Remarks by José Darío Uribe, Governor of the Central Bank of Colombia, at the Colombian American Association

New York, October 17, 2007

I. Introduction

Good morning. I am glad to be here in New York to take part in this breakfast kindly organized by the Colombian American Association. I would like to begin with a few words about the framework that guides the Central Bank of Colombia in conducting monetary policy. After this brief introduction, I will spell out my interpretation of recent economic developments and present our outlook for 2007 and 2008. I will then explain why I think the Colombian economy is resilient to any future external shocks. Finally I will open to the floor for your questions and comments.

II. The monetary policy framework

The objective of the Board of Directors of the Central Bank is to achieve and maintain a low and stable rate of inflation. For this year, the operational target is inflation between 3.5% and 4.5% but by the mid-term we aim to keep inflation to within 1 percentage point of 3%.

The objective of low, stable inflation is to provide the economy with a nominal anchor. But we recognize that monetary policy must also help to stabilize resource utilization in the economy near its average or long-term level providing that inflation expectations remain anchored to the inflation target. The challenge, therefore, is to set interest rates, our main monetary policy instrument, at a level which is conducive to meeting the quantitative target for inflation and does its best to keep resource utilization close to its long-term level.

The other central element of the inflation targeting scheme is exchange rate flexibility. The Board of Directors of the Central Bank does not have a target or a preferred level for the exchange rate.

Exchange rate flexibility does not mean, however, that exchange rate movements are not taken into account for devising monetary policy. On the

contrary, these movements play a key role on discussions of monetary policy. Variations of the exchange rate affect aggregate demand by changing relative prices, which modifies the demand for goods and services tradables and non-tradables. In this way, movements of the exchange rate influence inflation and growth forecasts, which are the bases for decision making on interest rates.

III. Recent economic developments

I will begin by discussing the effects of the global economy on Colombia. Colombia, like many other countries, has benefited greatly from the rapid world economic growth and the greater commercial and financial interdependence between countries. The recent pace of growth in the world economy, coupled with the rapid rise in output in China and India have led to a substantial increase in the international price of oil, coal and iron-nickel, which are Colombia's three leading export products (Table 1).

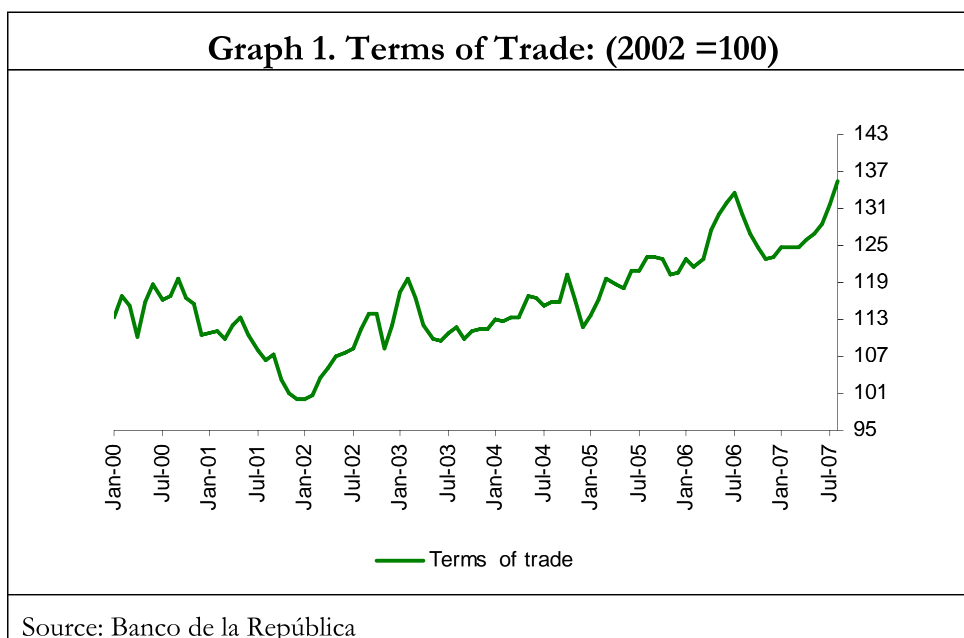
Table 1: International prices of main Colombian exports – 2002-2007

Description	2002	2003	2004	2005	2006	2007*
Coffee (Ex-Dock) (dollars/ pound)	0,7	0,7	0,8	1,2	1,2	1,23
Petroleum (dollars / barrel)	24,2	29,0	37,3	49,8	58,3	58,30
Carbon (dollars / ton.)	30,8	28,2	36,1	47,8	48,0	58,49
Iron-nickel (dollars / pound)	1,1	1,4	2,3	2,4	3,6	5,85

