Inflation Strategy and Objectives in Colombia

Objectives

Monetary policy in Colombia is based on inflation targeting, which is intended primarily to keep inflation low and to ensure stable long-term growth in output. Accordingly, monetary policy objectives combine the goal of price stability with maximum sustainable growth in output and employment. In this way, monetary policy complies with the country's constitution and contributes to the well being of the Colombian population.

Horizon and Implementation

The Board of Directors of Banco de la República (BDBR) defines quantitative inflation targets for the current year and the next. BDBR policy initiatives are designed to meet each year's target and to provide for long-term inflation at around 3%. The annual variation in the consumer price index (CPI) is the inflation measurement used.

The Decision-making Process

Monetary policy decisions are based on an analysis of the current state of the economy and its prospects for the future and on an assessment of the inflation forecast compared to the inflation targets. If the assessment suggests, with enough certainty, that inflation will deviate from its target under current monetary-policy conditions, and that said deviation would not be due to temporary shocks, the BDBR modifies its policy stance. It does so primarily by changing the intervention interest rate (charged by Banco de la República on short-term liquidity operations).

Communication and Transparency

Decisions on monetary policy are made at meetings of the Board of Directors and announced immediately thereafter, in a press bulletin posted on the Bank's website (www.banrep.gov.co). The inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and add to its credibility. Specifically, they i) let the public know how the Board of Directors and the Technical Governor of the Bank view recent and anticipated changes in inflation and its short and medium-term determinants; ii) explain the implications of those determinants for monetary-policy management, within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions taken during the quarter; and iv) provide information that helps economic agents to form their own expectations about prospects for inflation and growth in output.

Assessment of Inflation and Policy Decisions

The rate of growth in domestic demand remained high during the first quarter, similar to what it was at the end of 2006. The external context continued to favor good external demand, capital inflows and high terms of trade. These factors point to good growth in gross domestic product (GDP) during 2007 and additional pressure on the economy's productive capacity.

The Board of Directors of Banco de la República (BDBR) has raised its intervention interest rate by 250 basis points (bp) since April 2006, as precaution against the emergence of inflationary pressure on demand. A partial pass-through of the Bank's interest rate hike to the deposit rate and to several lending rates in the financial system was evident at the end of the first quarter. The pace of loan portfolio growth remained high, but has slowed somewhat in recent months. The impact of the cumulative intervention interest rate hikes on credit, growth in aggregate demand and inflation, particularly inflation in non-tradable goods and services, is expected to be more evident during the second half of the year.

The rise in consumer inflation during the first quarter was more than expected, mainly because of changes in the price of food and certain regulated goods and services. Although part of the recent increase in food prices should abate during the second half of the year, the inflation forecasts for 2007 are up and the likelihood of meeting the inflation target for this year is less than the estimate published in the January edition of this report. However, non-food inflation should be near the center of the target range (between 3.5% and 4.5%) by the end of the year.

Summary of the Inflation Situation

Annual consumer inflation was 5.8% in March, which is more than at the end of 2006 (4.5%). The market was surprised by the outcome for inflation in recent months, which surpassed the estimates published in previous reports. As to the Bank's projections, most of the forecast errors dealt with food. Non-food inflation behaved as expected.

The rise in inflation is explained mainly by the trend in food and regulated prices:

- The main inflation shock so far this year originated with El Niño weather and its effect on food prices. Nearly 45% of the build-up in total inflation during the first quarter and 80% of the increase in March are related to the impact of El Niño.

- The escalation in international prices for agricultural products was propelled by the rise in oil and fuel prices, given the increased demand for bio-fuels. This exerted upward pressure on domestic prices as of mid-2006, particularly in the case of processed foods, which saw an increase in inflation from 5.8% at December to 8.5% at March.

- Food prices, particularly for meat, have been seriously affected by the boom in legal and illegal sales to Venezuela. They began to rise at the beginning of the year, coinciding with sharp price increases and the reports of food shortages in Venezuela.

- The increase in inflation in regulated prices so far this year is related to the rise in fuel prices throughout 2006 (10.4%) and the impact this had on transport prices, which experienced an increase in inflation rise from 6.6% in December to 7.7% in March.

The rise in non-food inflation from 3.9% in December to 4.4% in March was due primarily to regulated price inflation. Non-food inflation, excluding regulated prices, went from 3.4% to 3.8% during that period. However, other core inflation indicators were up as well, and the average of the three most commonly used indicators (nucleus 20, non-food CPI, and CPI excluding staple foods, transportation and public utilities) was 5.1% in March, having been 4.5% in December.

