Introduction

Despite great uncertainty on the international front, the Colombian economy continued to grow at a faster pace than its average since 2000, thanks mainly to household consumption.

The first half of 2012 saw, besides relatively robust economic activity, progressive convergence of inflation toward the 3% long-term target, with the rate falling from 3.73% in December 2011 to 3.2% in June 2012.

To avoid excessive borrowing in the private sector and to reduce inflation to 3%, the Bank's Board of Directors decided to raise the intervention rate by 25 basis points in January and a further 25bp in February, up to 5.25%. Subsequently, in view of greater weakening of the global economy, which is already affecting Colombia's economy, the Board decided on July 27 to lower the rate by 25bp to 5.0%.

In the first quarter of 2012 international markets were optimistic about the likelihood of a solution being found to the European crisis and US economic recovery gathering momentum. But this optimism faded away in the second quarter as political and financial tensions grew in Europe and economic performance in the US proved to be less than expected. This was reflected in loss of stock values on exchanges, weaker global demand, lower oil and commodity prices and higher risk premiums.

The market optimism shown in the first quarter of 2012 was dispelled in the second quarter by greater political and financial tensions in Europe.

The year began relatively well thanks to confidence inspired by the new support plan for Greece with private-sector participation, and to the European Central Bank's decision to provide abundant market liquidity. In addition, good growth began to be shown by developed economies such as Germany and Japan, and in the US there were signs of improvement in the labor market and of recovery in industrial activity. This positive climate deteriorated fast around May on account of political uncertainty in the euro zone, a heightening of Spain's banking-sector problems, and release of discouraging US growth figures that pointed to the continued existence of many structural problems in the US economy. Moreover,

Despite high uncertainty and volatility on the international front, Colombia's economy grew by 4.7% in the first quarter of 2012.

declining global demand resulted in considerable slowdown of economic activity in China and other emerging Asian economies and also in Brazil.

Economic nervousness on the international front subsided somewhat as political uncertainty in the euro area decreased and the European authorities began to make progress on issues of banking integration and strengthening of the rescue fund.

Amid so such external uncertainty and volatility, the Colombian economy has shown considerable macroeconomic stability, becoming more attractive to foreign investment. In the first quarter of 2012, annual GDP growth was 4.7%, slower than growth in 2011 (5.9%) but faster than the average for the decade of 2000 (4.3%) and similar to the economy's estimated potential capacity.

The Colombian economy's growth in such a problematic international setting resulted from domestic demand remaining high, particularly household consumption, which expanded by 5.9% and contributed 3.8 percentage points to first-quarter growth. Strong consumption, in turn, resulted from lower unemployment, firm consumer confidence, and rapidly rising consumer borrowing (21% annual growth in the first quarter, much the same rate as in the previous two quarters). Investment grew by 8.3%, faster than GDP but much more slowly than in 2011. The slowdown in investment came from a fall in civil works (-8.1%), including road-infrastructure construction, transportation equipment and constructions for mining. Lastly, the first quarter saw the effects of deterioration in the international situation on Colombian foreign trade, with growth falling in both exports (6.3% against 11.4% in 2011) and imports (13% against 21.5% in 2011). The slowdown in external sales affected all kinds of goods, particularly mining and industrial products, while imports lost pace because of declining growth in purchases of capital goods, particularly transport equipment, and commodity imports. The different branches of activity exhibited a mixed behavior. Some sectors, such as mining, transportation and financial services, continued to expand at much the same pace as in 2011. Others, such as farming, industry, construction and commerce, slowed down, significantly in the case of farming and industry, because of supply problems in some cases, and in others because of weakening global demand, as discussed in detail further below.

The Colombian economy's first-quarter growth resulted from domestic demand, particularly a 5.9% increase in household consumption.

Despite the slowdown in economic activity, labor-market conditions continued to improve during the first months of the year compared with conditions twelve months earlier. According to the National Statistics Agency (DANE), in May unemployment for the country as a whole stood

In a context of relatively good growth in economic activity, inflation over the first half of 2012 converged toward the long-term target of 3%, from 3.7% in December 2011.

at 10.7%, down by 0.5 pp on May 2011, and for the thirteen major cities at 11.9%, up by 0.9 pp. Moreover, the quality of work has improved so far this year, with the number of wage earners in the thirteen cities growing on average by 5.0% up to May and the number of non-wage earners by 3.8%. Higher growth in wage employment has been boosted by the sectors of construction and industry, while slower growth in non-wage employment has resulted from a fall in the number of domestic workers and farmhands.