*Average price observed to September 2007

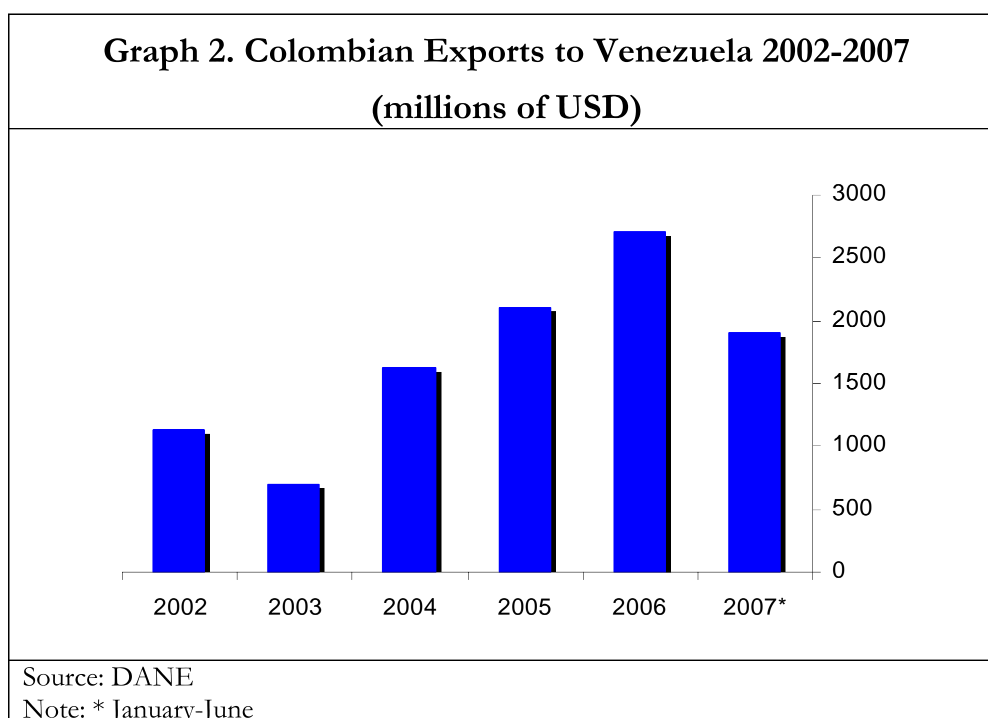
We also switched to import more from countries such as China, where wage and production costs are low. The prices of our manufactured imported goods have therefore dropped or increased at relatively low rates for several years on a row. That is the case, for instance, of prices for clothing, household electrical appliances, automobiles and computers, but also many other items.

Consequently, prices for imported goods have declined relative to those for exports. Thus the terms of trade have improved and the Colombian economy has received a positive boost to its income and real wealth (Graph 1). The latter has facilitated the growth in consumer, corporate and government spending.



Graph 1. Terms of Trade: (2002 =100)

Source: Banco de la República



Graph 2. Colombian Exports to Venezuela 2002-2007 (millions of USD)

