

# DEVELOPMENTS IN THE INFLATIONARY SITUATION AND MONETARY POLICY DECISIONS

At the end of the second quarter of 2010 inflation in Colombia was at 2.25%, a figure that is lower than what was projected by not only the Bank but also by the market on the average. This occurred together with an economic growth that, according to the most recent report from DANE as well as the new information that was available, has been higher than expected. The reductions in the Bank's benchmark interest rates, in turn, continued to be transmitted to the market interest rates and credit continued registering better rates of growth.

With respect to inflation, the upward risks related to the Niño phenomenon and its effect on the prices of food and regulated goods and services which were reported at the end of 2009 and beginning of 2010 were curtailed, due to that the final impact on these baskets ended up being minor. Furthermore, even though the decline in some of the core inflation indicators was halted, their levels and trends suggest that inflationary pressures are under control and that said indicators will remain within the long term target range fixed by the Banco de la República Board of Directors (between 2% and 4%) for what is left of the year. These results have had an influence on the inflation expectations of agents. These expectations have dropped over the course of the year and are within the long term inflation target range.

With respect to economic activity, the National Bureau of Statistics (DANE in Spanish) reported that in the first quarter of 2010 the GDP grew 4.4%, a figure that is higher than what was projected by the market, on average, as well as by the Bank. Part of the higher economic growth was due to the change in the methodology used to calculate national accounts. The other part was due to the better than expected performance of economic activity that was primarily because of the more substantial government consumption and exports that fell less than was budgeted for.

For the rest of the year, the new information that is available from the indicators such as consumer confidence, imports of durable consumer goods and retail sales suggest that household consumption will continue to recover.

The upswing in imports of capital goods, especially for industry, is also a symptom that investment in fixed capital could show growth that is similar to what was seen in the first quarter of 2010, especially investment other than public works projects.

So far this year, the recovery in consumption and investment is also explained by the actions on the part of monetary policy which took interest rates for loans to historically low levels and likewise contributed to a better performance for credit. In fact, since the change in monetary policy posture, which began in December 2008, the interest rates for the different types of savings and loans declined at a similar pace and, in the case of the rates for consumption loans, they fell at a faster rate than the reductions in the Bank's benchmark interest rate. So far to date, the annual increase in the total gross loan portfolio stabilized at rates that were close to 5% after the slowdown that occurred last year. As of June 2010, the strongest portfolios were mortgages (22.2%) and consumer (8.9%). The changes in loans going to households together with the transmission of the Bank interest rate to the market interest rates is evidence that the banking credit channel is active and that it will continue stimulating the aggregate demand.

The better pace of growth for domestic demand has occurred in the context of a sharp drop in Colombian exports to Venezuela and of a better than expected worldwide growth. In the case of our main trading partner, the United States, the recovery has occurred hand in hand with an unemployment rate that has not shrunk, a loan market that remains depressed and a declining public stimulus. These facts raise questions about the sustainability of the economic reactivation in that country.

Meanwhile, the fiscal problems of some European countries raised the risk premiums for the whole world though to levels that are much lower than the ones that were seen right after the bankruptcy of Lehman Brothers. Towards mid-May the fiscal and monetary support announced by the European Central Bank, the European Community and the International Monetary Fund for those economies having problems made the risk premiums ease off. Thus, various currencies of emerging countries appreciated again with respect to the dollar and euro, a tendency that the Colombian peso also followed.

This being the case, it is probable that foreign demand will remain weak though recovering for the rest of the year and that the interest rates set by the central banks' of the main developed economies will remain low. The international prices for the main commodities that Colombia exports could stay at levels that are higher than those registered in 2009.

Because of all of the above, the Bank's technical team raised their forecast range for 2010 from an interval of between 2.0% and 4.0% to one that is between 3.5% and 5.5%. Although this new range implies an upsurge in economic growth that is greater than expected, the indicators of installed industrial capacity and the weakness in the labor market and in foreign demand suggest that the output gap could come to an end this year and even go into negative territory towards the middle of next year.

With this macroeconomic environment, in the months of May, June and July 2010 the Board of Directors of the Banco de la República (JDBR in Spanish) decided to keep the benchmark rate unchanged at 3% and expect that a policy rate at that level would contribute to short term growth without putting the inflation target for this and next year at risk. The Board also reiterated that the future monetary policy actions would depend on new available information.

**Board of Directors of the Banco de la República**