

INTRODUCTION

The margin of maneuverability a Banco de la República has to defend price stability, to encourage growth and employment, and to curb fluctuations in the exchange rate depends mainly on its credibility with society. It is this credibility that keeps inflationary expectations on target and expands the range of policies a Banco de la República has to achieve its objectives. Accordingly, credibility is the most important asset the monetary authority can have and is a public asset for society as a whole.

As Congress is well aware, the Banco de la República steers monetary policy towards a low and stable rate of inflation. This is an important objective, inasmuch as price stability is essential to enhancing the well-being of the population on a long-term basis and to creating an atmosphere of confidence and stability that is conducive to greater investment, employment and productivity. Monetary policy in Colombia is based on the inflation targeting strategy. This involves explicit quantitative goals for the rate at which prices increase, so as to guide expectations and to give the public a clear basis for assessing the effectiveness of monetary policy. In practice, the search for price stability as part of the inflation targeting strategy is coherent with the effort to smooth economic cycles. When projected inflation is below target and output is below its long-term tendency, monetary policy is looser. This helps to stimulate economic growth. When projected inflation is above target and output exceeds its potential level, monetary policy becomes stricter in an effort to curb rising demand and inflationary pressures. Therefore, the success of a policy based on inflation targeting consists of achieving the maximum amount of growth in employment and output that is consistent with price stability.

The performance of the Colombian economy and the way monetary policy has been managed during the current decade show how this approach operates. The Banco de la República has lowered its intervention interest rates by 550 basis points (bp) since 2000, amidst an economy that grew below its potential after the crisis in the late nineties. As a result of these policies and other factors, the economy has grown by nearly 4% in the last two years. Inflation in 2004 was on target and continued to decline towards its long-term levels. Investment returned to historic levels and employment increased. The quality of employment improved substantially in 2004 and the number of full-time jobs rose by 4.3%, which is the highest rate in several years. Nevertheless, output has yet to reach its long-term levels and jobs still are not being created fast enough.

The peso has appreciated as of the second quarter in 2003 and there continues to be surplus of productive capacity in the economy. Both these factors have helped to lower inflation and expectations of inflation. Given these circumstances, the course of monetary policy has been more expansive. The Banco de la República lowered interest rates on its open market operations and has purchased foreign exchange on the market. Intervention in the exchange market is considered useful to avoiding sharp and prolonged deviations in the exchange rate with respect to its long-term trend, as subsequent corrections in this rate could have a negative impact on economic stability, price levels and financial stability.

Based on these considerations, the Banco de la República purchased US\$2,905 million (m) in 2004 and increased the stock of international reserves by nearly 25%. In absolute terms, this figure is the highest in the country's history; in percentage terms, it is one of the highest in the world. This policy staved off increased appreciation of the peso, which would have had a negative effect not only on economic activities that are exposed to international competition, but also on the sustainability of mid-term growth. As mentioned earlier, this operation was accomplished without affecting the inflation target and without interrupting the gradual decline in inflation to its long-term levels.

If the economy expanded beyond its capacity, these monetary policy and exchange measures would not have been possible. Under such conditions, intervention by the Banco de la República to mitigate peso appreciation would imply purchases of international reserves, liquidity growth and an incentive to spending, all of which are inconsistent with the inflation goals. The end result of this intervention would be negative for employment, well being and the credibility of the monetary policy. By the same token, a monetary and exchange policy aimed at a depreciated real exchange rate, contrary to its fundamental determinants, would raise inflation without affecting the trend in the real exchange rate and also would jeopardize the credibility of the country's monetary policy.

The margin of maneuverability a Banco de la República has to defend price stability, to encourage growth and employment, and to curb fluctuations in the exchange rate depends basically on its credibility with society. It is this credibility that keeps inflationary expectations on target and expands the range of policies a Banco de la República has to achieve its objectives. Accordingly, credibility is the most important asset a monetary authority can have and is a public asset for society as a whole. To uphold and enhance this credibility, the monetary authority must be conscious of the limits of its action and convey them to society in a clear and transparent way.

The present report illustrates the outcome of the inflation targeting strategy in terms of the continued decline in inflation and the incentive to growth

in output and employment. Chapter I summarizes economic activity and employment in 2004 and the prospects in this respect for 2005. Chapter II discusses the trend in inflation, its determinants and outlook for the future. The factors that explain recent appreciation in the exchange rate are analyzed in Chapter III, while Chapter IV offers an explanation of how the inflation targeting strategy works and the coherence of exchange policy measures adopted by the Banco de la República to restrain peso appreciation, without jeopardizing the inflation target. The country's fiscal policy is analyzed in Chapter V, and the position of international reserves and the how they are managed is described in Chapter VI. Finally, Chapter VIII reviews the financial position of the Banco de la República and projected income and expenses for 2005.