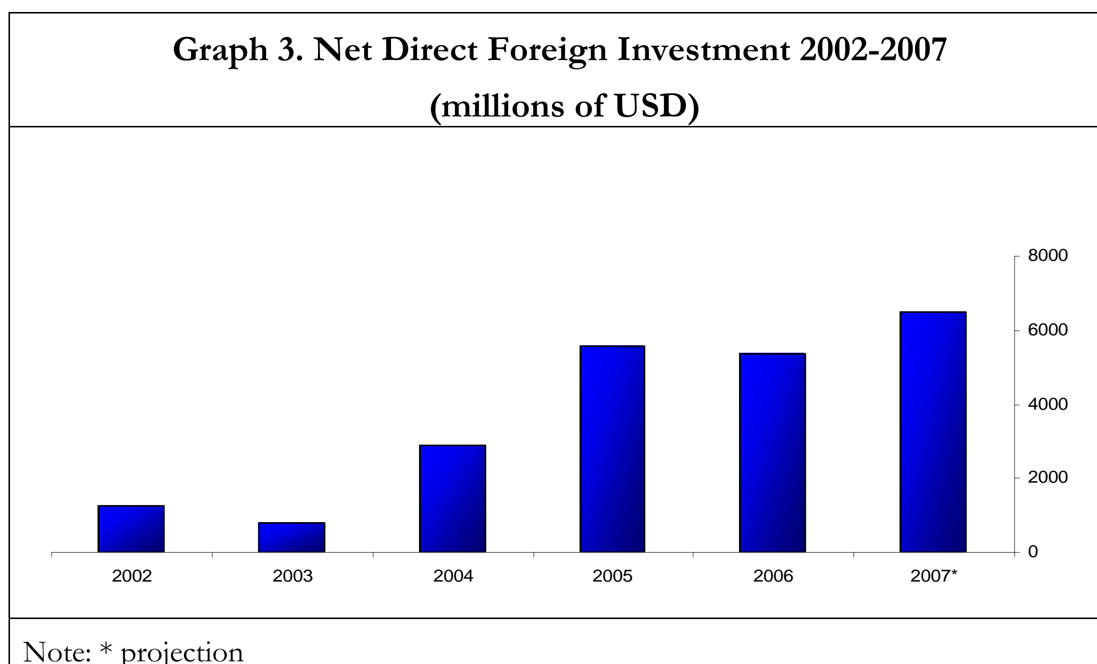
Source: DANE
Note: * January-June

In addition, given high oil prices, the economy of Venezuela, Colombia's second most important trading partner, has been growing at a high rate and has imported large quantities of food products and manufactured goods from Colombia

(Graph 2 above). Strong world economic growth has also led to an increase in exports from Colombia to countries other than the United States and Venezuela of about 60% over the last 4 years.

On its own, foreign net direct investment has increased from an annual average of US $1.277 million in 2002 to more than US$ 5365 million in 2006 (Graph 3). This extra investment has been used to expand the production of basic commodities and, more generally exports. It has even been used to take advantage of business opportunities created by domestic growth itself. This is the case, for example, with foreign investment in commerce and the financial services sector, both of which have experienced an important increases in productivity.

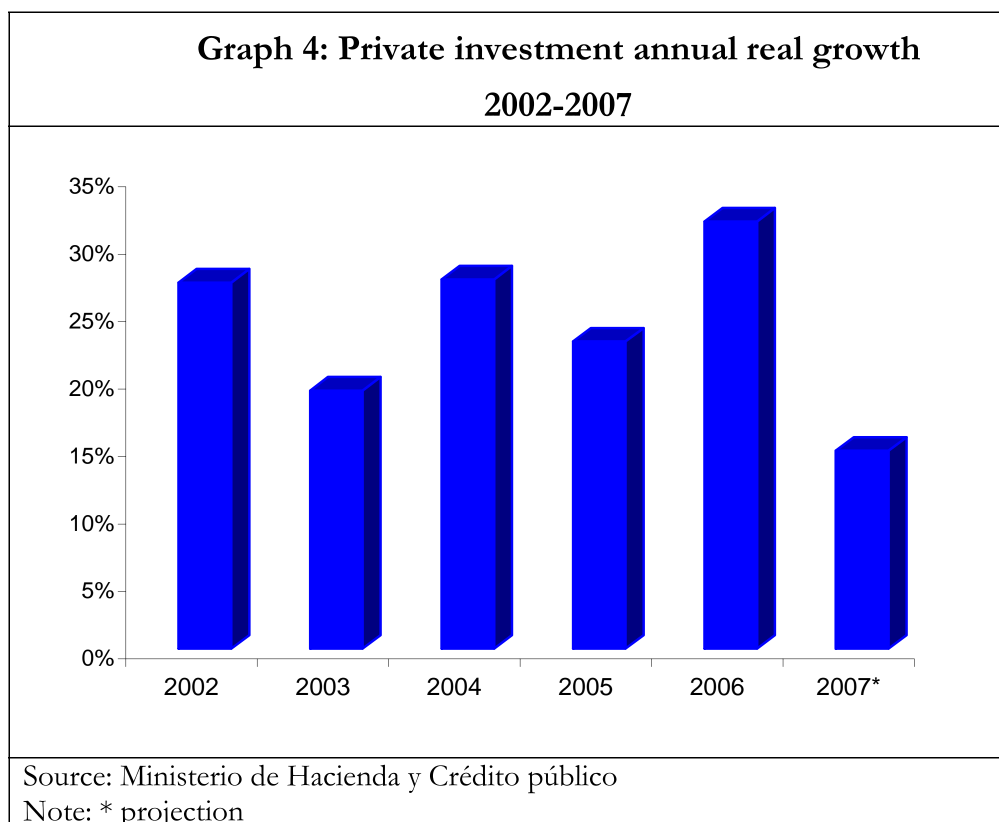
Graph 3. Net Direct Foreign Investment 2002-2007
(millions of USD)



Note: * projection

An improvement in the terms of trade in tandem with capital inflows in the form of foreign direct investment has induced a sharp peso appreciation against the dollar and against a basket of currencies. I will return to talk about this later.

