Inflation Report

March 2002

Banco de la Republica

(Central Bank)

Colombia

Presentation, summary and conclusions

Review of inflation to march 2002

✠ At the end of the first quarter of 2002, annual consumer inflation stood at 5.9%, down by 1.9 percentage points on a year earlier and by 1.7 points on December 2001. It was the lowest annual inflation for any March since 1962, having fallen continuously and ever faster in recent months, after a period of relative stability between February and November last year.

✠ It was also the first time this year that annual inflation stood below the 6% inflation target set for 2002.

✠ The first quarter saw annual inflation falling in all the major groups of the Consumer Price Index basket, but mainly in food, transport and communications. In the case of food, this was thanks to a good supply of staples, such as potatoes, and to a milder retention phase in cattle breeding. In transport, lower world oil prices from the second quarter of last year up to February this year, together with low devaluation, made it possible to stabilize domestic fuel prices in the first quarter.

✠ The alternate classification of the CPI basket shows that annual inflation fell by similar significant rates in both tradables and nontradables over the first quarter. In March, annual inflation was slightly lower in tradable s (5.8%) than in nontradables (6.0%), tradables having benefited from the peso's nominal appreciation against the dollar and from lower international inflation.

✠ Core inflation maintained its downward trend over the first quarter. The measures of core inflation (non-food CPI, inflation nucleus, and CPI excluding food staples, fuel and utilities) averaged 5.6% at the end of the quarter, 1.1 percentage points lower than in December 2001 and 2.3 points lower than in March 2001. The indicator registering the biggest drop relative to December was the inflation nucleus (1.4 percentage points), followed by non-food CPI (1.1 points) and the CPI excluding food staples, fuel and utilities (0.7 points). In March, all three core-inflation indicators were either on or below the 6% inflation target for 2002.

✠ Annual producer inflation was only 3.6% in the first quarter, 3.3 percentage points lower than in December 2001. The annual figure for March was the lowest for any month since reliable statistics began to be kept for producer inflation (1970). Moreover, annual inflation in final consumption, the component of the Producer Price Index (PPI) most resembling the CPI, stood at 4.3% in March, a fall of 4.2 percentage points relative to December 2001.

✠ Breakdown of the PPI by origin shows slower first-quarter price growth, at annual rate, both in locally produced and consumed goods and in imports; similarly, breakdown by industrial activity shows prices rising more slowly in all groups of the basket, particularly in manufactured and farm goods.

✠ There are several reasons for the first-quarter fall in inflation. First, inflation expectations continued to fall sharply, as evidenced by lower core inflation and smaller price adjustments in several traditionally indexed items, such as utilities and education. This is partly attributable to increasing credibility of a monetary policy consistent both with the inflation targets set by the Banco de la República's Board of Directors and with the long-term objective of price stabilization. Second, slower nominal devaluation of the peso since the middle of last year and lower international inflation together restrained price rises in tradable goods. Third, ample spare capacity, indicating weak aggregate demand, has kept economic growth from generating inflationary pressure. And, lastly, a relatively large food supply in recent months has substantially reduced food prices.

✠ As some of these factors should continue to exist over the rest of the year, no surge in inflation is expected to jeopardize meeting the 6% target. But food-price behavior will most probably be less favorable in the second half of the year. Today's relatively low prices for potatoes and other staples, combined with the productivity effects of the expected Niño climatic condition, may affect food supply during the rest of year, raising food prices substantially. In addition, prices for beef and beef substitutes will rise further as supply decreases in the course of the current retention stage in cattle breeding. Lastly, inflationary pressure began to increase again at the end of the first quarter because of the rise in world oil prices, which is likely to continue over the rest of the year, causing domestic fuel and transport prices to go up.

✠ On the basis of first-quarter figures, the Bank's forecast for inflation by the end of 2002 has been revised down from the rate predicted last December. The central path of the Bank's forecast now shows annual inflation averaging 5.0% in the fourth quarter of this year, down from 5.8% predicted three months ago. The latest forecast has an upward-biased risk balance because food and fuel prices and higher devaluation may create inflationary pressures. The combination of forecasts, using the structural models employed by the Economic Studies Division, gives a 5.6% inflation rate for December, which too is lower than the 6.4% projected by this method three months earlier.

✠ On figures to March, the Bank's forecasts continue to show core inflation decreasing over the rest of the year. According to the central path, core inflation as measured by non-food CPI will average 3.8% in the fourth quarter of 2002, and 3.5% in the fourth quarter of 2003.

✠ The few indicators available on real activity suggest that the economy continued to grow over the first quarter, albeit slowly. This view is based on such indicators as electricity demand up to March, and construction loans made in the first quarter. Household consumption seems to have been the main driving force behind first-quarter growth, to judge by the satisfactory behavior of new car sales to March, credit-card sales to March, beverage sales by the industry, and consumer imports to January. Investment growth was probably weaker than last year mainly because of the impact of the central government's fiscal-adjustment program, but should still have been positive thanks to investment in housing. Exports were not a major growth item in the first quarter, for sales to Venezuela slowed and nontraditional exports to the United States encountered difficulties.

✠ As regards growth over the rest of the year, a number of conditions exist that are conducive to it, including low interest rates, higher employment levels, a rising flow of remittances from abroad, and higher oil prices. These circumstances make it possible to expect positive growth during the coming quarters. But there are also large sources of uncertainty. In particular, doubts have arisen about approval of the Andean trade preference scheme in the near future. They are essential to revival of the industrial sector, given the poor outlook for sales to Venezuela. And it is still not clear whether the structural reforms needed for long-term adjustment of the country's public finances will be implemented in full and in good time, particularly in view of the change of government on August 7. These uncertainties and the current situation of public order may lead consumers and investors to postpone some of their spending. The recent deterioration of business and consumer expectations is a bad sign in this respect.

✠ The rate of growth expected for 2002 should not cause any significant inflationary pressures, for the economy continues to operate below potential. This is indicated by Fedesarrollo's data to February, which show capacity utilization running lower than a year earlier. In fact, the considerable investment effort made by business in 2001, reflected by a high volume of capital goods imports, may have left the economy with ample productive capacity to meet large rises in demand without putting price stability at risk.

✠ Falling inflation allowed the Board of Directors to reduce the Bank's intervention interest rates twice in the first quarter, by a total of 125 basis points in all rates except the Lombard contraction rate, which was cut by a total of 100 points. At the end of March, the Bank's rates stood as follows: Lombard expansion rate 11.0%, auction expansion rate 7.25%, auction contraction rate 6.25%, and Lombard contraction rate 5.25%.

✠ The Board also provided permanent liquidity during the first quarter by exercising reserve-building options amounting to $101.5 million.

✠ The interbank interest rate fell in the first quarter in line with the Bank's rate cuts, to 7.6% in March. The other market rates also declined in nominal terms, substantially in the case of consumer loans and credit card rates and less so in the case of Treasury and preferential loans and the DTF deposit rate.

✠ The Board of Directors set a new reference line for the monetary base at the beginning of March. The new line implicitly envisages a 14.4% average annual growth in the monetary base over 2002.

✠ In Marc, the monetary based stayed within the levels contemplated by the new reference line. At the end of the month, the monetary base's 20- and 45-day moving averages were very close to their respective reference lines. The broader measure of liquidity, M3, grew more slowly in the first quarter of this year than in the previous three months. This trend break resulted from a decline in CDs too strong to be offset by increases in current accounts, cash holdings and Treasury Repos.

- In the first quarter, the financial system's gross nominal loan portfolio maintained the slow pace of growth (about 2.0%) registered at the end of last year, but the rate of change varied for the different types of loans. The nominal consumer portfolio expanded by annual rates of 11.3% to February, while commercial loans grew by only 2.8%, and the mortgage portfolio continued to shrink. The overall portfolio grew slowly despite ample liquidity provided to the market by the Banco de la República, because of the real sector's low demand for credit, and also because the financial system seems to regard public-debt securities as a more suitable investment option in the present circumstances.

- The peso displayed a revaluationary trend over the first quarter of 2002, a development not fully anticipated by the market. At the end of March, the exchange rate stood at 2,261 pesos to the dollar, representing a revaluation of 2.1% relative to the same period in 2001 and of 1.3% relative to December. The drop in the exchange rate is partly explained by lower net private-capital outflows, higher inflows of remittances from Colombians living abroad, and the dissaving of oil earnings (Oil Savings and Stabilization Fund) authorized by law.

- Inflation in March was lower than predicted by the Banco de la República or expected by the market. It led to forecasts for the end of the year being revised downward, so that meeting this year's 6% inflation target is now highly feasible. The March result also bodes well for reducing inflation further in 2003 and for achieving the Board of Directors' long-term inflation target of 3%. An analysis of the country's real economic activity confirms that internal demand has revived moderately, while review of the international context indicates a weakening of external demand for Colombia's nontraditional exports.

- In view of the foregoing and with the aim of facilitating economic growth, the Board of Directors of the Banco de la República decided to cut the Bank's intervention rates by one percentage point (100 basis points) effective from April 15, 2002. They now stand as follows: Lombard expansion rate 10.00%, auction expansion rate 6.25%, auction contraction rate 5.25%, and Lombard contraction rate 4.25%. Thus, the Bank's total rate cuts so far this year come to 225 basis points, a steeper drop than the 170 basis-point fall in inflation over this period.

- Furthermore, pursuant to its policy of maintaining a reasonable ratio of international reserves to short-term foreign-debt payments, the Board of Directors, decided to set the amount for the auction of reserve-building options in May at $100 million.

The Board of Directors,

Chairman
Juan Manuel Santos Calderón
Minister of Finance and Public Credit

Directors
Carlos Caballero Argáez
Sergio Clavijo Vergara
Salomón Kalmanóvitz Kraute
Fernando Tenjo Galarza
Leonardo Villar Gómez

Governor of the Bank
Miguel Urrutia Montoya.

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I

Price indices

A. Consumer price index

1. Overall behavior

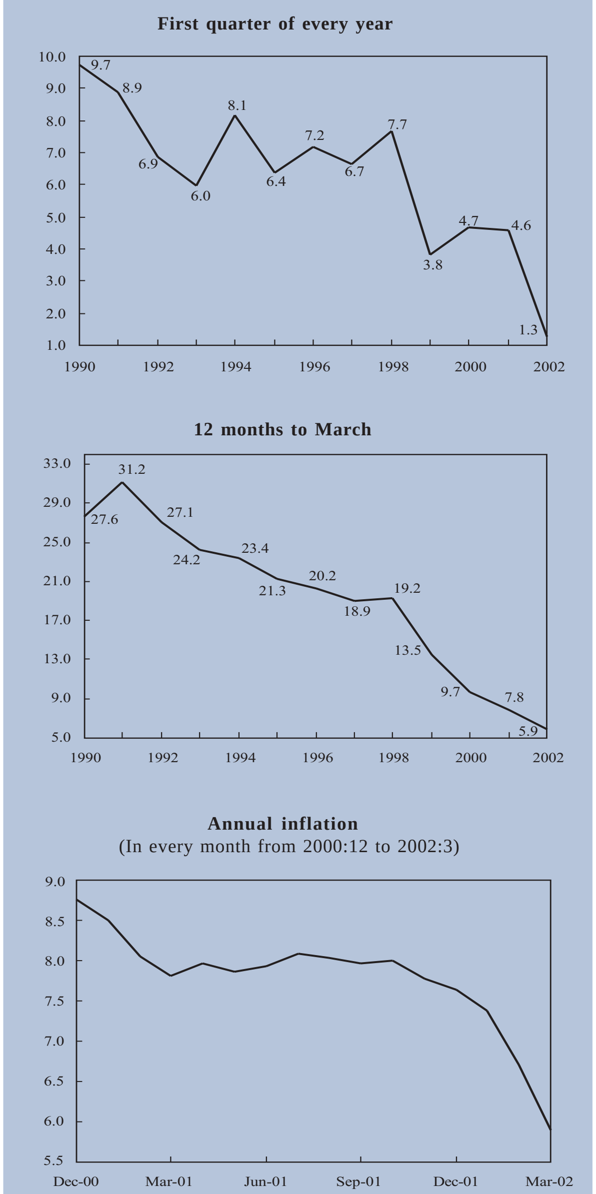
Annual consumer-price inflation was 5.9% at the end of the first quarter of 2002, down by 1.9 percentage points on March 2001 (7.8%) and by 1.7 points on December 2001 (7.6%) (Figure 1 and Table 1). This was the lowest March result since 1962, and made it the first time this year that annual inflation was running below the Board of Directors' 6% target for 2002.

As can be seen from Figure 1, inflation hovered around 8.0% for much of last year, then began to fall again in the fourth quarter. Its fall became considerably steeper in February and March this year, a development not fully anticipated by the market, to judge from private analysts' forecasts and the Banco de la República's expectations survey conducted in January.

Accumulated first-quarter inflation was 2.8% this year, 1.7 percentage points lower than last year (4.5%) and the lowest since 1970. But it is high in relation to the 6% target and indicates continued operation of the indexation mechanisms that have existed in Colombia for three decades and usually come into play early in the year, concentrating much of the year's inflation in the first few months.

Even so, it is worth noting that this year's first-quarter result compares favorably with last year's in terms of target meeting. First-quarter inflation last year

Figure 1
Consumer price index
(% Change)



Source: National Statistics Agency (DANE). Calculations by Banco de la República.