In a context of relatively good growth in economic activity, inflation over the first half of 2012 gradually converged toward 3%, the long-term target set by the Bank's Board of Directors. At the end of 2011 inflation stood at 3.73%, and by the end of the first half of 2012 it had dropped to 3.2%. Several factors have contributed to this drop, the most important perhaps being a significant decrease in inflation expectations: from more than 3.5% on a 12-month horizon and more than 4% on longer horizons, at the end of 2011, to around 3% today. This decrease in inflation expectations, which has helped to moderate price increases in many basic items, has resulted in good measure from a monetary policy that has reaffirmed by actions its commitment to control inflation.

Other factors that also helped to reduce inflation in the first half of this year included, notably, lower international oil prices, which allowed the government to moderate price increases for gasoline and other fuels. With the result that in June the annual rate of fuel price increase was just 1.84%, (down from 4.8% in December), which in turn led to lower increases in public-transport charges. Another major factor has been moderate price rises for food, particularly perishables, thanks to improved weather conditions that have greatly increased agricultural supply. Lastly, cost pressures in the first half of 2012 have been slight, as evidenced by the producer price index, which plunged from an annual rate of 5.5% in December to -0.69% in June. Lower cost pressures resulted from lower prices for oil and other commodities and from appreciation in the exchange rate.

The drop in inflation resulted largely from the decline in inflation expectations brought about in good measure by an active monetary policy committed to inflation control.

On the basis of rigorous analysis of the state of the economy and the outlook for inflation, the Bank's Board of Directors decided to raise the intervention rate by 25bp in January and by a further 25bp in February, up to 5.25%. This decision was consistent with the aim of keeping inflation low and stable and smoothing out fluctuations in output around a path of sustained growth. The Board's reasons for adopting this stance, as explained in good time through statements by the Board, minutes of Board meetings and Inflation Reports, consisted of the need to moderate rising

To prevent excessive borrowing and ensure stable growth, the Board raised the intervention rate by 25bp in January and by a further 25bp in February, up to 5.25%

domestic demand, prevent excessive private-sector borrowing, and ensure the economy's growth in line with its potential.

The monetary-policy measures described above have helped to ensure convergence of inflation toward the 3% target and to preserve macroeconomic stability. Their effects have been transmitted in due course to interest rates in the economy on savings and loans, thereby moderating growth in household spending and borrowing.

Subsequently, the Board cut the intervention rate by 25bp to 5% at its meeting on July 27, 2012. This decision was taken on the basis of a detailed assessment of the current state of Colombian and global economy, forecasts for inflation and growth, and analysis of different risks. Special weight was given to the global economy's greater-than-expected weakening, which has slowed Colombia's economic growth through lower external demand and lower international prices for the country's main exports. Particular attention was also paid to the favorable behavior of inflation expectations and their forecast for this year and next.

As in previous years, the peso's nominal exchange rate against the dollar has shown a mixed behavior so far this year. So, for example, it appreciated in January and February (as did other currencies of the region) because of a lower perception of international risk. In March and April the peso remained relatively stable in the face of a diversity of global news. In May it exhibited a depreciation trend, as the perception of international risk was increased by political uncertainty in Greece and banking-sector problems in Spain. In June the peso began to come under pressure again to appreciate, on the strength of a number of decisions by European leaders that reassured the markets.

Subsequently, the Board cut the intervention rate by 25bp in July because of greater-than-expected weakening of the global economy, which has in turn slowed Colombia's economy.

The real exchange rate, which takes into account relative external and domestic prices, is a better indicator of competitiveness than the nominal rate. It, too, has been mostly subject to appreciation pressure. From January to June the real exchange rate appreciated on average by 3.9% based on the producer price index, and by 5.1% based on the consumer price index. As a result, the real exchange rate index fell below its average historical levels. This trend is shared by several of our trading partners and has been caused by weakness of the global economy, greater confidence in emerging markets, and favorable terms of trade with the resulting capital inflows, particularly of direct foreign investment.

