Inflation at June and the Outlook

- Consumer inflation declined slightly to 3.9 % in June, mainly because of the drop in food inflation. The reduction in consumer inflation during the second quarter is explained by supply factors: lower prices for a number of perishable foods and the decline in inflation in regulated goods/utilities.

- The rise in the exchange rate since April has yet to be reflected fully in the consumer price index (CPI). Depreciation usually affects consumer inflation whit a three-months lag, which means the impact would not begin to be evident until July. However, there already has been an increase in producer inflation. If it continues, this would imply pressure on costs. On the other hand, non-tradable inflation without food and regulated goods/utilities has been stable for the past year. This suggests the increase in demand is not reflected in higher inflationary pressures, or that these have been neutralized by declining inflationary expectations that are consistent with the inflation target for 2006 and the range to be defined for 2007.

- The wage hikes observed during the year to date exceed current inflation and the target. However, the unit labor cost measured for industry is down as a result of important increases in labor productivity, which were evident in other urban sectors as well. Monetary policy decisions necessitate determining if these improvements in productivity are due to cyclical factors or temporary or permanent supply factors. There is still not enough information in this respect, and the behavior of the different indicators will have to be assessed further.

- In this report, the analysis of the macro economy and its prospects for the future is not radically different from that in recent editions.

    - In real terms, the Central Bank's interest rate and interest on deposits with the financial system remain at historically low levels.

    - Use of installed capacity is at its historic average values and measurements of the output gap suggest levels near zero, even considering the uncertainty surrounding these estimates.

  - Expectations of inflation for 2006 and 2007 continue to be consistent with the Bank's inflation targets.

  - External conditions remain favorable: external demand and terms of trade contributed to the rise in exports and the increase in national income. High volatility on the financial and stock markets and the increase in risk perception during the second quarter did nothing to change this situation, but did affect some capital flows, especially the short-term variety. As of late, the financial and stock market indicators have seen some recovery and less volatility, while the country-risk premium has declined.

  - Household and business confidence remains high, in keeping with what the surveys show. Under these circumstances, the economy continues to grow, supported by domestic demand, which has increased by an annual rate of 8%. The main items in this respect are the acceleration in household consumption and the high rate of investment.

- Given these conditions, the Board of Directors of Banco de la República (BDBR) has said the Colombian economy requires no monetary incentive to continue to operate satisfactorily. In fact, there are several reasons why the monetary incentive will have to be reduced gradually to lower inflation in the direction of the long-term goal.

  - If real interest rates remain low and external and domestic factors continue to favor an increase in spending, the momentum in aggregate demand would continue, making it harder in the future to lower inflation in non-tradable goods and services.

  - If part of the rise in external interest rates or in the country-risk premiums is lasting, the same will apply to a portion of the increase in the real exchange rate, and the relative price of tradable goods will tend to increase. This means tradable inflation will have less of an impact than before on lowering inflation.

  - Credit accelerated, although there was no change in real lending rates; some even declined. This increased momentum probably has broadened the current impact of the monetary incentive on aggregate demand.

- At its meetings on April 28 and June 20, the BDBR ruled an increase in intervention rates based on these considerations. No changes to this effect were adopted at the May 26 and July 27 meetings. These decisions consider the fact that monetary policy operates with a relatively long lag. This means the required adjustments must be made well in advance so as not to jeopardize future targets for inflation and the credibility of the policy itself.

- These decisions also ratify the gradual nature of the changes in the stance of Colombia's monetary policy. Given the uncertainty under which monetary policy operates, a gradual approach to decisions makes it possible to include new information that helps to redefine the BDBR's perception of important macroeconomic aspects such as changes in productivity, use of installed capacity, the extent of competition in different markets and the movement of international capital markets. These elements are crucial to a macroeconomic diagnosis, but are surrounded by a great deal of uncertainty. A gradual approach to adjustments in the stance of monetary policy also avoids excessive volatility in interest rates, output and employment. However, it is important to recognize that a gradual approach is possible due to the positive trend in inflationary expectations and the credibility acquired by the country's monetary policy.

Board of Directors
Banco de la República