Table 1
Inflation indicators
(Annual percentage change)

		Mar. 2001	Dec. 2001	Mar. 2002
I.	**CPI**	7.8	7.6	5.9
	Food	7.1	10.5	7.2
	Housing	4.2	4.3	3.8
	Clothing	3.5	2.6	2.2
	Health care	11.1	10.9	9.3
	Education	8.2	10.2	9.3
	Culture and entertainment	11.1	7.1	7.0
	Transport	15.2	8.9	5.8
	Diverse expenditures	9.3	7.6	6.7
II.	**Core inflation** 1/	7.8	6.7	5.6
	Non-food CPI	8.1	6.5	5.3
	Nucleus 2/	8.6	7.4	6.0
	CPI excl. primary food-stuffs. fuel & utilities	6.9	6.1	5.4
III.	**PPI**	10.9	6.9	3.6
	By economic use or destination			
	Intermediate consumption	12.4	5.8	2.9
	Final consumption	8.8	8.5	4.3
	Capital goods	10.2	5.7	2.4
	Building materials	14.4	7.4	5.0
	By origin			
	Domestically produced and consumed	10.4	7.7	4.4
	Imports	12.5	4.6	0.8
	Exports 3/	2.8	(7.9)	(7.1)
	By industrial activity (ISIC)			
	Farming, forestry & fishing	4.2	7.6	2.4
	Mining	27.0	(1.3)	1.7
	Manufacturing	12.4	7.0	3.9

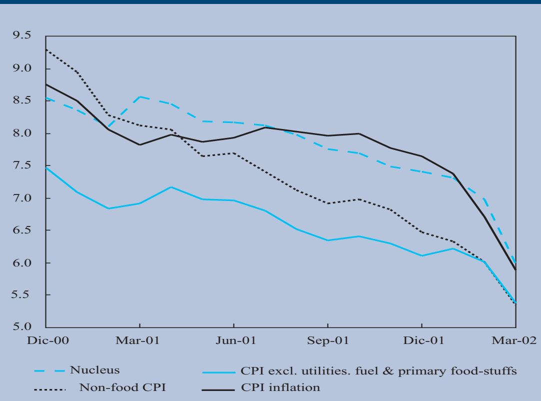
1/ The average of the three core-inflation indicators calculated by the Banco de la República.
2/ CPI excluding 20% of the weight of items showing the greatest price volatility between January 1990 and April 1999.
3/ Total PPI does not include exports. It is calculated from the weighted sum of domestically produced and consumed goods and imports.
Sources: Economic Studies Division (SGEE) of the Banco de la República, and DANE's PPI and CPI Lists.

represented 56% of the 8% target for 2001and 59% of actual inflation for 2001, whereas this year it represents 47% of the 6% target for 2002.

As in the case of headline inflation, the first quarter saw an improvement in the three indicators of core inflation: non-food CPI, inflation nucleus, and CPI excluding food staples, fuel and utilities. The three indicators averaged 5.6% in March, 1.1 percentage points lower than in December and 2.2 points lower than in March 2001. The biggest first-quarter drop was in the inflation nucleus (1.4 percentage points), followed by non-food CPI (1.2 points), and CPI excluding food staples, fuel and utilities (0.7 points). In March, all three core-inflation indicators were either on or below this year's target, and only the inflation nucleus stood higher than headline inflation (Table 1 and Figure 2).

Three factors are largely responsible for the first-quarter drop in core inflation. The first has been the application for the past two years of a monetary

Figure 2
Headline and core inflation
(Annual % change)



Source: DANE. Calculations by Banco de la República.

policy consistent both with the Board of Directors' inflation targets and with the aim of achieving price stability in the long term. One outcome of this has been a large reduction in inflation expectations over recent months, as evidenced by lower and fewer price adjustments in highly indexed items such as utilities, transport, and professional health-care services. The second factor has been a combination of ample spare capacity in most sectors of production and low growth in demand. Lastly, lower devaluation, beginning towards the end of last year and growing steeper this year, has meant smaller price adjustments in tradable goods. As explained in various other parts of this Report, since these three circumstances are likely to persist for the rest of the year, core inflation is not expected to pick up and might, in fact, continue to decline.

In the 12 months to March, consumer inflation was highest in the city of Montería (8.9%), (Table 2) followed by Cali (7.2%) and Cúcuta (7.1%), and lowest in Manizales (4.9%), Pasto (4.9%), and Bogotá (5.2%). All the cities included in the Consumer Price Index registered lower annual inflation in March this year than in December 2001, with Cúcuta showing the biggest drop (3.4 percentage points), followed by Pasto (3.2 points) and Cartagena (2.9 points).

Table 2
Consumer price index, total and by city
(Annual % change)

	Mar. 2001	Dec. 2001	Mar. 2002
Total	7.8	7.6	5.9
Bogota	7.7	7.1	5.2
Medellin	7.3	7.1	6.1
Cali	7.6	8.3	7.2
Barranquilla	8.8	9.2	6.9
Bucaramanga	7.7	8.4	6.7
Manizales	8.0	7.2	4.9
Pasto	8.8	8.1	4.9
Pereira	8.1	7.0	5.6
Cucuta	9.5	10.5	7.1
Monteria	8.8	10.1	8.9
Neiva	8.5	9.5	6.9
Cartagena	8.8	9.2	6.3
Villavicencio	7.2	8.1	5.7

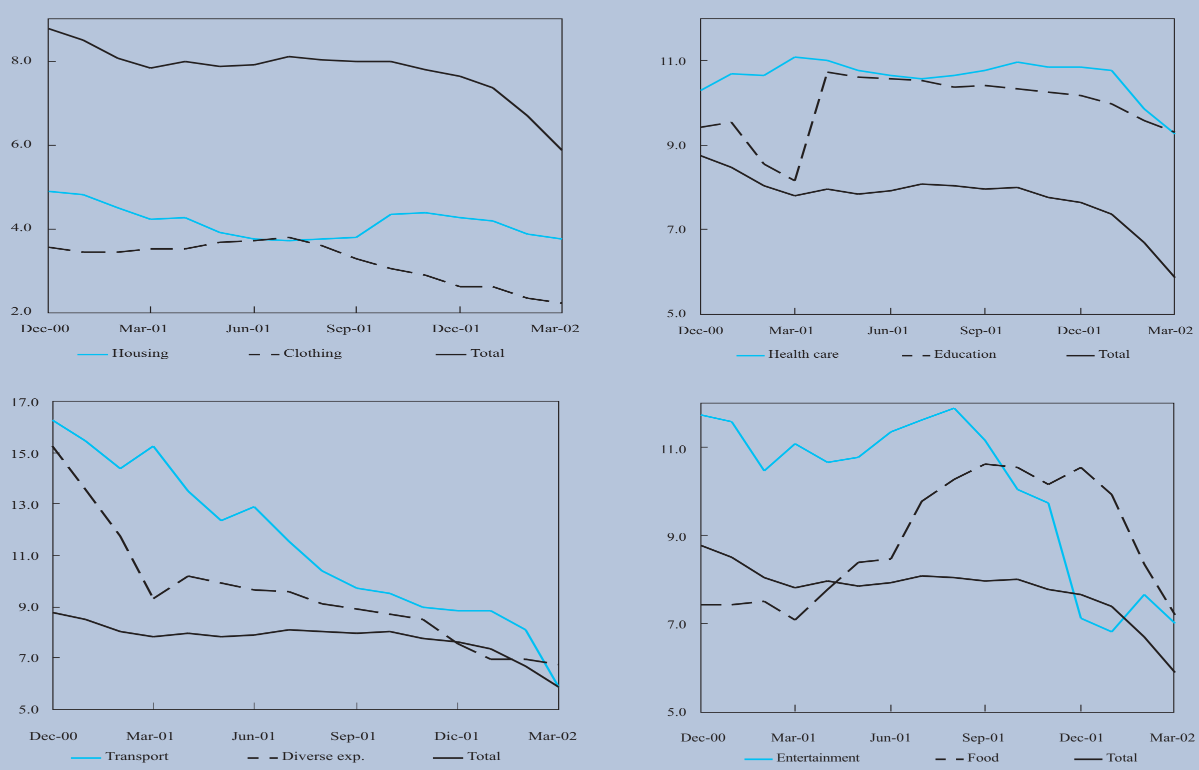
Source: DANE's Lists. Calculations by Banco de la República, SGEE.

2. Behavior of main CPI components

The first quarter of 2002 saw annual inflation falling in all CPI groups except in the group of entertainment, culture and recreation, which showed no clear tendency. In clothing, transport and education, the fall in inflation started in the middle of last year and simply became steeper early this year. In contrast, the first-quarter drop in health-care and food inflation was a break with an inertial price rise that had persisted over the second half of 2001. (Table 1 and Figure 3).

The biggest first-quarter drop in annual inflation occurred in the food group, with the rate falling from 10.5% in December to 7.2% in March. The December Report had actually predicted a first-quarter fall in food inflation but not as big as this, which resulted from highly satisfactory price movements in fruit and root crops, especially potatoes. Potato prices usually rise sharply at the beginning of the year but did not this year, registering one of the lowest relative prices in recent years.

Figure 3
Consumer inflation, by CPI group
(Annual % change)



Source: DANE. Calculations by Banco de la República.

The large decrease in food inflation is even more surprising since prices for beef and beef substitutes have been high because of the current retention stage in Colombian cattle breeding.[1]

Food prices are unlikely to stay stable over the rest of the year, and everything points to their becoming a source of inflationary pressure in the second half. Low prices for staple crops early this year might discourage planting in the coming months, resulting in price rises in the second half of the year that could push up consumer inflation. The risk is increased by the possible occurrence of the Niño climatic condition in the second half of 2002, given its upward impact on prices. The Niño, besides reducing supply by lowering crop productivity,[2] causes farmers to reduce their areas under cultivation to avoid losses. Lastly, the price of beef will continue to put pressure on food inflation, because the cattle-retention stage is expected to last over the rest of the year.

Annual inflation in education declined by almost one percentage point over the first quarter but, at 9.3%, it was still higher than headline inflation in 2001. Given that education prices are subject to regulation, their annual rate of increase may continue to drop further until it is close to last year's inflation, as required by law.

1 Meat prices rose sharply in the first quarter, but the increases were smaller than in the first quarter of 2001 and therefore technically helped to reduce food inflation. They were, nevertheless, historically high.

2 The Hydrology, Meteorology and Environmental Studies Institute (IDEAM) estimates that the Niño tends to reduce the yields of the country's main crops by 4% to 5%. ("Efectos naturales y socioeconómicos del fenómeno El Niño en Colombia", in IDEAM's monthly publication Informe de condiciones ambientales en Colombia, No. 190, March 2002.)

Other groups registering large drops in annual inflation were utilities, medicines, and public transport (including fuel). It is worth noting that last year utilities were among the biggest contributors to overall inflation, partly as a result of the dismantling of consumer subsidies. Dismantling has continued this year but more gradually. Moreover, utility rates are becoming less strongly indexed because, in authorizing price rises, regulators are now known to take into account the Banco de la República's inflation targets and the current year's inflation movements, rather than just the previous year's inflation as they used to do until not long ago.

Transport and fuel inflation has been declining since the middle of 2001, thanks to lower world oil prices and exchange-rate stability. But this trend may reverse in the coming months because of rising international fuel prices and expected increases in domestic prices over the rest of the year. In fact, the government has already announced a 4.0% in crease in the domestic price of gasoline from April.

By individual items, the biggest contributors to higher inflation in the first quarter of 2002 were services and certain food items. Banking services, with a January to March price increase of 5.8%, accounted for 7.3% of accumulated inflation in the first quarter, while bus fares rose by 6.8% and contributed 6.0%. The item designated as "other fresh fruit" surged by 16.5%, accounting for 4.9% of first-quarter inflation, while a 5.4% price rise in milk and a 2.9% rise in restaurant lunches together contributed a little under 10.0% (Table 3).

3. Alternate classification: tradable and nontradable goods

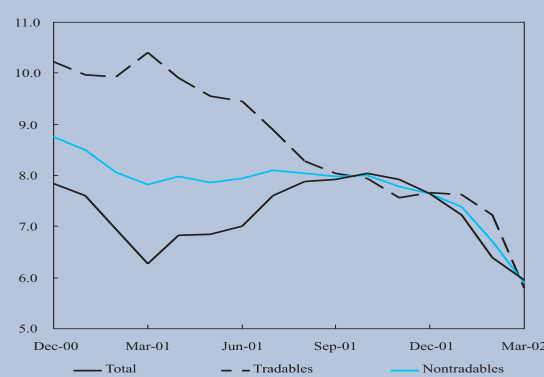
In the first quarter of this year, tradables inflation resumed the downward trend briefly interrupted in the previous quarter, and now fell faster than overall inflation, down to 5.8% by the end of March (Figure 4). In the 12 months to March, declining tradables prices accounted for 87.5% of the drop in consumer inflation.

Table 3
Greatest contributors to first-quarter consumer inflation, 2002

Item	First-quarter price change	Contribution to inflation	
		Puntos	Porcentaje
Total	2.8	2.8	100.0
Banking services	5.8	0.2	7.3
Bus fares.	6.8	0.2	6.0
Other fresh fruit	16.5	0.1	4.9
Milk	5.4	0.1	4.9
Lunches	2.9	0.1	4.7
Other	2.3	2.0	72.1

Source: DANE's Lists. Calculations by Banco de la República, SGEE.

Figure 4
Consumer tradables and nontradables inflation
(Annual % change)



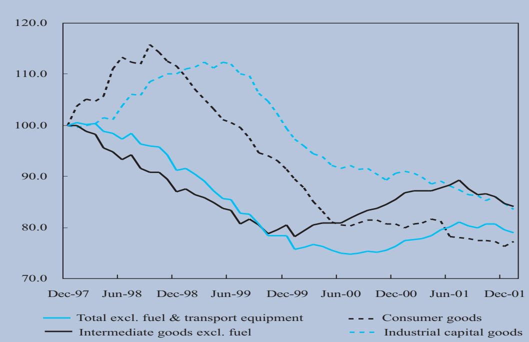
Source: DANE. Calculations by Banco de la República.

The weakening of inflationary pressure from tradables over the first quarter was connected with devaluation running at very low rates since mid-2001, which has allowed companies to defer price adjustments over a much longer period without sacrificing profits. But lower tradables inflation was also part of a downward trend in international prices. Several indicators, including implicit import prices (Figure 5), indicate a fall in international prices in recent years, which probably became steeper in the second half of 2001 owing to weak world demand and lower energy prices.

Tradables inflation may continue to decrease in the short term, because international prices are not expected to rebound appreciably in the medium term, given the present state of world demand (see Chapter III for greater details), and because devaluation is expected to remain moderate.

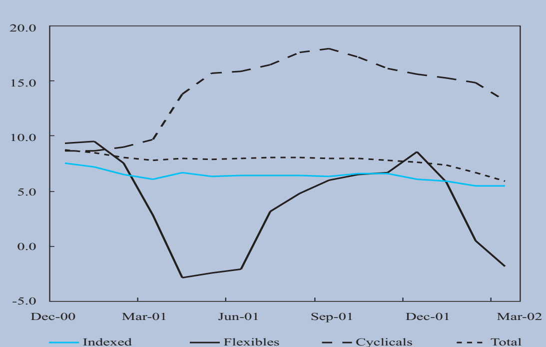
Nontradables inflation, too, decreased in the first quarter, down to 6.0% at the end of March. As in 2001, it was lower than overall inflation thanks to very weak annual growth in rents (an indexed item) and lower price rises in flexible items (root crops, fruit and vegetables) (Figure 6). The CPI basket's tradable items exhibited two patterns of behavior: indexed and flexible items slowed the rate inflation, while cyclicals accelerated it.

