms, improvements in the security situation and favourable global economy situation.

Our recent success does not mean that we can rest on our laurels. In a constantly changing and increasingly globalized world economy, the Colombian economy will continue to be buffeted by shocks. We have learned from experience that the best way to be prepared for future shocks is to implement sound macroeconomic policies and structural reforms that help our economy become more flexible and thus more adaptable to change. The Banco de la Republica is totally committed to doing its part. And of course, the Government has also shown its commitment with the structural reform agenda and sound fiscal policy. We have reasons to be optimist about our future economic development.

Thank you very much.