Introduction

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In 2006, the rate of economic growth in Colombia (6.8%) surpassed all projections, even those calculated by Banco de la República. This represents a surge in economic activity compared to 2004 (4.9%) and 2005 (4.7%), consolidating a healthy increase that makes Colombia one of the countries in Latin America with the fastest growing economy.

The characteristics of the increase in 2006 bode well for continued growth in the years ahead. For example, the increase in gross capital formation, especially in machinery, equipment and construction, was largely responsible for the expansion in the economy, contributing to an increase in productive capacity and productivity.

The outcome for 2006 is clear. Economic growth encompasses a number of goods and service sectors, such as the construction industry, commerce and transport. Performance in the agricultural sector, which saw 4% growth during the fourth quarter of 2006, is another high point and was mainly the result of a good coffee crop. The recovery in household consumption, which was hard hit during the crisis in the nineties was consolidated in 2006. This introduces an important factor for economic growth that will be a fundamental driving force in the months ahead.

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The context surrounding the consolidation of economic growth during 2006 was one of less inflation. Consumer inflation that year was 4.5%, precisely at the center of the target range and below inflation in 2005 (4.9%). The rate of inflation in 2006 completes three consecutive years of rigorous compliance with the targets set by the Board of Directors of Banco de la República (BDBR). This adds to the credibility of its monetary policy, helping to focus inflationary expectations on the announced targets. It also is an important step forward, by reducing the inflationary inertia that was common in the past and made it difficult to lower inflation.

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Figures from the Home Survey conducted by the National Bureau of Statistics (DANE) show an increase in unemployment, which seems strange in an economy with a healthy growth rate. A number of factors that might offer an explanation are analyzed in this report. One could be the difficulty in comparing figures, because of the changes introduced in the survey as of the second half of 2006. However, other sources of information, such as direct surveys of the business community, point to the possibility of strong employment gains in specific sectors. Commerce and industry are two examples. The increase in the number of affiliates in the social security system also seems to reflect the positive impact of economic growth on employment.

The favorable economic environment, with fast growth and lower inflation, has been accompanied by gradual appreciation of the Colombian peso. This has sparked logical concern in sectors that export and compete with imports. It is particularly important to understand that peso appreciation originates largely with the force of the Colombian economy, which has bolstered confidence among foreign and domestic entrepreneurs, who are investing heavily in the country or repatriating resources saved abroad. The appreciation of currencies against the dollar is a phenomenon that affects most economies and is associated with the imbalances in the United States economy and the surplus liquidity in its markets. Moreover, a great deal of capital from the sale of public and private assets entered the country in the early months of 2007.

Under these circumstances, the objective of the exchange market intervention policy is to tone down abrupt and temporary appreciation or depreciation, without trying to modify the trends explained by the economy's fundamental determinants. At the same time, intervention in the exchange market is done within the limits determined by the inflation-targeting strategy, without jeopardizing compliance with the target for inflation. In fact, as demonstrated by the outcome for inflation between 2004 and 2006, respect for the limits on exchange market intervention has been no obstacle to meeting the targets for inflation.

The build-up in economic indicators also reflects the positive trend in the Colombian economy. As discussed in this report, there have been major improvements in the external vulnerability indicators, represented in net international reserves that now exceed US$17 billion (b). This amount of reserves offers the economy important protection against the serious consequences that could come with a negative external shock.

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The same is true of the risk and performance indicators for the financial system. Profitability indicators are at historically high levels and the system's capital soundness far exceeds the required minimum. The vigorous loan growth during 2006 occurred in a context of good loan portfolio quality indicators and high coverage.

Given the favorable economic environment, it is important not to ignore the risks to economic stability and sustainable growth. Obviously, the increase in demand could exceed productive capacity, exerting inflationary pressures that could undermine confidence and eventually affect economic growth. To keep this from happening, the Board of Directors has gradually raised the intervention interest rate in the money market since April, based on a careful technical analysis. The objective is to slowly eliminate the monetary stimulus being provided to the economy, which now is unnecessary.

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Another risk involves the rapid expansion in aggregate demand, which could raise the current account deficit in the balance of payments to an unsustainable level. The gradual increase in interest rates helps to prevent this from happening by curbing the aggregate demand and, with it, excess spending of economic earnings. In a macroeconomic sense, the latter is tantamount to the current account deficit.

If criteria on lending and risk are relaxed during an economic boom, accelerated growth in the loan portfolio can jeopardize portfolio quality. The gradual increase in monetary intervention rates helps to temper loan portfolio growth. In doing so, it also reduces risks to the financial system. However, on this front, it is important to establish prudent regulations of an anticyclical nature, particularly along the lines of those being developed by the Superintendent of Financial Institutions.

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Monetary policy can be used to prevent these risks and to help preserve growth in an economically stable environment. Nevertheless, its capacity should not be overestimated. For this reason, a policy of fiscal restraint that is consistent with the prevailing monetary policy and contributes to economic stability and sustained growth is indispensable. In this respect, efforts to control government spending help to avoid excess aggregate demand in the economy, which is accompanied by inflationary pressure, currency appreciation and current account deficit.

This report is organized into chapters. The outcome of inflation in 2006 and the outlook for 2007 are presented in Chapter I. Chapter II contains an account of economic activity in 2006 and projections for 2007. The recent trends in the labor market and the possible reasons why unemployment has not declined are examined in Chapter III. The monetary policy and exchange intervention strategy are reviewed in Chapter IV. The changes in financial markets, interest rates and monetary aggregates are analyzed in Chapter V, which also contains an evaluation of the quality and risk indicators for financial institutions. The balance of payments is outlined in Chapter VI and the fiscal policy, in Chapter VII. International reserves and the external vulnerability indicators are discussed in Chapter VIII. Banco de la República's financial situation is described in Chapter IX.

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This report also contains a series of special sections or boxes on topics that are considered important to an analysis of the current economic situation: Box 1: Is the economy heating up?; Box 2: Inflation-targeting Worldwide; Box 3: Interest Rate Pass-through to the Economy; Box 4: Anti-cyclical Provisions; Box 5: Foreign Direct Investment during 2006; Box 6: Fiscal Policy and the Economic Cycle; and Box 7: The Public Debt and Macroeconomic Stability.