As part of non-food inflation, excluding regulated prices, inflation in non-tradable goods and services went from 4.7% in December to 4.9% in March. The rise in non-tradable inflation since September 2006 (when it reached 4.2%) and its deviation from the inflation targets is probably associated with the strong growth in demand and the decline in the economy's surplus productive capacity.

The following is predicted with respect to the emergence of shocks and how they might affect inflation in the future:

- Inflation pressure on food, as a result of El Niño weather, is temporary and should disappear during the second half of the year. However, the inflation pressure generated by exports to Venezuela is expected to continue throughout 2007. The pressure associated with international oil and bio-fuel prices will depend on how world demand responds to the high prices for products such as corn, sugar and vegetable oil, among others. As a whole, the food inflation forecast for the end of the year has increased from 5.8% in the last quarterly report to 6.5% in this report.

- Inflation in regulated prices is expected to decline during the second half of the year to 6% by December, which is similar to the forecast published in the last edition of this report.

- Given the sharp rise in food prices so far this year, annual food inflation is expected to decline substantially during 2008, at least during the first six months and provided no major shocks occur.

Tradable and non-tradable inflation (excluding food and regulated prices) during the next four to eight quarters will depend primarily on: i) the momentum in aggregate demand and changes in surplus productive capacity; ii) the way inflation expectations develop; iii) how the exchange rate behaves; and iv) wage hikes compared to labor productivity gains:

- In 2006, domestic demand (including inventory changes) was up by 9.9%, bolstered principally by investment in machinery and equipment. Growth in household consumption accelerated during the last six months of the year, going from 5.5% to 8.0%. The GDP growth forecasts for 2007 are between 5% and 6.5%, with an increase in domestic demand of about 8%, in the middle of the GDP growth range (5.8%). Household consumption, as part of domestic demand, should increase even more.

- Despite a considerable rise in investment, the various measurements of productive capacity showed historically high levels for the second half of 2006 and for the year to date. Based on the way a number of indicators have behaved, it is estimated that demand-pulled inflationary pressure on productive capacity has increased and should continue to do so for the remainder of the year. Nonetheless, the impact of previous interest rate hikes on demand is expected to be more evident during the second half of the year.

- According to various indicators, inflation expectations rose during the first quarter, along with the surge in inflation. Moreover, the survey of expectations conducted quarterly by Banco de la República shows the credibility of the inflation target for 2007 is low (26%), much less than at the start of the year (85%).

- There is a great deal of uncertainty surrounding the exchange rate forecast. However, trends in the balance of payments show higher international prices for commodities and larger private capital flows, primarily foreign direct investment (FDI), compared to the forecasts in the December quarterly report. These factors, as a whole, would result in a lower average rate of exchange than the one predicted in the December report. Consequently, by the end of the year, tradable inflation would be somewhat less than it is now.

- Available figures on wages and productivity suggest that, up to now, the increases in these variables have been aligned, which means little probability of inflationary pressure on wage costs. Nonetheless, this outcome should be viewed with caution, inasmuch as productivity has an important cyclical component and there are no indicators available for economic activities other than industry and commerce. For the remainder of the year and given the projected growth in GDP and its impact on the demand for work, the labor market could tighten, without ruling out the appearance of mid-term inflation pressure on labor costs.

How core inflation behaves in the coming quarters also will depend on the impact of the policies adopted in April 2006, which occasioned a cumulative hike of 250 bp in the intervention interest rate by April 2007. These increases have passed through, in part, to other interest rates in the economy. Since March 2006, the term deposit rate (DTF in Spanish) has increased by 156 bp, the average CD rate, by 178 bp, and the rates on CDs over 360 days, by 230 bp or more. Rates for short-term credit such as treasury or preferred loans are up by 200 bp or more.

Even so, there is evidence that the extent to which monetary intervention interest rate hikes have passed through to other rates in the economy and to the demand for credit has been affected by a shift in bank portfolios from TES to loans and by a growing preference for deposits with the financial system. The latter tends to raise the amount of funds available for bank loans. This is happening in an economy that continues to grow quickly and sustains agents' confidence to loan and borrow money.

Policy Decisions

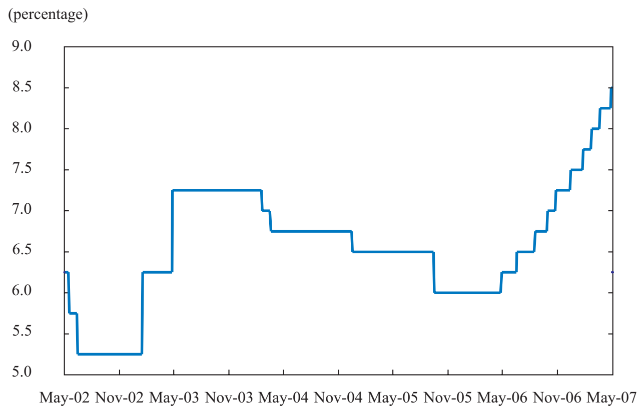
Macroeconomic data available for the first quarter confirmed the acceleration in economic activity and aggregate demand as of the last quarter of 2006. It also raised prospects for economic growth in 2007, above what was anticipated at the start of the year, and showed unexpected increases in inflation.