To moderate exchange-rate volatility and maintain a level of international reserves consistent with the size and needs of Colombia's economy, the

In the first half of 2012 nominal exchange-rate behavior was mixed and volatile because of international uncertainty, whereas the real exchange tended to appreciate.

Banco de la República has continued to apply the policy of accumulating reserves through competitive auctions of at least $20 million a day. According to the latest statement from the Board, this policy is to be extended at least up to November 2nd of this year. Auctions during the first half of the year provided $1,959m, raising the total of international reserves to $34,272m by the end of June. Colombia is thus able to keep its international-liquidity indicators at levels in line with the patterns recommended by organizations such as the International Monetary Fund. This places the country in a secure position for dealing with any unexpected capital outflows caused by such factors as deterioration in the terms of trade, financial panic, or international financial crises. It also helps to reduce the country's external vulnerability and maintain confidence in the economy. The international-liquidity indicators presented in this Report include notably, among others, the ratio of net international reserves to foreign-debt repayments to be made the following year. In 2012 this ratio is over 1.6, indicating that the economy is fully capable of meeting its loan obligations to the rest of the world, should access to international finance be curtailed. Colombia's international-liquidity ratios are similar to those of other economies of the region such as Chile, Mexico and Brazil.

Furthermore, on May 6, 2011 the IMF approved a two-year line of contingent financing for Colombia in the amount of 3.87 billion special drawing rights, equivalent to $5.98bn at May 4, 2011, providing the Colombian economy with considerable supplementary liquidity in the event of external funding being abruptly cut off.

In today's highly uncertain and complex international environment, it is particularly difficult to define economic outlooks. At all events, economic growth in the euro zone is expected to be negative in 2012, and pressure in public-debt markets is projected to continue affecting business and consumer confidence. Nevertheless, recent measures announced by European leaders to promote greater financial and fiscal integration have made a disorderly solution to the crisis less likely. In the case of the United States, everything points to GDP growth continuing to run below the historical average (2.4% since 1990) this year and next, because of persisting structural problems and the declining pace of global demand. Emerging economies, including China, are also experiencing a slowdown from the effects of weaker expansion in the advanced economies.

To moderate nominal exchange-rate volatility and keep an appropriate level of international reserves, the Bank's Board of Directors has extended at least up to November 2, 2012 the policy of daily purchasing of at least $20m.

Although Colombia's economic fundamentals are robust and the country has so far enjoyed consumer and investor confidence, it will not be immune to the impact of the international crisis. If external demand continues to weaken, the Colombian economy will be exposed to contagion through

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various channels, some of which were clearly in operation during the 2009 crisis. They include, notably, negative income shock from deterioration in the terms of trade, and especially lower oil prices, which mainly affect state revenues. Another channel that transmits the impact of external crisis is a decrease in worker remittances, which will reduce household income; and if this situation persists it may raise the unemployment rate by increasing the overall participation rate, which is a measure of labor supply. Yet another channel, strongly in evidence in 2009, is loss of consumer and investor confidence, which ends up by affecting household consumption and business investment.

Colombia's monetary authority and government are on the alert for changes in the situation at home and abroad, by means of technical monitoring of economic variables. This enables them to take coordinated, timely, counter-cyclical action to lessen the impact of the external crisis on the country's economy. If any good has come of past crises, it is the knowledge of how to deal with them. This valuable experience, and institutional characteristics of such importance as exchange-rate flexibility, which cushions the impact of external crisis on the country's economy, are key advantages, should the international situation grow any worse.

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The present *Report to Congress* contains four chapters. Chapter I describes the international context, with emphasis on the crisis in Europe and its impact on the United States and emerging economies. Chapter II provides a detailed analysis of Colombia's economy, based on figures available to date, and discusses the outlook for 2012. More specifically, it describes the behavior of economic activity, employment, the financial sector, and the balance of payments. It also contains a special section that analyzes the behavior of the economy in the different regions of the country. Chapter III reviews the management of the country's international reserves, a subject requiring particular attention, given the current volatility of external markets. Lastly, Chapter IV describes the financial position of the Banco de la República. As usual, the *Report* also includes several boxes providing in-depth analyses of technical matters considered to be particularly relevant to understanding the current economic situation and monetary-policy design.