The combination of high international prices for our main export products, the strong demand for exports and the increase in confidence levels and security, has meant that the growth of both investment and household consumption have accelerated in recent years. Private investment has grown at two–digit rates since 2002 and, until recently, was concentrated in machinery and equipment (Graph 4).



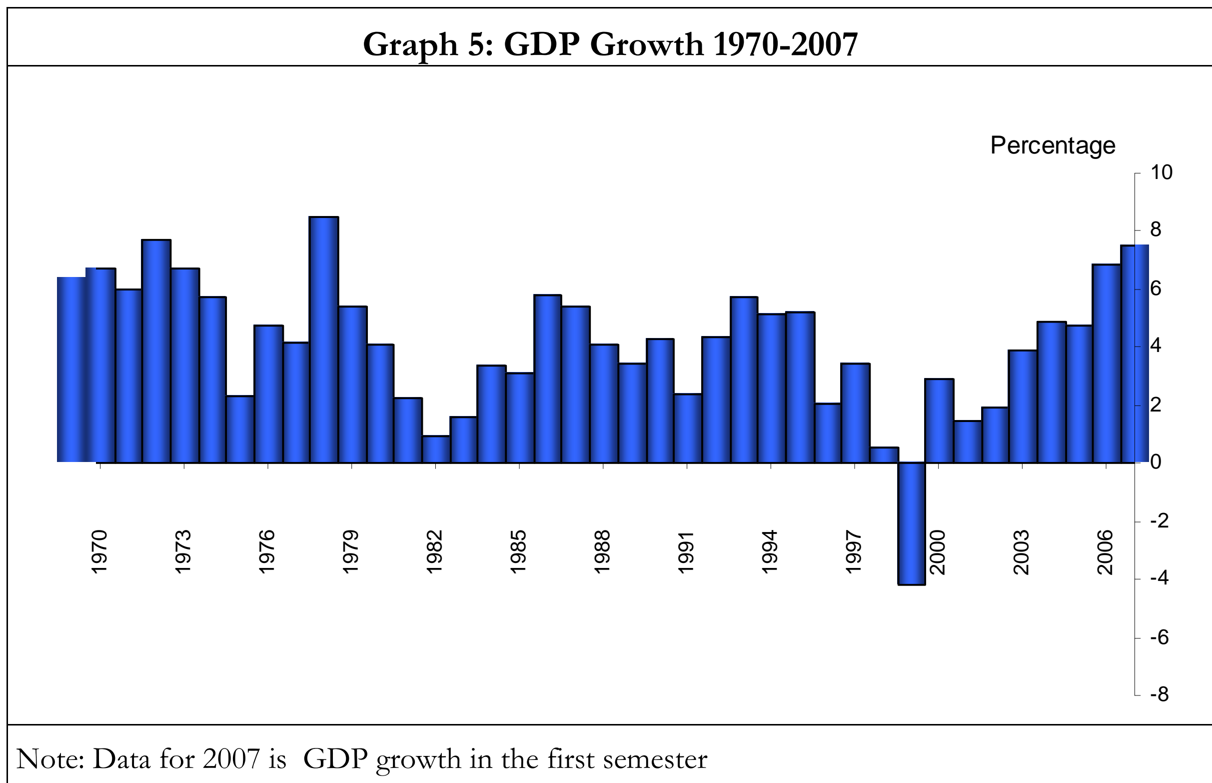
Graph 4: Private investment annual real growth 2002-2007

Source: Ministerio de Hacienda y Crédito público
Note: * projection

Similarly, following a slow recovery from the economic recession of the late nineties, consumption of durable goods started to pick up since 2003. Subsequently, since 2005, spending on durable and non-durable goods as well as services have been very dynamic. Over the last three quarters, total consumption has been expanding at an annual rate that is close to 8%.