Although the build-up in inflation is explained primarily by supply factors and exogenous shocks to monetary policy, those shocks could translate into added inflation expectations and further pressure on prices and wages. The more prolonged the shocks over the course of time, the more likely this is to occur, as is anticipated in the case of inflation pressures derived from exports to Venezuela and possibly from international prices for certain agricultural products associated with bio-fuel production. If inflation expectations increase, more effort will be required in terms of monetary policy to maintain convergence towards the long-term target for inflation.

Another current risk to monetary policy is the possibility of excessive growth in demand compared to the increase in productive capacity. In this case, non-tradable inflation could swell even more, jeopardizing price stability and causing problems with respect to convergence towards the long-term target for inflation. Furthermore, the external deficit might grow to levels that threaten future macroeconomic stability.

Considering these elements and the foregoing assessment of the macroeconomic context, the BDBR decided to continue to reduce the monetary stimulus by increasing the Bank's intervention interest

Intervention Interest Rate
Repo Auctions



Source: Banco de la República.

rates. As a result of that decision, those rates were increased by 25 bp at each BDBR meeting in February, March and April 2007 (Graph), bringing the base interest rate for repo auctions to 8.5% by the end of April.

The BDBR continued its discretional intervention in the exchange market during the first four months of the year to curb peso appreciation and its impact on the productive sector and macroeconomic stability. In pursuit of that policy, Banco de la República purchased US$4,527.4 million (m) in foreign currency by April (Table).

On April 2, 2007, the BDBR activated auctions for interest-bearing non-reserve deposits at 7 and 14

Banco de la República Foreign Currency Purchase/Sale Operations
(Millions of dollars)

Item	2006 Acumulado Jan-Dic	2007 January	February	March	April	Accumulated Jan-Apr
Purchases	**1,780.5**	**1,001.6**	**1,022.9**	**1,836.7**	**666.2**	**4,527.4**
Put options	**583.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
To accumulate international reserves	0.0	0.0	0.0	0.0	0.0	0.0
To control volatility	583.8	0.0	0.0	0.0	0.0	0.0
Discretional Intervention	**1,196.7**	**1,001.6**	**1,022.9**	**1,836.7**	**666.2**	**4,527.4**
Sales	**1,944.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Call options	**944.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
To control volatility	944.3	0.0	0.0	0.0	0.0	0.0
National Government	**1,000.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net Purchases	**(163.8)**	**1,001.6**	**1,022.9**	**1,836.7**	**666.2**	**4,527.4**

Source: Banco de la República.

days to increase the Bank's capacity to offset the effects of monetary intervention. Later, it activated deposit auctions at 30, 60 and 90 days. The amount of these auctions will be defined in a way intended to keep the market's short-term interest rates in line with the Bank's intervention interest rate. The base rate for reverse repo auctions was set 10 bp below the one-day repo rate.

Moreover, unlimited seven-day deposits, in the form of interest-bearing deposits that do not constitute reserves held by the Bank, will be authorized at a Lombard contraction rate equivalent to the base rate for interest-bearing deposit auctions, minus 100 basis points. The Lombard contraction rate is now 7.40%.

To supplement its interest rate hikes, the BDBR introduced other measures to curb the growth in credit and aggregate demand. At a meeting on May 6, 2007, it imposed a non-remunerative marginal reserve requirement for domestic currency liabilities that exceed the level registered on May 7. The following percentages apply:

- 27% for checking accounts and other checkable deposits
- 12.5% for savings accounts and similar deposits
- 5% for certificates of deposit under 18 months and similar time deposits.

The foreign debt deposit stipulated in External Resolution 08/ 2000 was reinstated to prevent the interest rate hikes and the new reserve requirements from leading to an influx of short-term capital. The deposit is held for six months and equals 40% of the disbursed amount, calculated at the representative market rate of exchange (TRM in Spanish) on the date the loan is furnished.

Finally, the leveraged position of derivative operations carried out by foreign exchange market intermediaries was limited to 500% of their technical capital. In this case, the goal is to reduce the risk to foreign exchange brokers by restricting their possibilities to hedge positions via leveraging. It also supplements the requirement calling for an external debt deposit.

Board of Directors, Banco de la República