Figure 5
Implicit import price index
(December 1997 = 100)



Source: Banco de la República, Economic Studies Divsion (SGEE).

Figure 6
Consumer tradables inflation



Source: DANE. Calculations by Banco de la República.

B. Producer price index

In March 2002, annual producer inflation was 3.6%, the lowest rate for any month since 1970, when reliable statistics on this indicator first began to be compiled. Producer inflation in March was 3.3 percentage points lower than three months earlier (6.9%) and 7.3 points lower than a year earlier (10.9%) (Table 1 and Figure 7). Moreover, annual

Figure 7
Producer price index
(% change)

Source: Banco de la República, SGEE.

inflation in final consumption, the PPI component closest to the CPI basket, stood at 4.3% in March, 4.2 percentage points lower than in December 2001.

This behavior of final-consumption PPI confirms the large drop in consumer inflation over the first quarter. Falling producer inflation will make it easier to reduce consumer inflation in the coming months, for it precludes inflationary pressure from production costs.

Breakdown of the PPI by origin of goods shows that the first-quarter fall in annual producer inflation largely resulted from satisfactory behavior of import prices, which rose by barely 0.8% compared with 4.6% in December, at annual rate, thanks once more to minimal devaluation prevailing in the past few quarters and to lower international prices.

Domestically produced and consumed goods also registered a big decrease in annual inflation, their rate falling from 7.7% in December to 4.4% in March. This makes it clear that the drop in inflation occurred across all producer prices, as in the case of consumer prices, and that it resulted from a number of factors such as weak pressure from demand, lower expectations and good harvests, and not just from satisfactory behavior of the exchange rate and world prices.

Breakdown of the PPI by economic activity shows that, here too, all sectors contributed to the first-quarter drop in producer inflation, but most particularly manufacturing and farming. Annual inflation in manufactured goods fell from 7.0% in December to 3.9% in March, and in farming, forestry and fishing products from 7.6% to 2.4%. Lastly, annual variation in mining prices surged from a 1.3% contraction in December to a 7% expansion in March, thanks to a 4.7% rise in mining prices in the month of March.

Price adjustments in Colombia: characteristic features

Economic literature abroad and in Colombia contains few studies that throw light on the characteristics of consumer-price adjustments. Internationally, the subject has been treated by Kashyap (1995),[1] Tommasi (1993),[2] Lach and Tsiddon (1992)[3] and Cecchetti (1986),[4] among others. In Colombia, there was until recently only one such study, by Jaramillo and Cerquera (1999).[5]

A new study, published in the December 2001 issue of the Revista del Banco de la República,[6] takes up this line of investigation with the aim of identifying and analyzing various aspects of microeconomic price adjustment and behavior in Colombia. The study made use of daily price information covering a period of about ten years (1989-1999), provided by one of the major supermarket chains in Bogotá, on a set of 209 products. The basket of goods ranges from primary food-stuffs, including root crops, vegetables and fruit, to processed products, notably oils and fats, meat, dairy produce, grains, toiletries and housecleaning items. The basket's wide range of contents represents 30% of DANE's overall CPI basket and 67% of the CPI basket excluding services.

The study analyzed price-adjustment behavior in Colombia using statistics on such factors as average price, adjustment size, and downward adjustment inflexibility. Some of the study's main findings are reviewed below as answers to various questions.

How long do prices remain stable?

To respond to this question, the authors of the study built a price persistence (duration) indicator, calculated as the average number of days in which no adjustment is made to the price of a particular item. The findings show that price changes are not frequent for most articles. On average, the price of a typical item is changed every 130 days. Thus, the price remains stable for 98.1% of the days of the sample period.

The price duration, however, varies substantially across product groups. For example, it is lower for less processed products. Primary food-stuffs exhibit the lowest average price duration, 30.3 days, probably because of the instability of their supply and their perishable nature. The highest average durations were mostly among medicines (201.6 days) and the group of other products[7] (209.3 days).

After how big a real-price loss are adjustments made?

Real-price erosion was another indicator constructed to capture price persistence. Average prices for the basket as a whole lost 6.8% of their real value before being adjusted. Breakdown by groups of products showed that, as in the case of average duration, the less processed the product, the lower its real-price erosion. Average real-price erosion for primary food-stuffs was 1.8% before the nominal price was readjusted, while for meat and dairy produce it was 7.7%, for processed foods 8.4%, and for drugs 10.4%.

Do consumer prices usually fall in Colombia?

To respond to this question, the study determined what, in economic literature, is known as the degree of downward price flexibility, by counting the number of negative price changes. The results obtained by analyzing the supermarket chain's price information reveal a low degree of downward price flexibility, with only 23.7% of total adjustments being negative. As in the case of the price-persistence indicator, the less processed the product, the greater its downward flexibility. Thus, for primary food-stuffs, 40.4% of non-zero price changes were negative, while the lowest flexibilities were shown by the group including cigarettes, magazines and newspapers (13.3%), and by drugs (15.2%), processed foods (17.8%), and meat and dairy produce (18.2%). In the remaining groups (soft drinks, alcoholic beverages, and toiletries and housecleaning products) downward flexibility was moderate, with 20% to 30% of non-zero price changes being negative.

How big are price adjustments in Colombia?

The study developed an indicator to determine the average price rise for each product, so as to get an idea of the size or range of price adjustments. For the basket as a whole, price adjustments averaged 12.5%. The smallest adjustment was for alcoholic beverages (7.1%) and the largest for drugs (16.3%), followed by food staples (13.7%).

What do the above findings suggest?

The study's findings reviewed above show that price changes are not very frequent in a typical item of the Colombian economy, that is, the item has a relatively high price permanence. They also show that it has a moderate downward flexibility, and its price adjustments are significant but not very large. Moreover, the findings suggest that menu costs are important in deciding about prices readjustments. For example, where an item has a high price permanence, a high degree of downward price flexibility, and the size of the change is large, menu costs may be regarded as playing a fundamental role in price adjustments.

Price rigidity In Colombia is associated with the type of market and the costs incurred by manufacturers and traders in readjusting prices (i.e., menu costs). Non-processed foods have the lowest price permanence, their prices tend to fall easily, and price adjustments are large. All these characteristics are the outcome of instability in farm supply. Processed goods have a longer price duration, large price adjustments, and a slight degree of downward flexibility. In markets for these industrial products, considerable importance is attached to costs connected with changing nominal prices. Such costs include getting new sales catalogs, adjusting cash machines, changing labels, and perhaps losing clients because of the price rise. These menu costs create price rigidity, by making it preferable to leave prices unchanged when demand or supply shocks are not too great.

Lastly, an interesting finding of the study may account for the rapid fall in Colombian inflation in recent months. It has to do with the real-price loss that tends to trigger price rises. For the goods analyzed in the study, such real-price loss averages 6.8%, suggesting that when actual inflation or inflation expectations are below this figure, as they are today, price rises for many goods may be postponed for more than a year. This should lead to an event faster inflation fall than is predicted by the forecasting models' estimated transmission channels. It should be pointed out, however, that this and other findings relate to a period (1989-1999) when inflation was higher than it is now, so that the study's estimate magnitudes do not all necessarily obtain today.

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[1] Kashyap, Anil (1995). "Sticky Prices: New Evidence from Retail Catalogs", in *Quarterly Journal of Economics*, Vol. 110, pp. 245-74.

[2] Tommasi, Mariano (1993). "Inflation and Relative prices: Evidence from Argentina", in *Optimal Pricing, Inflation and the Costs of Price Adjustment*. Cambridge, Mass. MIT Press

[3] Lach, Saul; Tsiddon, Daniel (1992). "The Behavior of Prices and Inflation: An Empirical Analysis of Disaggregated Price Data", in *Journal of Political Economy*, Vol. 100, pp. 349-389.

[4] Cecchetti, Stephen (1986). "The Frequency of Price Adjustment: A Study of the Newsstand Prices of Magazines", in *Journal of Economics*, Vol. 31, pp. 255-274.

[5] Jaramillo, Carlos Felipe; Cerquera, Daniel (1999). "Price Behavior in an Inflationary Environment: Evidence from Supermarket Data", in *Borradores de Economía* No. 138, Banco de la República, SGEE.

[6] Espinosa, Alexandra; Jaramillo Carlos F.; Caicedo, Edgar. "Caracterización del ajuste microeconómico de precios en Colombia, 1989-1999", in *Revista del Banco de la República*, No. 890, December 2001, Bogotá.

[7] This group includes such products as cigarettes, magazines and newspapers.

II

Determinants of inflation

A. Monetary aggregates, interest and exchange rates

1. Monetary-policy measures

The Bank's Board of Directors maintained a loose monetary policy over the first quarter, based on its assessment of expected price behavior, economic activity and the international setting. The Board reduced the intervention rates twice in the first quarter: on January 18 it cut all rates by 50 basis points, except for a 25-point cut in the Lombard contraction rate; and on March 15 it lowered them all by 75 basis points. Thus, at the end of March the intervention rates stood as follows: Lombard expansion rate 11.0%, Lombard contraction rate 5.25%, auction expansion rate 7.25%, and auction contraction rate 6.25% (Table 4). The Board's pre-set amounts for one-day Repo expansion and contraction operations were large and, with demand averaging 54.8% and 26.1% respectively, underused (Table 5). The Bank also provided permanent liquidity through reserve-building options amounting to 232.6 billion pesos, equivalent to 101.5 million of dollars (Table 6).

On December 14 last year, the Board fixed a reference line for the monetary base in 2002.[3] But in the first two months of this year demand for cash grew considerably faster than implicitly envisaged in the reference line, causing the base to expand faster than expected. The Board therefore adopted a new reference line for 2002 on March 1. The new estimate, which incorporates changes in cash demand, contemplates a growth of 14.5% in the monetary base by the end of the year and an average growth of 14.4% for the year.

[3] This reference line envisaged a growth of 12.4% in the monetary base by the end of 2002, and a 10.6% growth on average.

Table 4
Banco de la repúlica's intervention rates

Rate	14 de Dec.	18 de Jan.	18 de Feb.	15 de Mar.	First-quarter cuts (basis points)
Lombard expansion	12.25	11.75	11.75	11.00	125
Auction expansion	8.50	8.00	8.00	7.25	125
Auction contraction	7.50	7.00	7.00	6.25	125
Lombard contraction	6.25	6.00	6.00	5.25	100

Source: Banco de la República.

Table 5
One-day expansion and contraction repos: Daily averages
(Billions of pesos)

	Expansion			Contraction		
	Pre-set amount	Use	% used	Pre-set amount	Use	% used
January	565	294	52.0	1.300	298	22.9
February	920	433	47.0	1.050	256	24.3
March	1,019	648	63.5	529	199	37.6
First-quarter daily average	835	458	54.9	960	251	26.1

Source: Banco de la República.

Table 6
Reserve-building operations

	Millions of dollars	Billions of pesos	Exchange rate pesos/dollar
January 2	27.5	63.0	2,291.2
January 15	22.5	51.7	2,297.3
Total January	50.0	114.7	
February 5	1.5	3.4	2,266.6
Total February	1.5	3.4	
March 8	50.0	114.5	2,289.8
Total March	50.0	114.5	
Total first quarter	101.5	232.6	

Source: Banco de la República

2. Monetary and credit aggregates

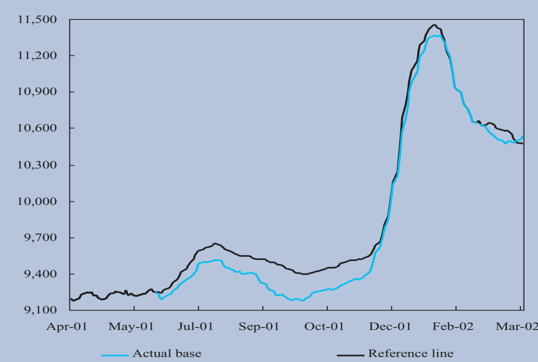
The monetary aggregates' behavior is reviewed below by examining movements in the monetary base, M1 money supply, broad money M3, and the financial system's loan balance.

Monetary base

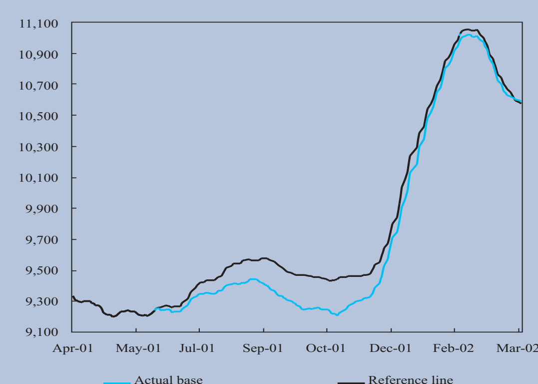
By the end of March, the monetary base's 20-day and 45-day moving averages were very close to those of the new reference line,[4] exceeding them by 0.6% and 0.1% respectively (Figure 8). Between

Figure 8
Monetary base and reference line
(Billions of pesos)

20-day daily moving average



45-day daily moving average



Source: Banco de la República, SGEE.

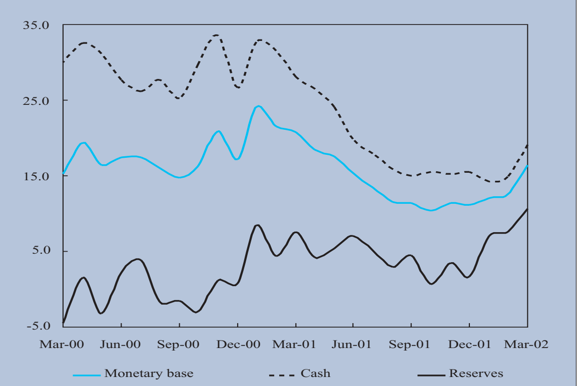
[4] This is the reference line adopted by the Board on March 1, 2002.