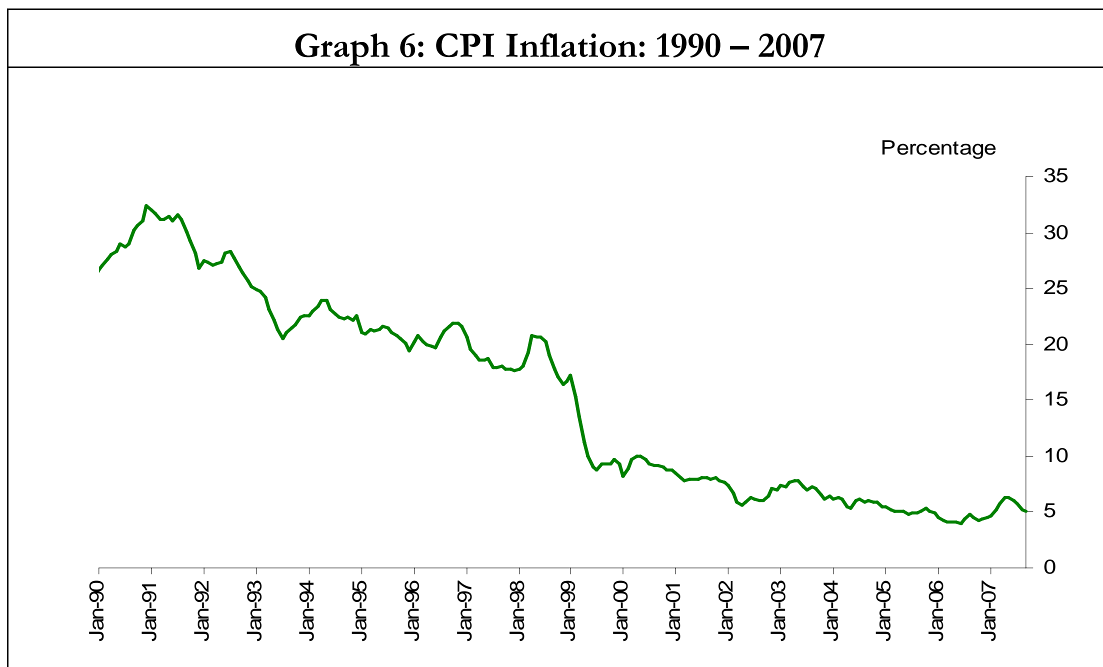
In consequence, the Colombian economy is growing strongly. Following two consecutive years when the economy grew at annual rates close to 5%, in 2006 it expanded 6.8%, and during the first semester of this year at a rate of 7.6%. Average real growth rates for the past four years were well above 5.69%. The continuous growth period of recent years will be the longest ever recorded since early 1970s (Graph 5).

Graph 5: GDP Growth 1970-2007



Note: Data for 2007 is GDP growth in the first semester

Graph 6: CPI Inflation: 1990 – 2007

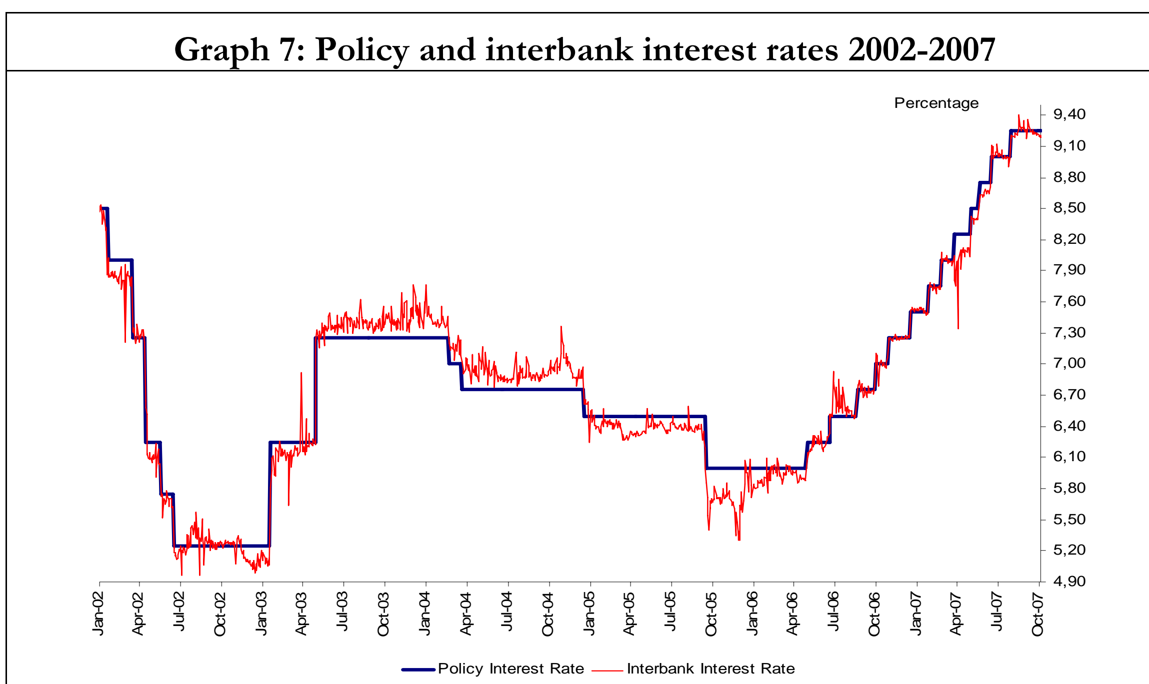


Turning now to inflation, the historical context is that annual headline CPI inflation decelerated gradually from the early 1990s to 1998 and then fell markedly in 1999. In recent years, inflation decreased from 6.5% in 2003 to 4.5% in December 2006, and it is now currently at 5.0% after being at 6.3% in April (Graph 6 above).

