

DEVELOPMENTS IN THE INFLATIONARY SITUATION AND MONETARY POLICY DECISIONS

In March 2010, annual inflation was 1.84%, 25 basic points (bp) lower than in February, and below by 16 bp the figure recorded in December 2009. This decrease in annual – and particularly March - inflation, was not forecast by the technical team of *Banco de la República*, the Central Bank of Colombia, neither by the average market analysts since inflation was expected to increase in the first quarter of the current year.

Inflation overestimation was partly based on the projection of the Consumer Price Index (CPI) for food. By the end of 2009, the presence of the so-called El Niño event and its adverse effects on weather and harvest made predict that the prices in this group would rise since early 2010, though with stronger emphasis on the second and third quarters. However, notwithstanding the fact that in March some prices of perishable products recorded significant rises, the annual total food CPI variation was 0.34%, therefore a lower result than expected.

Several facts may have counteracted the adverse effect of the El Niño event presence on food prices. Firstly, restrictions of trade with Venezuela enhanced the domestic supply of meat, vegetables and other processed products formerly exported to that country. Likewise, the stability seen in some international prices along with the appreciation of the exchange rate, did contribute as well to a lesser increase of imported food prices. On the other hand, demand weakness and a rise in salary costs that were more coherent with the long-term inflation target have caused prices of items such as food away from home to show a significant slowdown since early 2009. Finally, important improvements in both food distribution channels and production should not be ruled out as price-increase mitigating factors.

Although the above aspects serving to mitigate the impact of the El Niño event with respect to food prices were taken into account in the preparation of the previous report projections, their slowdown incidence has been more intense than expected. For this reason, the technical team anticipates increasing food prices, but at a lower rate than those projected in December. Therefore, this

temporary price shock is likely to continue being felt even more intensely in the second and third quarters of 2010, but in this occasion it would not lead to total inflation beyond the target range, such as it had been predicted in the previous report for these periods. The reversal of the food price shock would take place by the end of the year and early 2011. In this way, the improved behavior of the food CPI reduces the risks of second-round effects on the other prices in the economy.

Inflation slowdown took place as well in the CPI without food (2.4%). Similar behavior was shown by the other core inflation measures and, as of March 2010, the mean of the four measures officially calculated by the Bank was set at the lower stripe of the target range.

Within the CPI without food, the greatest drop in annual growth was seen in the tradable group, which has been going through a continuous deceleration process since 2009 to finally stand at 0.27% in March of the current year. The exchange rate appreciation and a negative output gap partly explain this behavior, although to a lesser extent, since last August, non-tradables have shown a diminishing annual increase rate and, as of March 2010, reached 3.98%. As for the regulated group which in the course of 2009 had been decelerating, they experienced an upturn so far in 2010 and recorded an annual increase of 3.37% in March.

With regard to economic growth, the real GDP results published by the DANE (the National Administrative Department of Statistics) for the last quarter of 2009 accounted for better dynamics than expected, mainly explained by the behavior of Government consumption and civil works. Household expenditures recovered as well, but at a slower rate than their historical average. The real increase in exports and imports remained in negative terrain.

For the first quarter of 2010, the available economic activity indicators show an economy growing at a faster rate than projected. Factors such as the best results of world economy, a revived confidence in agents, and the dynamism of several leading indicators, evidence the strength of this dynamics. For the whole year of 2010, the technical team has been foreseeing an economic growth between 2% and 4%, the mid-point being the most likely to occur. Despite this recovery, the output gap would continue to be negative, which may imply a reactivation with no inflationary pressures.

At the labor market, the employment increase has not offset the higher labor supply and, as a result, the unemployment rate is still remaining at high levels. By eliminating the effects of seasonal unemployment series, the trend suggests that this variable would stop growing and even go down. Any way, the labor market will continue to be loose, with low pressures on salaries. In addition, the employment increase continues to concentrate in the informal and low-quality sector, a fact likely to affect consumer confidence and prevent a more accelerated increment of household expenses.

So far this year up to March, the broader monetary aggregate (M3) kept a relatively stable annual growth close to 7%. A similar behavior was shown by the total gross portfolio in national currency, with an annual increase of nearly 5%. The mortgage portfolio continued to show important annual increments, and the consumer portfolio went on recovering slowly but on a continuous basis. The commercial portfolio was the less dynamics, this being explained partly because of big enterprise prepayments and the issue of real sector bonds. The Holy Week seasonal change affected portfolio indicators as well.

In the last semester, the downturn of both passive interest and commercial credit rates ceased. On the other hand, interest rates for households, particularly for consumption and, to a lesser extent, mortgage rates, began to decline again. In real terms, both passive and active rates increased in March due to deceleration of inflation index without food.

In the external overview, world growth continued to accelerate thanks to the recovery of the big emerging economies and the United States economy. Generally, economic growth results tended to be better than expected and, for this reason, GDP forecasts for 2010 boosted. The remarkable exception has been Europe where the high public debt levels and doubts about their sustainability in countries such as Greece, Portugal and Spain, have put the soundness of the euro zone to test. To this date, market uncertainty about the type and amount of help the member countries will give to Greece, together with the requisites they would demand in exchange for any such help, have led to devaluations at the international stock exchange markets and a fall in the value of currency, particularly the euro, with respect to the dollar. Therefore, the impact this crisis may have on the other two countries and on the dynamics of the world economy will depend upon a solution to be given by the European Community.

In brief, in the first quarter of 2010, total inflation as well as all the CPI disaggregations traditionally calculated by the Bank (such as coves, food, regulated, tradable without food, non-regulated and non-tradable without food, and regulated items), are below the upper limit of the target range. All of the measurements decelerated, with the exception of the regulated and food groups. The foregoing gave origin to a decline in the Central Bank's inflation forecasts and market inflation expectations, and enhanced the likelihood of meeting the price increment goal in the current year and the years to come.

Notwithstanding the increased growth of the economy, the output gap remains negative; this fact, added to the good behavior of inflation and the expectations, allows an even more expansive monetary policy without compromising inflation targets and macroeconomic stability.

For the above reasons, in their session of 30th April, the Board of Directors of the Central Bank of Colombia (BDCB) has decided to reduce the intervention interest rate by 50 bp in order to establish it at 3%. Given the higher deposits

by the General Treasury of the Nation in the Central Bank, the Board decided as well to stop the sale of the Colombian peso-denominated bonds known as TES that it was carrying out on a monthly basis in order to counteract the monetary effect of reserve accumulation.

The BDCB will continue to carefully monitor the international situation, together with inflation behavior and forecasts, and it reiterates that the future monetary policy will depend on the new information available.

Board of Directors of the Central Bank of Colombia