December and March, the pace of growth of the monetary base accelerated (from11.1% to 16.4%), as a result of faster expansion in both cash holdings (from 15.5% to 19.1%) and reserves (from 1.6% to 10.7%) (Figure 9).

M1 money supply

The M1 money supply expanded sharply over the first quarter, breaking the downward trend displayed since November 2000, partly because of higher cash growth but mostly because of strong recovery in checking accounts, whose growth surged from 4.1% in December to 12.5% in March (Figure 10).

FIGURE 9
MONETARY BASE AND ITS USES
(ANNUAL % CHANGE IN MONTHLY AVERAGE)



Source: Banco de la República, SGEE.

M1's faster expansion may be connected with the opportunity cost of holding liquid assets being lower, given the low rates of interest, plus lower inflation, and higher transaction costs arising from the transaction levy.

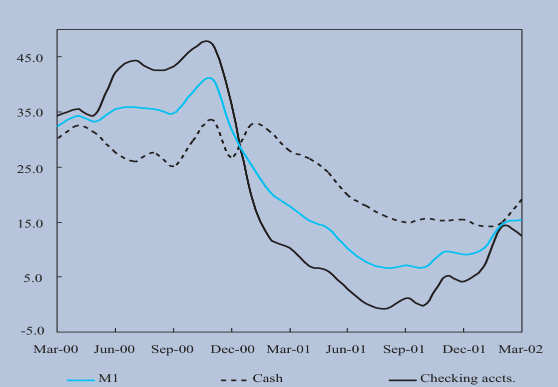
M3

Unlike M1, the broader measure of money supply (M3) weakened considerably in the first quarter, reversing the rising trend it had shown all through 2001. Growth in M3's average balance dropped from 10.6% in December to 7.3% in March (Figure 11).

M3's weakening stemmed largely from slower expansion in CDs and savings accounts (Figure 12), which in turn may be explained by lower demand for these instruments because of low rates of interest and the high transaction costs involved in their management. This lower demand may, to some extent, be the counterpart of a greater preference shown in recent months for liquidity.

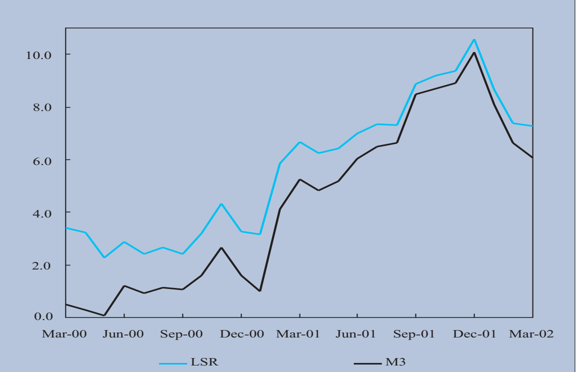
From the standpoint of supply, slower growth in CDs and savings accounts may have resulted from a disinclination on the part of financial intermediaries' to capture funds, since there was ample liquidity in the market and portfolio growth was slow.

FIGURE 10
M1 AND ITS COMPONENTS
(ANNUAL % CHANGE IN MONTHLY AVERAGE)



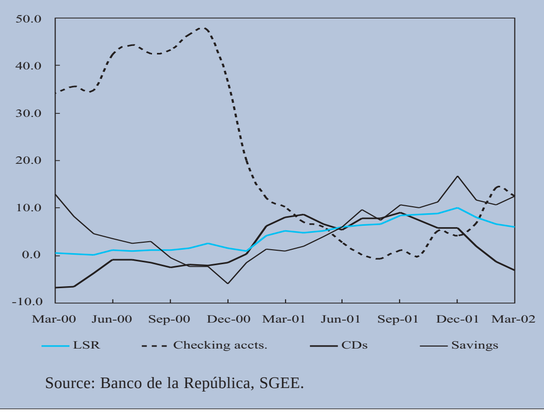
Source: Banco de la República, SGEE.

FIGURE 11
M3 AND LIABILITIES SUBJECT TO RESERVE (LSR)
(ANNUAL % CHANGE IN MONTHLY AVERAGE)



Source: Banco de la República, SGEE.

Figure 12
Liabilities subject to reserve (LSR), by main components
(Annual % change in monthly average)



Source: Banco de la República, SGEE.

The greater availability of liquidity in the market in recent quarters is borne out by the findings of the Bank's January 2002 expectations survey. Liquidity was considered to be high by 54.3% of respondents, a larger percentage than in the preceding surveys. And 64.2% of respondents did not expect it to change much in the following six months (Figure 13), as compared with 56.8% in the October survey.

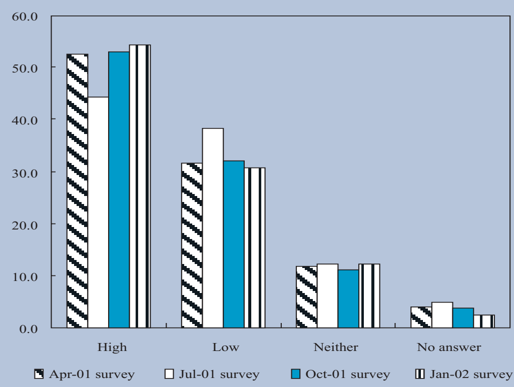
Loan portfolio and credit

In March, the gross nominal local-currency loan portfolio[5] showed much the same slow growth as it had at the end of last year, registering an average annual rate of 1.7% for the first quarter. Breakdown of the portfolio into the mortgage banks' balance and the rest of the system's balance shows that no major changes occurred in the behavior of these two either (Figure 14).

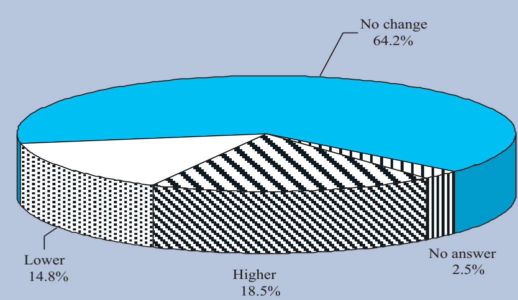
The overall portfolio's scant growth is partly explained by the statistical effect of loan removals from the balance sheets of financial intermediaries.[6]

Figure 13
Liquidity perceptions

(A)
Current perception of liquidity

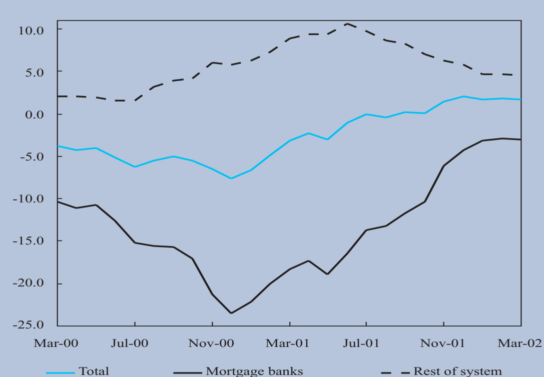


(B)
Perception of liquidity in 6 months' time, January 2002 survey:



Source: Banco de la República, expectations surveys.

Figure 14
Gross nominal local-currency loan balance of financial system excluding FEN
(Annual % change in monthly average)



Sources: Banco de la República and Banking Superintendency.

5 This section refers to the average monthly balance of the gross nominal local-currency portfolio, excluding the National Energy Financing Company (FEN).

6 These removals were brought about by the liquidation of a number of financial entities, the writing-down of unproductive assets, reductions by reason of property received in payment, securitization and sale of loans to institutions outside the system, and recalculations of mortgage loans.

The gross nominal portfolio as adjusted for these removals[7] shows a 3.9% annual growth in February 2002 (Figure 15).

Figures to February reveal no significant changes in the individual behavior of the different loan portfolios (commercial, consumer, mortgage) (Figure 16). Thus, growth in consumer loans, having continuously accelerated last year, was a satisfactory 11.3% in February, much as it had been at the end of 2001, while the commercial portfolio's 2.8% expansion in February and the mortgage portfolio's -3.5% variation were also similar to the rates registered two months before. It is important to point out that, as a result of falling inflation, such stable nominal growth has meant higher real growth.

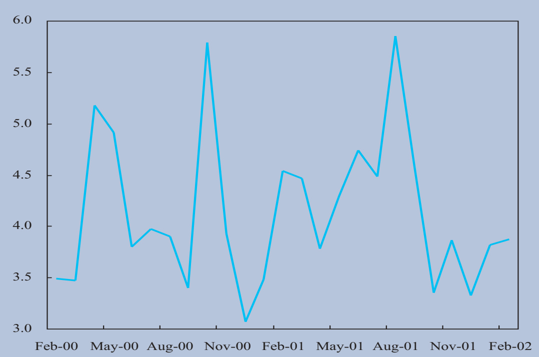
Though overall portfolio has showed poor growth in recent months, there are signs that its quality has got better. In effect, the loan quality indicator[8] improved from 11.6% in January 2001 to 9.8% in December. There has also been a surge in the coverage indicator,[9] with provisions amounting to 73.9% of the overdue balance last December, up from 49.9% in January last year (Figure 17).

[7] The adjusted portfolio is the gross portfolio as it would have been without those loan removals.

[8] Quality indicator = Overdue balance / Gross balance.

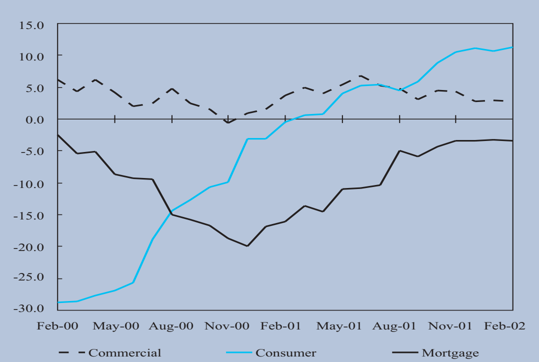
[9] Coverage indicator = Loan provisions / Overdue balance.

FIGURE 15
ADJUSTED GROSS NOMINAL LOCAL-CURRENCY LOAN BALANCE, EXCLUDING FEN
(ANNUAL % CHANGE IN MONTHLY AVERAGE)



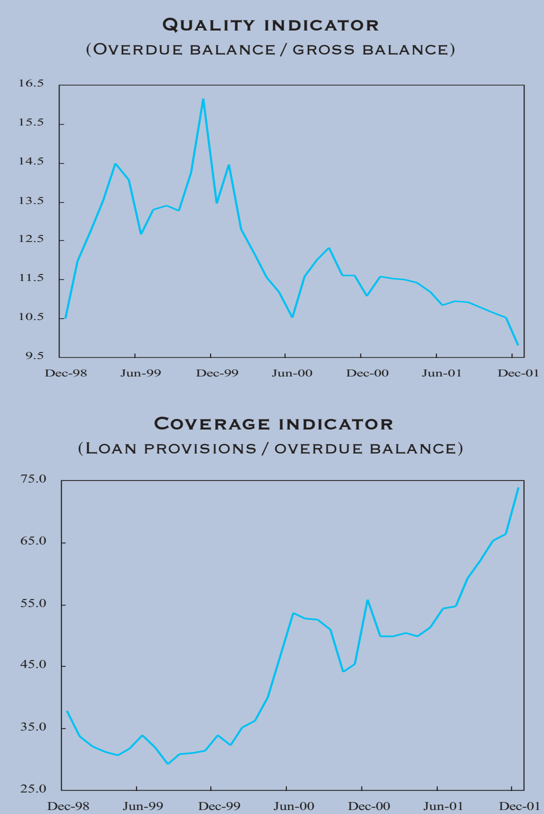
Sources: Banco de la República and Banking Superintendency.

FIGURE 16
GROSS NOMINAL LOCAL-CURRENCY LOAN PORTFOLIO BY TYPE OF LOAN, EXCLUDING FEN
(ANNUAL % CHANGE)



Sources: Banco de la República and Banking Superintendency.

FIGURE 17
LOAN-PORTFOLIO INDICATORS



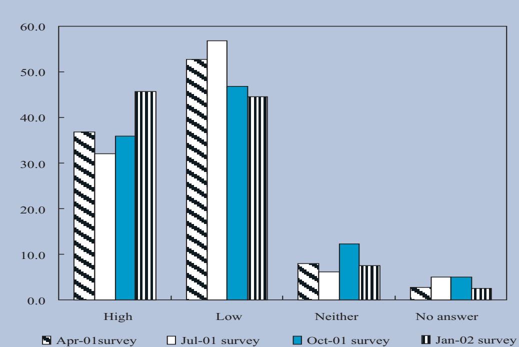
Source: Banking Superintendency.

The financial intermediaries' improved situation suggests that favorable conditions now exist for the system to reactivate lending and allow greater portfolio expansion. Demand for credit, however, has been restrained by various factors, including feelings of uncertainty among investors and consumers. Moreover, the high yield and security of public-debt paper issued by the central government has made new lending less attractive to intermediaries.

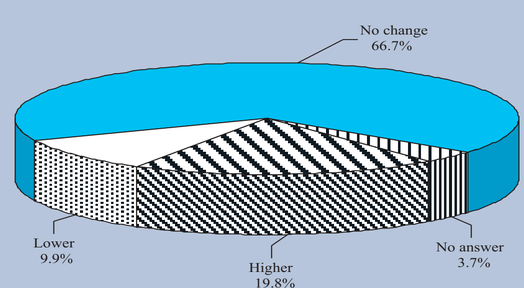
Lastly, according to the Bank's January 2002 expectations survey, the percentage of respondents considering credit availability to be high at the time was 45.7%, an improvement on the preceding surveys. As regards credit availability over the following six months, 66.7% expected it to remain the same as in January, while 9.9% thought it would be lower (Figure 18).

FIGURE 18
CREDIT-AVAILABILITY PERCEPTIONS

(A)
PERCEPTION OF CURRENT AVAILABILITY



(B)
PERCEPTION OF AVAILABILITY IN 6 MONTHS' TIME, JANUARY 2002 SURVEY



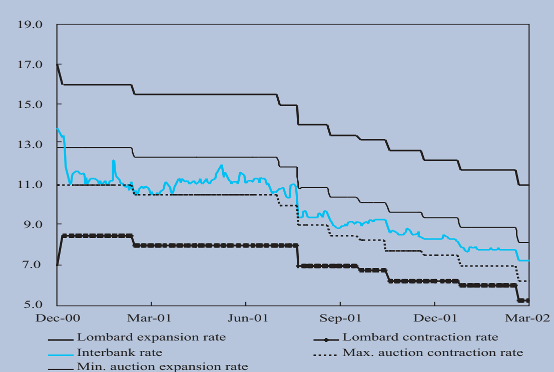
Source: Banco de la República, expectations surveys.