The rise in our inflation in the first months of 2007 was in part due to a variety of special factors. Poor crops as a result of the El Niño weather condition caused a sharp rise in the price of certain foods during the early months of the year, particularly in perishable farm products. Then there was a boom in food exports to Venezuela that pushed up prices within Colombia for meat, eggs and chicken, among other items. Also important was the growing demand for food worldwide.

On the other hand, annual *non-food* inflation went from 3.6% in June 2006 to 4.3% by August of this year. The average of the three core inflation indicators used by the Central Bank increased from 3.7% to 4.9% during the same period. All of this suggests that while the special food price factors were important, there was also an underlying demand-push pressure on consumer prices.

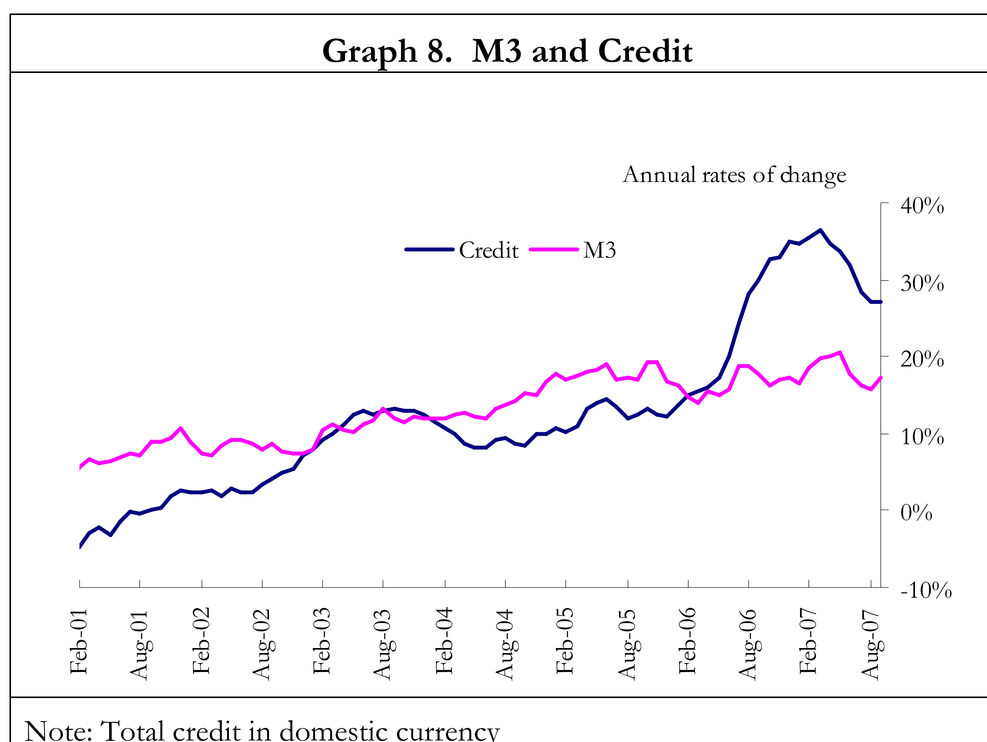
Graph 7: Policy and interbank interest rates 2002-2007



In line with the monetary policy framework I outlined earlier, the challenge for the Central Bank in the second half of 2006 and the first of 2007 was to deal with inflationary demand. Since April 2006, our monetary policy response has been to raise the Central Bank intervention interest rate from 6% to 9.25% (Graph 7). As of May 2007, these hikes have been supplemented with a 24% average marginal reserve requirement on liabilities in the banking system.

The early evidence is that our preemptive and counter-cyclical actions have been working. Domestic demand grew 9.% during the second quarter of this year. Credit is becoming more expensive and is not expanding as quickly. The same can be said of the growth in monetary aggregates (Graph 8).