3. Interest rates

The nominal interbank rate continued to fall during the first quarter of 2002, as a result of cuts in the Banco de la República's intervention rates. In March, the average interbank rate was 7.6%, its lowest level since January 2000, and down by 0.9 percentage points on December 2001 (Figure 19). Despite the significant drop in the nominal rate, the real rate rose because the decrease in inflation was larger. The real interbank rate was1.3% in March, 0.7 percentage points higher than in December (Figure 20).

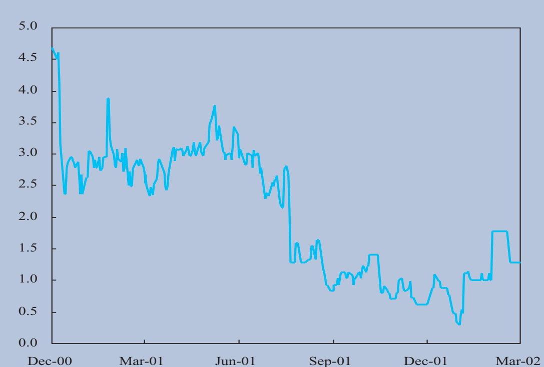
The financial system's nominal interest rates also decreased over the first three months of this year.

FIGURE 19
BANCO DE LA REPÚBLICA'S INTERBANK AND INTERVENTION RATES
(PERCENTAJE)



Source: Banco de la República.

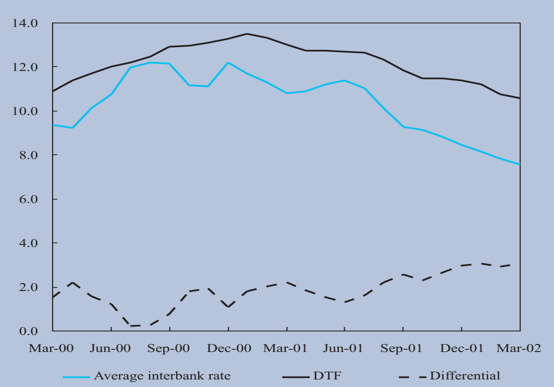
FIGURE 20
REAL INTERBANK RATE
DAILY SERIES
(PERCENTAJE)



Source: Banco de la República.

The average deposit rate, as measured by the DTF rate, stood at 10.6% at the end of March, 0.8 percentage points lower than in December. But, from January to March, the DTF rate decreased by much less than the interbank rate or the Bank's intervention rates. So the difference between the DTF and the interbank rate has widened, to about 300 basis points, far bigger than the long-term differential estimated at 200 basis points[10] (Figure 21). This suggests that the DFT could drop lower in the coming months, even without any further changes in the interbank rate or the Bank's intervention rates.

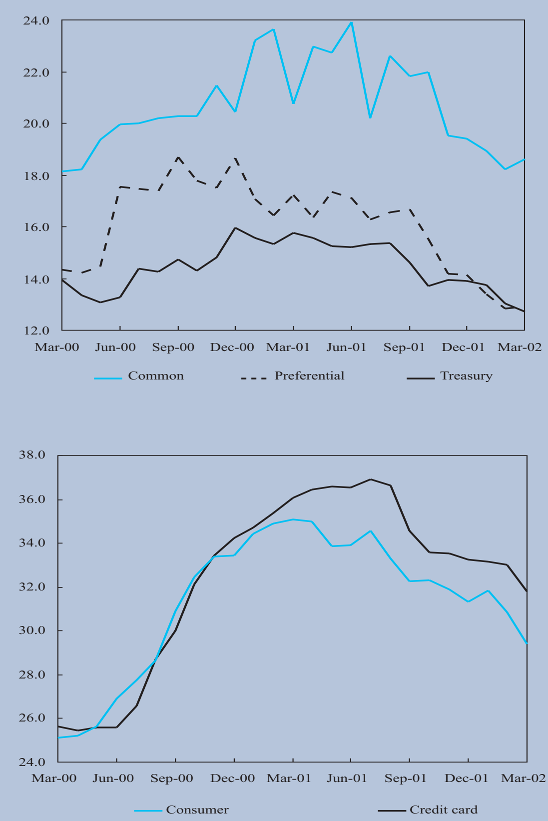
Figure 21
Differential between 90-day DTF rate and average interbank rate
(Percentaje)



Sources: Banco de la República, SGEE.

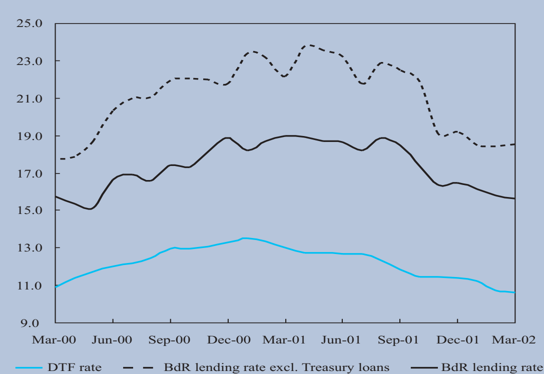
The DTF's declining trend had a positive influence on lending rates, which fell too, and more steeply. Consumer loans showed the biggest rate drop (1.9 percentage points), followed by credit cards (1.5 points), and preferential and Treasury loans (1.2 points) (Figure 22). With these reductions, the average lending rate as calculated by the Banco de la República (BdR lending rate) declined over the first quarter to 15.6%, and this BdR average rate excluding Treasury loans fell to18.5% (Figure 23).

Figure 22
Nominal interest rates, by type of loan
(Percentaje)



Sources: Banco de la República, SGEE.

Figure 23
Nominal interest rates
(Effective annual rate)



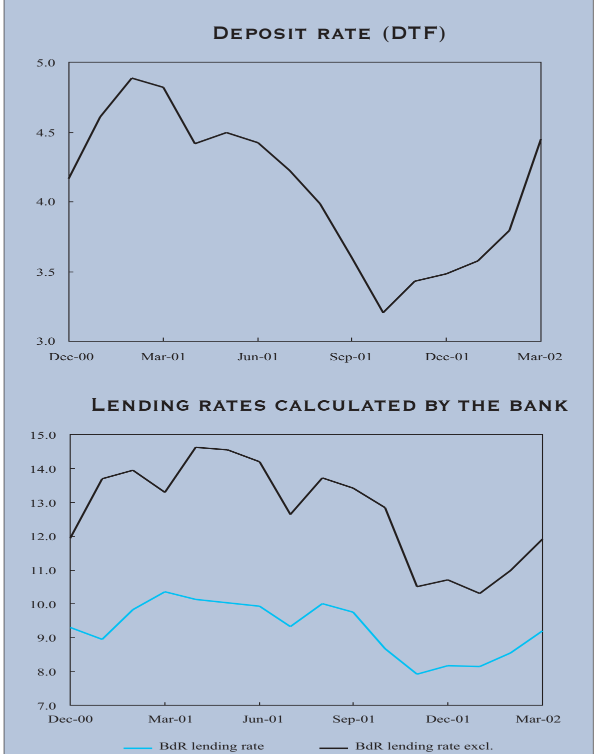
Source: Banco de la República, SGEE.

[10] As estimated by the Economic Studies Division.

Over the first quarter, inflation decreased by more than nominal interest rates, causing all ex post real rates to rise. In real terms, the DTF rate went up from 3.5% in December to 4.4% in March, while the BdR lending rate rose by 1.0 percentage points to 9.2%, and this BdR rate excluding Treasury loans by 1.2 points to 11.9% (Figure 24).

No large rises are expected in short-term (up to one year) deposit rates in the coming months. In fact, the yield curve of the basic deposit rate calculated by the Banking Superintendency (TBS) suggests a continuation of the falling trend. In March, TBS rates for all maturities stood at historically low levels: 7.2% for the shorter maturities and 11.3% for the longest. In addition, the curve's slope in March was much the same as it had been in the preceding three quarters, reinforcing the idea that the market does not expect deposit rates to rise in the near future (Figure 25).

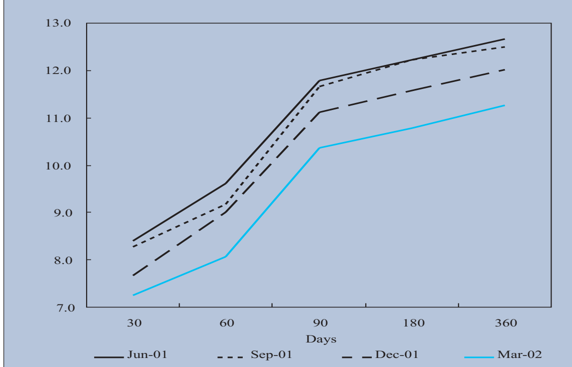
Figure 24
Real interest rates
(Percentaje)



Sources: Banco de la República and Superintendencia Bancaria.

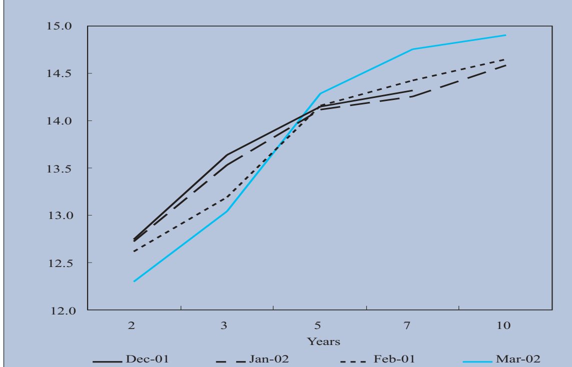
Figure 26 shows the evolution of the yield curve of Treasury securities (TES) in the secondary market over the past four months. The short-term and long-term rates present two quite different patterns of behavior. Interest rates for the shorter maturities (2 and 3 years) continued the downward trend displayed in the preceding months: in March the two-year rate was 0.4 percentage points lower than in December and the three-year rate 0.6 points lower. In contrast, interest rose on Treasury paper with a maturity of 5 or more years, reversing a downward trend that had lasted for some time. Demand for long-term TES decreased in March, causing the interest rate to rise, and it may conceivably have

Figure 25
Yield curves of basic deposit rate calculated by Banking Superintendency (TBS)
(Percentaje)



Source: Superintendencia Bancaria.

Figure 26
Secondary-market treasury yield curves
(Percentaje)



Source: Banco de la República.

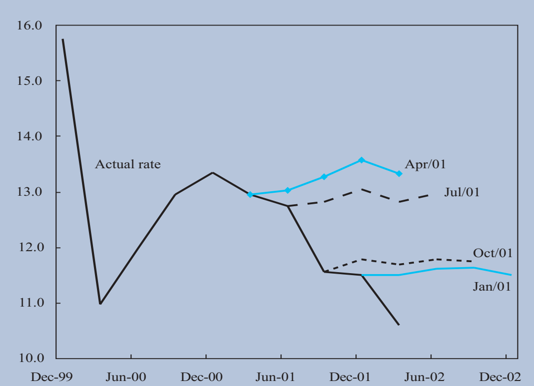
been the outcome of greater uncertainty generated by various circumstances, such as the breaking-off of the peace talks, doubts about the sustainability of the public debt, and a possible downgrading of Colombia by some foreign risk-rating agencies.

The Bank's latest quarterly survey, conducted in January, shows that interest rates were still expected to remain relatively stable. It is worth noting that expected rates proved to be much higher than actual rates in March. In other words, the market did not anticipate the recent fall in interest rates. Specifically, in January the expected rate for March was 11.5%, 0.9 percentage points higher than the actual rate (Figure 27).

as the external reference rate, and the DTF deposit rate as the domestic one.

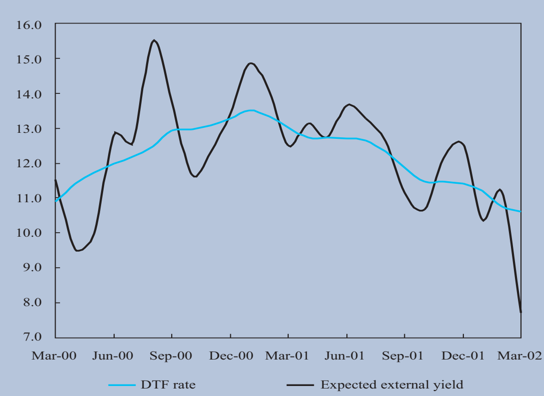
Figure 28 compares expected external yield with actual return on domestic investments (as measured by the DTF rate). For the first two months of this year, the difference between the two was not great, but in March domestic interest was running far above the expected external yield, which ended the quarter at 7.7%, some 4.8 percentage points lower than in December. This drop was mainly caused by lower devaluation expectations: in March, expected devaluation was 6.2%, down by 4.7 percentage points on December.

FIGURE 27
ACTUAL AND EXPECTED DTF RATES
(EFFECTIVE ANNUAL RATE)



Source: Banco de la República, expectations surveys.

FIGURE 28
ACTUAL DOMESTIC RETURN
AND EXPECTED EXTERNAL YIELD
(PERCENTAJE)



Source: Banco de la República.

4. Yield differentials

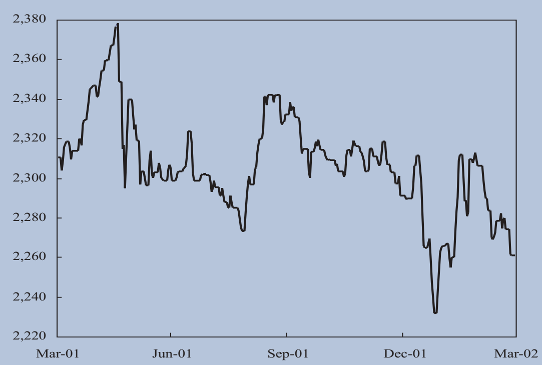
This section discusses the differential between external and domestic yields. External yield is defined as the return that local investors expect to obtain if they decide to invest in dollar-denominated assets; it is estimated on the basis of an external interest rate of reference and expected devaluation. The expected rate of devaluation used for this purpose is the rate implicitly envisaged in the financial system's forward (80- to 100-day) dollar sales contracts. The 90-day CD rate in New York is used

5. Nominal exchange rate

The first quarter of this year saw the peso rising against the dollar. The exchange rate at the end of March stood at 2,261.2 pesos to the dollar, down from 2,291.2 pesos three months earlier, giving an annual revaluation of 2.1% and a first-quarter revaluation of 1.3% (Figures 29 and 30).

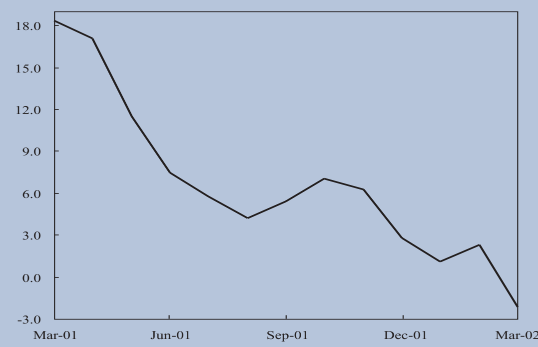
It is noteworthy that the peso's appreciation early this year was unexpected, as can be gathered from analysts' and rating agencies' forecasts made at the

Figure 29
Market exchange rate
(Pesos/dollar)



Sources: Banco de la República and Banking Superintendency.

Figure 30
Devaluation
(Nominal annual rate)



Sources: Banco de la República and Banking Superintendency.

end of last year and from the Bank's January expectations survey. According to the survey, the exchange rate was expected to reach 2,330.5 pesos to the dollar by the end of March. The actual rate was 69.3 pesos lower.

The nominal exchange rate's behavior in the first quarter of 2002 was largely the outcome of a surge in the supply of foreign currency. Analysis of current-account flows in those three months shows that this surge was produced by higher net income from non-financial services and transfers: they rose by a total of $434.4 million relative to the first quarter of last year, to $859.2 million in March (Table 7).

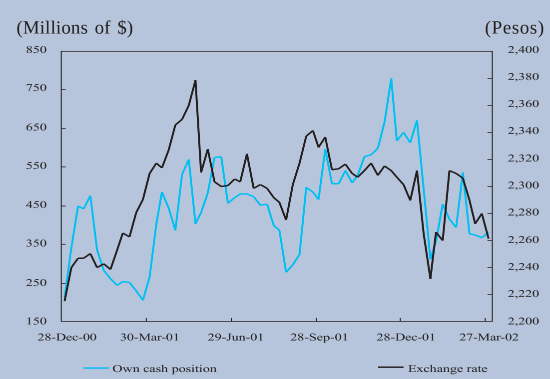
Table 7
Balance of foreing exchange transactions
(Millions of dollars)

	January-March		2001-2002 variation	
	2001	2002	Absolute	Relative %
Current account	(393.3)	(46.5)	346.8	(88.2)
A. Trade balance	(493.0)	(531.5)	(38.5)	7.8
Exports	727.9	656.6	(71.3)	(9.8)
Imports	1,220.9	1,188.1	(32.8)	(2.7)
B. Services and transfers balance	112.8	495.4	382.6	
Financial services	(311.9)	(363.8)	(51.9)	16.6
Non-financial services	324.2	528.3	204.1	63.0
Non-regulated market	306.4	248.2	(58.2)	(19.0)
Transfers	100.6	330.9	230.3	228.9
C. Purchase of oil and natural gas	(13.1)	(10.4)	2.7	(20.6)

Sources: Banco de la República.

The peso's unexpected revaluation may have triggered, and been intensified by, some portfolio-management mechanisms of certain major participants in the exchange market, such as pension-fund administration companies (AFPs) and financial intermediaries. As can be seen from Figure 31, the financial system's own cash position widened over the first quarter. Moreover, a Banking Superintendency measure limiting unhedged exposure of the AFPs' foreign-currency investment portfolio has forced these companies to make forward sales of foreign-currency balances in the spot market.

Figure 31
Financial system's own cash position, and market exchange rate

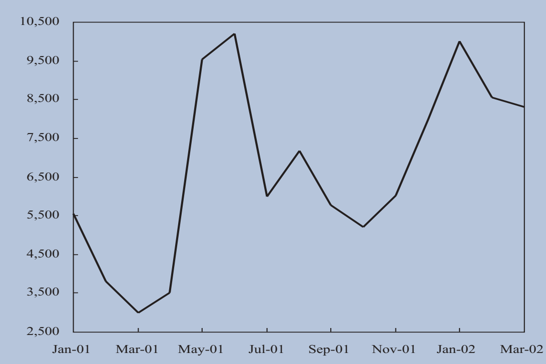


Source: Banco de la República, SGEE.

The latest information suggests that devaluation expectations are lower than in the fourth quarter of 2001. This is indicated by a higher premium on the Bank's auctions of options for purchase of foreign currency (Figure 32), by the full take up of the pre-set amounts for these operations in February and March, and by a lower devaluation implicitly envisaged in forward contracts.

Today, both analysts and market operators agree that, in the long term, economic and other factors might cause the exchange rate to return to its devaluationary trend. In the short-term, however, the persistence of a number of circumstances might give the peso a certain degree of stability. These circumstances include: almost complete prefinancing of public

Figure 32
Premium on reserve-building put-optios auctions
(Pesos/thousand dollars)

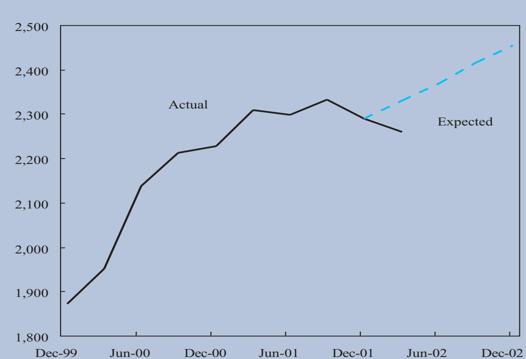


Source: Banco de la República, SGEE.

spending for this year; higher remittances from Colombians working abroad; lower import demand because of the economic slowdown; and higher oil prices. In addition, a yield differential now running in favor of domestic rates, and a greater availability of foreign capital for other emerging countries now that Argentina is out of the market may also help to keep the peso stable in the short term.

Lastly, the Bank's January survey shows that the exchange rate is expected to run at 2,370.3 pesos to the dollar in June, 2,415.9 pesos in September, and 2,455.4 pesos in December, with annual devaluation rates of 3.1%, 3.6% and 7.2% respectively (Figure 33).

Figure 33
Actual and expected exchange rates
(Pesos to the dollar)



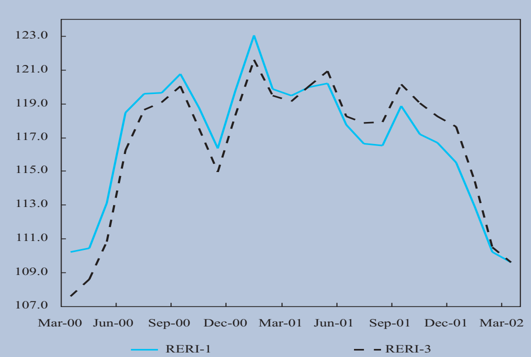
Fuente: Banco de la República, encuesta de expectativas, enero de 2002.

6. Real exchange rate

The real exchange rate, as measured by the RERI-1 index (1994 = 100), which is based on Colombia's Producer Price Index and those of its 20 trading partners, averaged 109.6 in March, its lowest level since June 1999, giving a 5.1% real revaluation for the first quarter and a real annual revaluation of 8.2%. Using the RERI-3 index (1994 = 100), which is based on Consumer Price Indices, gives a real revaluation of 6.8% for the first quarter and a real annual revaluation of 8.0% (Figures 34 and 35).

The real exchange rate is determined by the ratio of an internal factor to an external factor, each determined by the respective devaluation inflation ratio. Since January, both the internal and the external components have been causing the peso to appreciate in real terms. Inflation has been lower than devaluation in countries that are Colombia's major trading partners, while in Colombia itself inflation has run higher than the peso's nominal appreciation (see Chapter III).

Figure 34
Real exchange rate indices
RERI-1 and RERI-3 (1994 = 100)



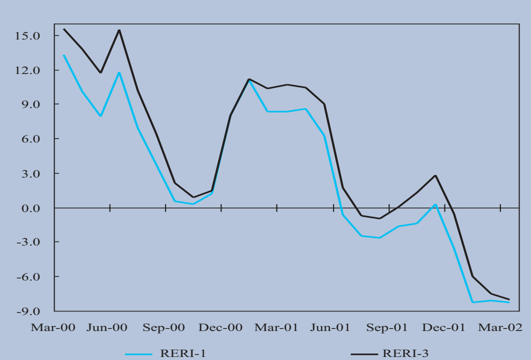
Source: Banco de la República, SGEE.

7. Asset prices

A description follows of two variables that indicate the price behavior of certain assets in Colombia. The first is the Colombia Stock Exchange General Index (IGBC), an aggregate measure of price movements in the market's most representative shares, using a basket of shares periodically selected on the basis of their rotation and frequency.

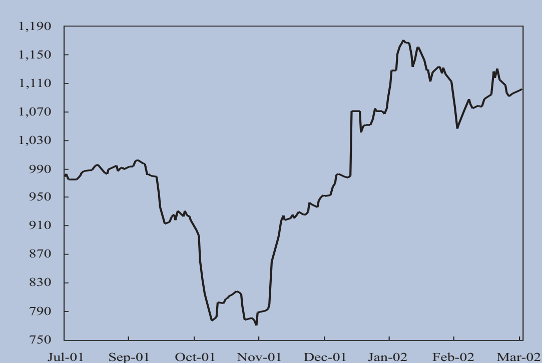
The IGBC index was relatively stable over the first quarter of 2002, because there were few investors and trading volumes were low. At 12.3%, the index's annualized first-quarter valuation gain was lower than the 22.2% gain in the fourth quarter, but still higher than that of any other financial asset. Behind this behavior lie such factors as the peso's appreciation against the dollar, stability in the fixed-income securities market, and highly volatile share prices because first-quarter company results and dividend decisions were expected to be mixed. (Figure 36)

Figure 35
Real annual devaluation rate
RERI-1 and RERI-3 (1994 = 100)



Source: Banco de la República, SGEE.

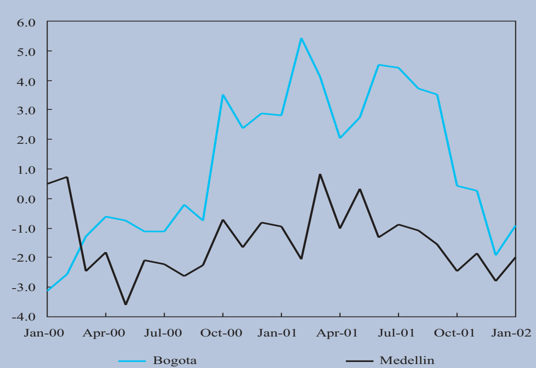
Figure 36
Colombia stock exchange general index



Source: Bolsa de Colombia.

Another asset-price indicator in Colombia is the National Planning Department's housing-price index for Bogotá and Medellín, prepared on a monthly basis since 1994. Figure 37 shows inflation in housing prices in Medellín and Bogotá. In January, the latest month for which information is available, housing prices fell nominally in both cities: in Bogotá for the second month running, and in Medellín for the eighth month running. At annual rate, Bogotá's -0.9% variation and Medellín's -2.0% variation in housing prices in January were respectively 8.3 and 9.4 percentage points below consumer inflation in January.

Figure 37
Housing-price inflation: Bogota, Medellin
(Percentaje)

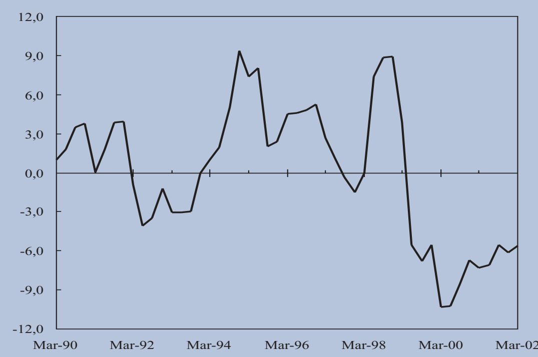


Source: National Planning Department.

8. Monetary Conditions Indicator

According to the Monetary Conditions Indicator (MCI), in the first quarter of 2002 the Board continued to pursue a policy of monitory easing, conducive to reactivation of the economy. The MCI for aggregate demand remained below the base-period level (1998:01 = 100) over the first quarter, largely thanks to lower interest rates, but the offsetting effect of the peso's revaluation kept it at much the same levels as in the previous two quarters (Figure 38).

Figure 38
Monetary conditions indicator for aggregate demand
(percentage)



Source: Banco de la República, SGEE.

B. Supply and demand

1. General considerations

At 1.6%, growth for 2001 was below the government's official target of 2.4% and also below the 2.7% rate for 2000. Several factors were responsible for this mediocre performance. First, everything seems to suggest that the tax reform introduced in 2001 affected disposable income more than expected, affecting household consumption. Moreover, the US economy's worse-than-expected performance meant a weakening of US demand for Colombian manufactured exports. Furthermore, major supply shocks at the beginning of 2001, including the strike at Bavaria (a big beverage producer) and attacks against the Caño Limón-Coveñas pipeline, adversely affected industrial output and oil production. Lastly, persisting negative factors, such as high unemployment, unfavorable terms of trade (including, in particular, low coffee and oil prices), and large external debt-servicing outlays reduced disposal income and affected household and government consumption.

Nevertheless, as anticipated in the December 2001 Inflation Report, the economy showed some signs of recovery in the fourth quarter. It grew by an annual rate of 1.7%, up from 1.0% in the third quarter, thanks to improvement in government and household consumption, which offset weaker growth in external demand and in investment.

Growth in 2002 could be driven by internal demand, particularly by household consumption. Some factors that should help to strengthen consumption are: lower interest rates, exchange-rate stability, better terms of trade (especially oil prices), and a possible increase in household income through higher remittances from abroad. Moreover, disposable income this year will not be under the impact of a tax reform.