Graph 8. M3 and Credit

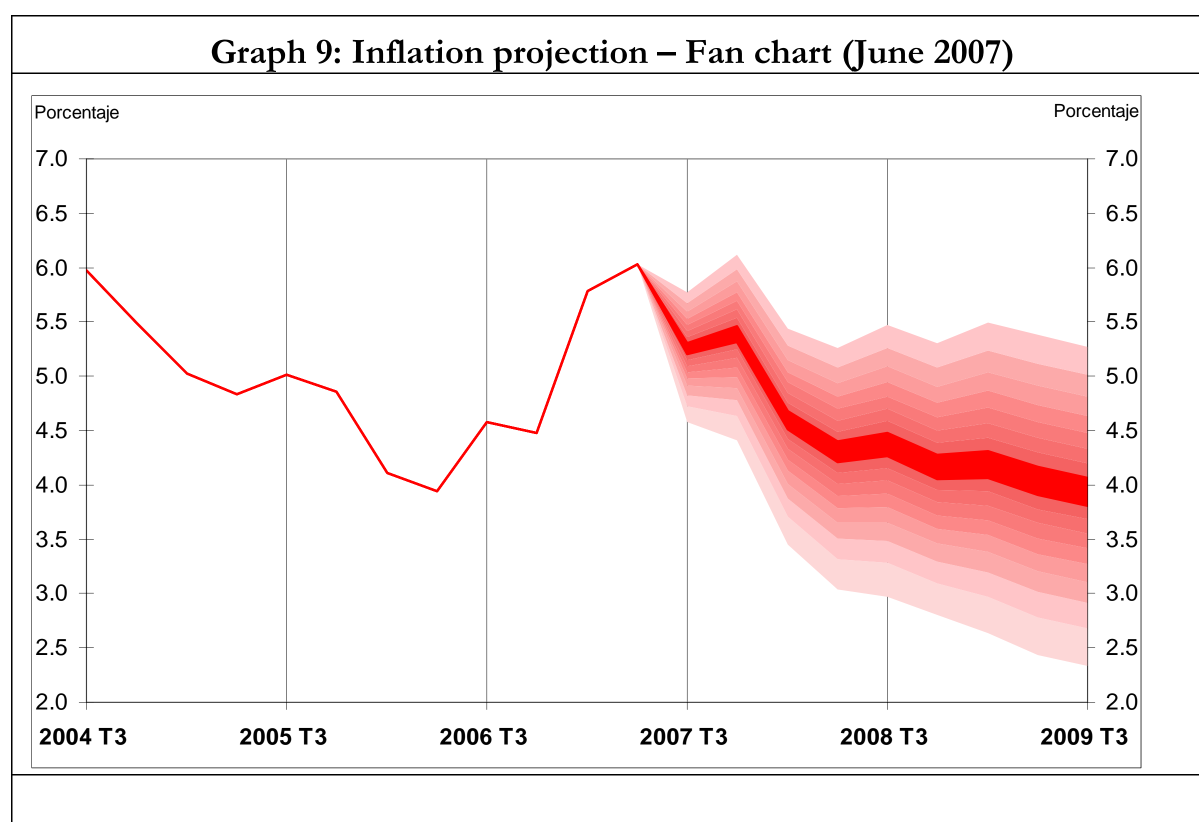


Note: Total credit in domestic currency

IV. Economic outlook

That was a quick look backwards. Now let me turn to the Bank's base-case projection for the whole 2007 and 2008. Overall, we at the Bank believe that domestic GDP in 2007 and 2008 will grow more than 6% and 5%, respectively. Domestic and foreign analysts have similar expectations. These are certainly good rates of growth.

The Bank projects that headline inflation will continue moving to around 5% for the rest of 2007, and then to continue trending towards 4% next year (Graph 9).



Graph 9: Inflation projection – Fan chart (June 2007)

That was our base-case economic projection. But there are risks both to upside in inflation and downside in growth.

The main upside risk to our inflation projection comes from the possibility that economic activity and household consumption continue responding to the favorable economic conditions with a greater intensity than expected. The robust dynamism of credit for consumption and housing, together with a rapid growth of imports, seems to indicate that the vigorous expansion of expenditure will continue. This, in a situation where economic growth surpasses its historical average and the GDP gap is positive, represents a risk of inflation.

Moreover, there is a risk of inflationary pressures at a world level, due to the high prices of fuel and foodstuffs. Even though the price rises in these goods reflect

a change in relative prices, if central banks do not face these increases in a proper way, they could unchain an international inflationary process.

On the other hand, the main downside risks to growth come from abroad. One comes from the recent financial market turbulence triggered by problems in the US sub-prime lending market.

So far, all we can say about the impact of the international financial turbulence on the Colombian economy is that there was an important initial impact but most of that was quickly reversed: i) the Colombian peso depreciated 13.8% between July 15 and September 12 but then appreciated by 9.58% to October 10; ii) the country-risk premium increased from 97 to 204 basis points from July 15th to September 13th but fell back to 147 basis points by October 11; and iii) interest rates on TES 2020, the country's most liquid domestic government bonds, rose by 75.1 basis points from July 15th to September 13th but since then recovered 29 of those basis points.