However, meeting the government's projected growth target of 2.5% may conceivably be impeded by such negative factors as deterioration of foreign and local investors' perception of the country's economic outlook (because of the break-up of the peace talks and the high level of public debt), political and economic developments in Venezuela, and the persistence of a high rate of unemployment.

2. Consumption

As anticipated in the previous Report, overall consumption picked up significantly in the fourth quarter of 2001 (Table 8), in clear contrast to its slowdown in the preceding nine months. The recovery occurred in both household and government consumption.

Table 8
Demand view of GDP growth
(Annual % change)

	2000 (p)					2001 (p)				
	I	II	III	IV	Full year	I	II	III	IV	Full year
Gross domestic product	2.26	3.62	3.32	1.78	2.74	1.81	1.77	0.98	1.67	1.56
Total imports	1.91	7.34	13.68	11.72	8.62	11.35	20.44	8.16	4.66	10.94
Total final supply	2.21	4.14	4.76	3.19	3.57	3.19	4.45	2.06	2.14	2.95
Final consumption	3.47	3.15	2.86	0.54	2.49	1.17	1.00	0.99	2.17	1.33
Households[1/]	2.61	3.42	4.65	3.91	3.65	1.91	1.20	0.43	1.85	1.34
Nondurables[2/]	6.00	3.83	4.16	1.39	3.82	0.55	(0.48)	(2.44)	0.12	(0.57)
Semidurables[2/]	3.75	14.23	20.56	23.19	15.28	7.00	5.57	3.85	2.46	4.64
Services[2/]	0.20	1.22	2.41	2.56	1.60	2.62	2.32	2.61	3.12	2.67
Durables[2/]	3.23	7.83	6.47	6.13	5.90	4.17	2.30	2.16	6.56	3.82
Government	5.96	2.36	(2.08)	(8.25)	(0.74)	(0.89)	0.41	2.62	3.14	1.30
Gross capital formation	(7.22)	14.85	22.24	20.48	11.79	12.31	20.45	4.40	2.74	9.64
Gross fixed capital formation	(14.83)	(3.77)	4.43	13.61	(0.84)	6.06	13.37	12.53	12.42	11.16
Machinery & equipment	(4.18)	17.17	0.02	0.46	3.10	4.75	(2.19)	9.70	9.24	5.19
Transport equipment	(10.67)	(2.78)	13.16	19.65	4.22	16.74	34.23	18.34	10.24	19.44
Buildings	(1.57)	12.00	7.21	18.00	8.65	30.68	33.44	45.85	37.81	36.95
Civil works	(28.49)	(16.94)	(0.37)	7.14	(11.10)	7.16	10.88	8.26	17.29	11.02
Subtotal: final domestic demand	1.90	4.58	5.30	3.03	3.70	2.66	3.62	1.48	2.26	2.50
Total exports	3.85	1.79	1.98	4.04	2.92	6.00	8.91	5.11	1.52	5.32
Total final demand	2.21	4.14	4.76	3.19	3.57	3.19	4.45	2.06	2.14	2.95

(p) Provisional.
1/ Includes purchases by Colombian residents made abroad but not those made in Colombia by non-residents.
2/ Final consumption in Colombia by resident households.
Source: DANE.

Household consumption

The fourth-quarter recovery in household consumption resulted partly from a rise in disposable income thanks to a 25.0% increase (relative to the third quarter) in remittances from Colombian workers abroad, and the fact that the government implemented a salary increase ordered by the Constitutional Court in early 2001 and also paid the December bonus earlier than usual. Moreover, reduction of the Banco de la República's intervention rates by 150 basis points in the fourth quarter, together with a similar reduction in the third quarter, brought down households' financial-liabilities costs, stimulating the purchase of items usually bought on credit, such as durable consumer goods (mostly new vehicles).

Private consumption in the fourth quarter was driven not only by the rise in durable-goods purchases but also by higher consumption of services, and by actual expansion in nondurable goods after contractions in the second and third quarters (Table 8). According to DANE's January monthly retail sample, consumption rose over a wide range of goods in the fourth quarter, with positive growth in13 out of the sample's 16 groups of merchandise, and particularly fast expansion in sales of vehicles, furniture, electrical appliances and footwear (Table 9).

Disposable income is expected to have recovered further in the first quarter of 2002 and strengthened growth in private consumption, thanks in part to a rise in real incomes produced by inflation falling below expected rates (see the box in Chapter IV). In addition, the Bank's first-quarter rate cuts of 125 basis points must have again reduced financial-liability costs for households and stimulated purchasing on credit. There are also signs that households are making an early start on the process of replacing durable consumer goods. The consumer boom that started in the early 1990s ended more than five years ago, so that many of these goods are coming to the end of their useful life, especially electrical appliances, and to some extent cars (durable-goods cycle).

TABLE 9
ACTUAL SALES, BY GROUP OF MERCHANDISE
(ANNUAL % CHANGE)

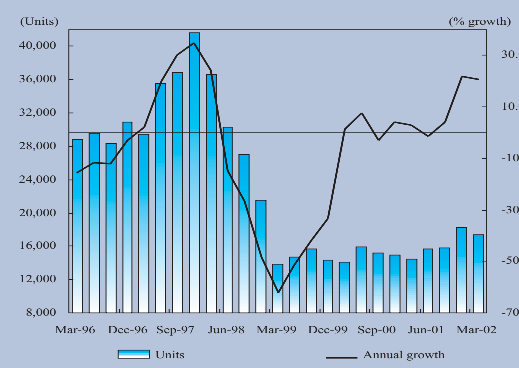
	2001 (p)			
	I	II	III	IV
Total excluding fuel	1.9	4.2	3.4	5.1
Total excl. fuel & vehicles	3.1	3.7	2.9	4.2
Food and beverages	1.6	1.6	(1.2)	0.9
Liquor & cigarettes	1.7	3.2	4.3	3.6
Clothing & textiles	5.4	4.1	1.9	4.0
Footwear & leather goods	9.6	6.1	5.7	10.8
Medicines	2.5	(2.6)	(2.6)	(3.8)
Toiletries	(3.1)	(0.6)	0.7	4.5
Furniture & electrical appliances	6.9	2.6	5.2	10.0
Household articles	3.2	18.1	14.3	13.0
Housecleaning products	11.7	8.3	19.2	10.6
Office furniture & equipment	9.6	34.0	53.3	32.9
Books & stationery	7.1	18.9	12.4	11.3
Hardware & glass	(2.4)	4.8	(0.3)	2.2
Spare parts	0.5	1.2	(0.8)	(3.9)
Vehicles	(17.2)	12.5	12.9	23.4
Lubricants	(0.6)	4.3	12.6	(5.6)
Other	4.6	16.4	18.1	13.5

(p) Provisional.
Sources: DANE's lists. Calculations by Banco de la República, SGEE.

The perception of satisfactory consumption behavior so far this year is borne out by some first-quarter figures on commerce. Sales of new cars (domestic and imported) within Colombia grew by an annualized rate of 20.6%, much as they had in the previous quarter (Figure 39). Likewise, at 7.4%, real growth in credit-card sales and advances not only accelerated but also turned positive for the first time in five quarters (Figure 40); it is worth noting that this strong upturn came from recovery in both advances and sales. For their part, financial entities reported a fair improvement in consumer-loan disbursements. Lastly, faster cash growth may be indicative of an expansion in sales in the first quarter.[11]

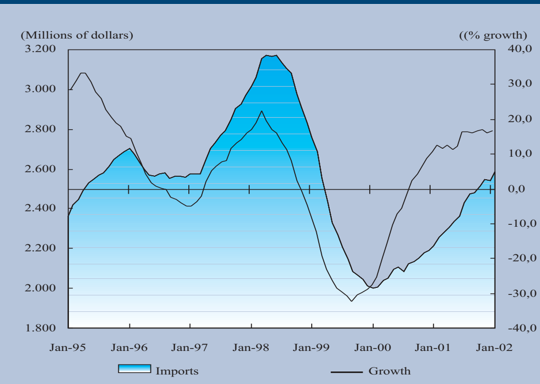
[11] See the section on Monetary Aggregates for further details.

Figure 39
Quarterly vehicle sales,
excluding exports



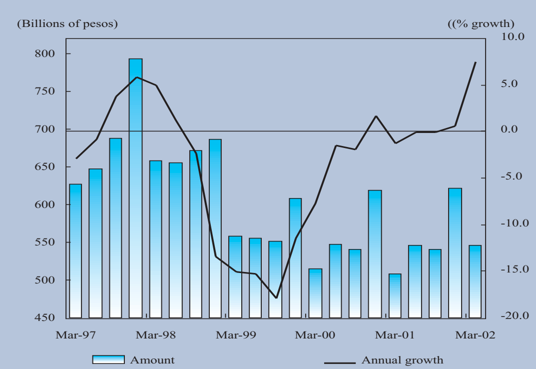
Source: Colmotores.

Figure 41
Consumer-goods imports,
latest 12 months



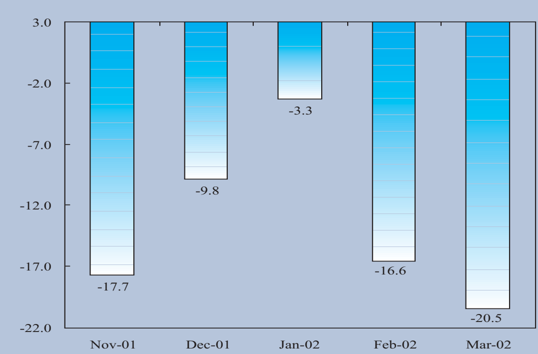
Source: DANE.

Figure 40
Credit card purchases and advances
(billions of 1994 pesos)



Source: Red Multicolor.

Figure 42
Consumer- confidence index
(percentage)



Source: Fedesarrollo.

Another satisfactory development was a 16.8% annual expansion in consumer imports in the 12 months to January, a growth trend maintained since the middle of last year (Figure 41). Imports of consumer durables expanded at a faster pace (27.6%) than nondurables (11.0%).

Private consumption is expected to continue growing over the rest of 2002 thanks to such favorable factors as low interest rates, lower household indebtedness, and a decline in unemployment. It is not yet clear, however, whether public-order developments in February have had a permanent or temporary effect on consumer confidence and whether or not they will affect decision-making by consumers. Fedesarrollo's new consumer-confidence indicator, published on a monthly basis since November 2001, fell in March. A permanent decline would mean greater discouragement among consumers, which would probably end up affecting consumption and eventually the whole economy (Figure 42).

Government consumption

Growth in government consumption accelerated in the fourth quarter of 2001 (Table 8). This is partly attributable to last year's policy of reducing payment arrears, whereby settlement of payments due in 2001 was accelerated and some overdue accounts were paid. The fourth quarter also saw the government complying with the retroactive pay rise for public employees ordered by the Constitutional Court.

As regards the first quarter of 2002 and the rest of the year, the adjustments scheduled in the 2002 Financial Plan[12] are expected to reduce government consumption. In nominal terms, the Plan provides for a 4.0% increase in personal-service payments, a 10.0% increase in total transfers, and a 3.0% decrease in general expenditures.

3. Investment

Total investment, measured as gross capital formation, grew at a slower pace again in the fourth quarter after its slowdown in the third. But this loss of pace is not explained by the behavior of the item investment less inventory accumulation (gross fixed capital formation), since this item expanded in the last quarter at an annualized rate of over 10.0%, similar to its growth rates in the previous quarters (Table 8). Hence, the slowdown in total investment must have been caused by destocking. This is just a deduction, however, for DANE has yet to release explicit data on this aggregate.

A possible destocking would send conflicting signals about the outlook for investment. If destocking was not intentional, it may have resulted from a pick-up in demand, which would augur well for investment and growth. But if it was in fact intentional, it may indicate greater doubt among businessmen about the future of demand, which would mean cuts in production and investment.

Private investment

Gross fixed capital formation connected with private-sector investment spending (on machinery and equipment, transport equipment, and buildings) expanded strongly again in the fourth quarter (Figure 8). Factors such as the upturn in construction and higher spending on Bogotá's massive transport system were behind this buoyancy.

The rest of private investment spending was also dynamic. Companies made large investments in machinery and equipment over the second half of 2001, as indicated by the big increase in this item over that period. A good part of this spending by companies may have gone to make the equipment replacements they had been unable to afford in the previous years (Table 8). The rest must have been invested in expanding production capacity and improving the competitivity of their productive processes.

Investment spending by companies is expected to be less dynamic in 2002 than it was in the second half of last year. Some indicators appear to suggest that firms have "over-invested", or simply that demand for their products has been below expectations. For example, as discussed in greater detail below, in February Fedesarrollo's capacity-utilization indicator stood below its already low level a year earlier. The same was true of ANDI's indicator. Moreover, this year neither investments under Plan Colombia nor those for Bogotá's massive transport system will be of the same magnitude as they were last year.

The recent behavior of capital-goods imports may be a sign that growth in private investment was already slowing in the first quarter. Annual variation in imports of industrial capital-goods decreased substantially in January, as their level fell for the second month in a row. January also brought slower annual growth in imports of transport equipment, which stayed at much the same value as in December 2001.

Investment in buildings is expected to be the most dynamic component of gross fixed capital formation in 2002. It registered high rates of growth in 2001 and, to judge by various sectoral indicators, should not change its growth tendency over this year. In fact, construction spending may have actually grown at a faster pace in the first quarter of 2002.

[12] 2002 *Financial Plan*. Document No. 17, dated December 21, 2001, prepared by Fiscal Policy Council Advisors.

According to ICAV (building and loan association), loans to house builders surged by a real annual rate of 141.5% in the first quarter, a considerable acceleration on 57.7% in the fourth quarter of 2001 (Figure 43). Approvals of house-building licenses rose by 54.5% over January and February, with licenses for non-social housing increasing faster than those for social housing: 67.5% against 38.8%.

As regards the rest of the year, positive demand shocks (such as approval of the Andean trade preference system) may conceivably occur that could lead to acceleration of private investment spending, especially in equipment and machinery.

Public investment

Investment in public works rose steeply in the fourth quarter of 2001 (Table 8), reflecting both an increase in public spending and the policy of speeding up budget execution so as to reduce payment arrears.