Another downside risk relates to the future of both the international price of oil and the performance of the Venezuelan economy. The high oil prices have benefited Colombia, since it is an oil exporter, but also because Venezuela is our second most important trading partner. Over the last few years Venezuela (and to a lesser degree Ecuador) have offset the fall of Colombian exports to U.S., thus promoting industrial production growth in Colombia. A fall in oil prices, a sharp slow down of the Venezuelan economy, or difficulties for the bilateral trade with Venezuela, could harm economic growth in Colombia.

When looking beyond 2008, I would like you to bear in mind that Colombia is a country that has improved its security; that has dedicated about 25% of its GDP to physical capital investment; that has significantly reduced its macroeconomic instability; that has developed the human capital of its citizens; and that is ever more integrated in the world economy.

V. The Colombian resilience to external shocks

Finally, before opening the floor for your questions and comments, let me talk about some of the policies we are taking that help us to deal with the challenges

of today's global economy. As producer of commodities, Colombia relies heavily on international trade for our economic expansion, and we also rely extensively on global capital markets.

We have as yet no idea how long the effects of the international financial turbulence on the real economy will last, or how strong they will be. We do not know either for how much longer Colombian trade with Venezuela can keep expanding. But what we do know is that, over the years, Colombia has constructed a policy and institutional framework that makes the economy more resilient to negative external shocks.

The policy framework I am referring to features an independent central bank that has lowered inflation, allowed some exchange rate flexibility, and accumulated large amounts of international reserves.

Low and stable inflation rates reduce the uncertainty associated with long-term investment decisions, which in turn restrain the risk premium asked by investors. As a result, both the level and volatility of long term nominal interest rates diminish, and also the volatility of inflation and economic growth are reduced. Diminished macroeconomic volatility and lower interest rates in the long run support the good quality investment that the economy needs to adapt to changes in external conditions.

Furthermore, credible central banks and economies with inflation expectations anchored to inflation targets reduce the pass through from exchange rates to prices. This implies that monetary policy should not be pro-cyclical when the economy is hit by shocks that depreciate the local currency and slow down economic activity. On the contrary, with anchored expectations and credible inflation targets, monetary policy should be rather more counter-cyclical.

On the other hand, the strong real appreciation of the peso over the last four years has taken place through a nominal appreciation. The exchange rate reached almost $3,000 during the first quarter of 2003 and is now at about $2,020. In a context of favorable terms of trade shifts, growing foreign direct investment, rising remittances from Colombians abroad, and a dollar that tends to depreciate with respect to other world currencies, a fixed exchange rate would have prevented these price signals from working. With a fixed exchange rate the burden of necessary

economic adjustment would have fallen on domestic prices and wages, imposing large costs on the economy, and creating unnecessary variability of output and employment.

Another important policy is fiscal responsibility. The Colombian government has made it a policy, in recent years, to reduce the net public debt as a share of GDP from 54% in 2002 to 40% in June of 2007. Moreover, it has changed the currency composition of its debt to the point where nearly 65% is denominated in pesos and 35% in foreign currency.

Reducing the debt/GDP ratio increases the economy's robustness and enables it to respond to negative external shocks such as changes in liquidity and foreign interest rate. This ratio is one of the main factors that rating agencies take into account when assessing the economies resilience to shocks.

Likewise, a low debt/GDP ratio reduces the exposure of the public sector to foreign exchange risk and the exposure of the financial system to domestic market risk. Hence, it enhances financial stability.

The flexibility of the economy is also enhanced by a sound and efficient financial system. As is well known, domestic financial systems amplify and propagate external shocks to emerging markets economies, rather than helping smooth their effects. The build up of internal and external imbalances and the subsequent recession and financial crisis of the nineties in Colombia attest to the perils of a pro-cyclical behaviour of the financial system.

Our financial system is in good shape. It is deeper and more solid. During recent rapid expansion, solvency ratios have remained well above the minimum capital asset ratio (9%). Loan portfolio quality (measured by the percentage of risky loans) has improved steadily too, on average.

Also from the point of view of our balance sheets, it is encouraging that our current account deficit has been mostly funded by foreign direct investment. The level of private sector indebtedness does not seem excessive. In historical terms, there is less currency and maturity mismatches in balance sheets, and the amount of international reserves is at its highest level.

Finally, headway is being made in integrating us further with world trade through various means, one of the most important being bilateral trade agreements.