But outlays on public works are expected to contract this year, because the 2002 Financial Plan calls for a drastic (70.0% nominal) reduction in the central government's investment spending, and also because local governments are not expected to make any large investments in infrastructure. In the case of Bogotá, the city administration's failure to obtain approval for a tax reform and for decapitalization of Codensa (electricity distributor) is a serious setback for financing this year's investment projects included in the Land Development Plan.

4. External demand

As predicted in the previous Report, export growth continued to lose pace in the fourth quarter (Table 8), mainly because of a decline in oil exports. Nontraditionals, too, weakened further because the decline in US demand was not fully offset by higher nontraditional exports to Venezuela and Ecuador.

Data to February indicate that the declining trend in total exports continued into the first quarter of this year, with 12-month accumulated exports showing a 6.4% contraction in February (Figure 44). Nontraditionals remained at about the same levels as in November 2001, which translated into a slower rate of annual growth for their 12-month accumulated value (Figure 45).

Figures to February also show that nontraditional industrial exports to the United States have been falling (Figure 46). Their decline is attributable to both the US economy's downturn and delay in approval of the Andean trade preference system.

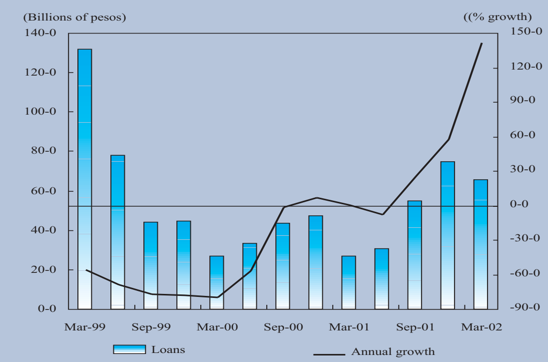
Nontraditional industrial exports to Venezuela stagnated in value from December to February (Figure 47), and some preliminary figures point to a strong decline in their growth in March (exports of new vehicles were about 65% of their February level).

Exports are not expected to be good in 2002. Traditional exports will probably continue to shrink as oil production declines through depletion. Nor do coffee exports have much chance of recovery, because low prices are likely to discourage supply. Satisfactory behavior of coal exports will not make up for all those these sources of lower export growth.

Nontraditional exports are expected to be less buoyant than last year, for the growth trend of exports to the United States is not likely to change until the Andean Trade Preference Act has been renewed and the US economy's recovery has become stronger. Exports of nontraditionals to Venezuela are likely to shrink because of the difficult political and economic situation there.

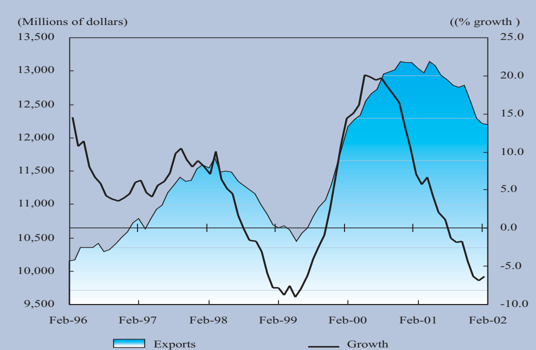
In contrast, nontraditional exports to Ecuador are expected to expand robustly all through this year, though at rates below last year's (Figure 48).

Figure 43
Loans to house builders
(billions of 1998 pesos)



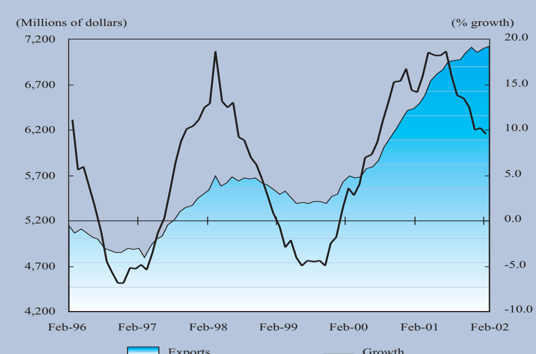
Source: ICAV (building and loan association).

Figure 44
Total exports, latest 12 months



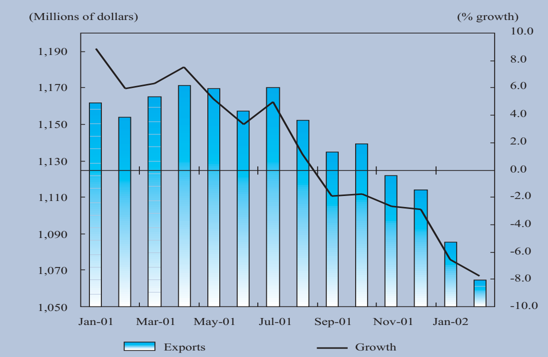
Source: DANE.

Figure 45
Nontraditional exports, latest 12 months



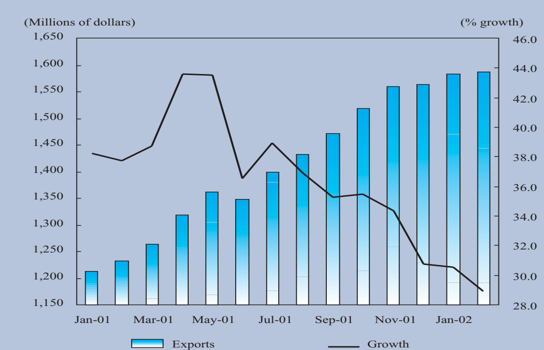
Source: DANE.

Figure 46
Nontraditional industrial exports to USA, latest 12 months



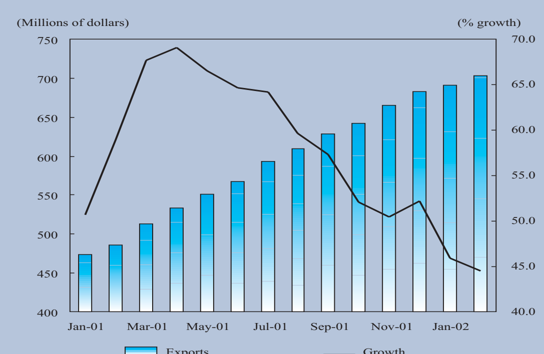
Source: DANE.

Figure 47
Nontraditional industrial exports to Venezuela, latest 12 months



Source: DANE.

Figure 48
Nontraditional industrial exports to Ecuador, latest 12 months



Source: DANE.

5. Supply

Most sectors of economic activity registered faster annual growth in the fourth quarter of 2001 than in the previous two quarters. Recovery was particularly strong in construction: at 10.9%, the rate of annual growth was far higher than at any time in the past four years. Farming and commerce, too, showed good recovery. These three sectors, together with personal services, accounted for faster GDP growth in the fourth quarter (Table 10). Unfortunately, a contraction in mining and quarrying caused by lower oil production, and the manufacturing sector's poor performance kept GDP from expanding even faster.

At the time of this writing, DANE had still not released figures on industry and commerce. For this reason, the following review is only based on surveys conducted by trade associations and private research centers, rather than on official figures.

There are signs that sectors such as commerce and construction continued to expand over the first quarter of this year. Energy demand rose by 2.6%, suggesting that urban activity in general suffered no major deterioration (Figure 49).

In February, ANDI's Joint Industrial Opinion Survey pointed to a recovery-or at least a slower rate of contraction-in industrial output, largely because early this year there was no supply shock like the Bavaria strike that had affected industrial production in the first quarter of 2001 (Figure 50). The survey also reports upturns in some other important industrial sectors, such as the food industry (8.5% over January and February), which may indicate a rise in domestic demand.

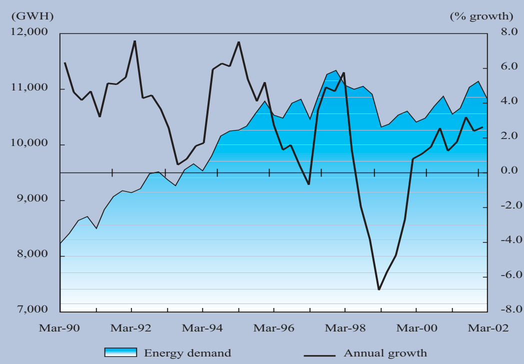
Slower deterioration in industrial output is also suggested by imports of intermediate goods for industry. Although 12-month accumulated imports

TABLE 10
QUARTERLY GDP, BY SECTOR - SEASONALLY ADJUSTED SERIES
(ANNUAL % CHANGE)

Sector	2000 (pr)					2001 (pr)				
	I	II	III	IV	Full year	I	II	III	IV	Full year
Farming, forestry, hunting & fishing	1.60	7.33	3.96	7.34	5.03	4.12	0.26	(0.33)	2.08	1.51
Mining and quarrying	(5.27)	(11.81)	(12.57)	(10.55)	(10.04)	(7.68)	(3.69)	1.92	(6.39)	(4.04)
Electricity, gas and & water	2.93	0.75	(0.56)	(0.25)	0.70	1.00	2.78	2.76	1.12	1.91
Manufacturing	10.33	11.82	12.14	4.91	9.73	2.57	0.85	(3.36)	(2.95)	(0.76)
Construction	(13.95)	(4.38)	0.49	8.42	(2.85)	(3.49)	(0.02)	4.80	10.87	3.17
Commerce, repairs, restaurants & hotels	6.13	12.04	13.31	10.41	10.46	4.10	1.78	0.26	2.16	2.05
Transport, warehousing & communications	2.14	2.33	2.81	1.65	2.23	3.22	4.57	2.90	3.21	3.47
Financial, insurance and real-estate firms	0.50	1.67	2.56	(0.13)	1.15	0.38	(0.80)	0.35	0.84	0.19
Social, community & personal services	3.89	1.33	(1.71)	(6.66)	(0.92)	(0.19)	0.77	2.41	2.91	1.47
Gross Domestic Product	2.26	3.62	3.32	1.78	2.74	1.81	1.77	0.98	1.67	1.56

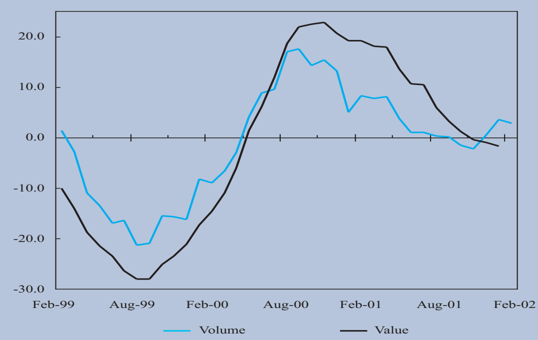
(pr) Preliminary.
Source: DANE.

FIGURE 49
QUARTERLY ENERGY DEMAND



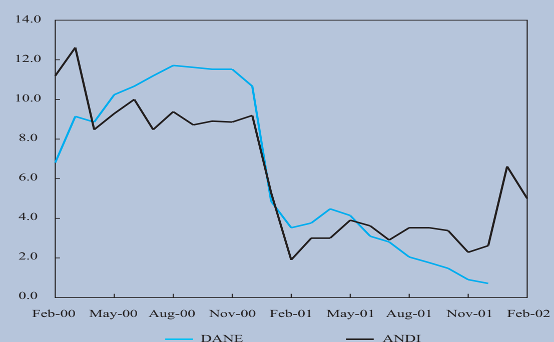
Source: ISA.

FIGURE 51
INTERMEDIATE INDUSTRIAL GOODS IMPORTS, LATEST 12 MONTHS



Source: DANE.

FIGURE 50
REAL INDUSTRIAL PRODUCTION INDEX
(ANNUAL % CHANGE, JANUARY TO DATE)



Sources: DANE and ANDI (major business association).

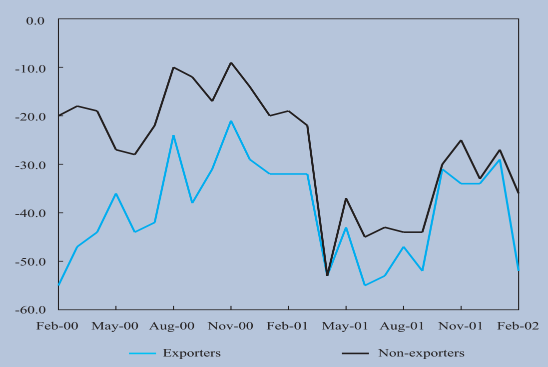
contracted in value by an annual rate 1.7% in January, in volume they have been expanding since November, at an ever increasing annual rate, which stood at 3.6% in January (figure 51).

It is difficult to say which sectors will be driving growth over the rest of the year, and more difficult still to predict whether industry will actually recover. The findings of Fedesarrollo's Business Opinion Survey in February seem to suggest that the breaking-off of the peace talks affected industrial performance. Moreover, non-exporting manufacturers reported a sharp fall in orders and a rise in inventories. If undesired inventory accumulation continues, it will affect industrial activity in the coming months (Figures 52, 53 and 54). In contrast, exporting companies reported a smaller decrease in the volume of orders, and despite the decrease, which was expected because of weakening external demand, they managed to keep inventory levels stable and increased their productive activity.

As was to be expected, the breaking-off of the peace talks caused manufacturers to reduce their economic and production expectations; this was reflected by a significant decline in the business-climate indicator estimated from Fedesarrollo's survey (Figure 55). The March survey's expectations results should be similar to the February survey's.

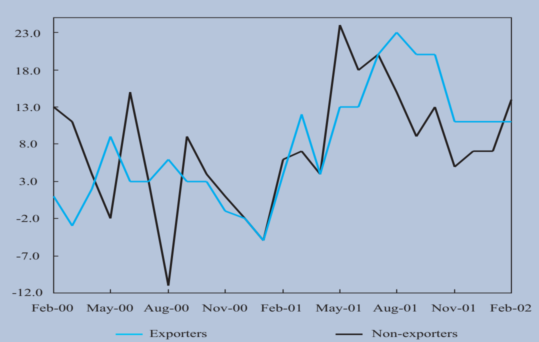
At the moment there is no knowing whether the deterioration in businessmen's expectations is temporary or permanent, much less how it is going to affect their decisions on production and investment. In addition, there is great uncertainty about the final outcome of events in Venezuela and their effect on Colombia's nontraditional exports. Lastly, approval of the Andean trade preference system could provide a positive shock to industrial output and expectations, but it is still unclear when it is going to be approved, and uncertain what products are going to benefit from tariff exemptions.

FIGURE 52
CURRENT VOLUME OF ORDERS
(BALANCES)



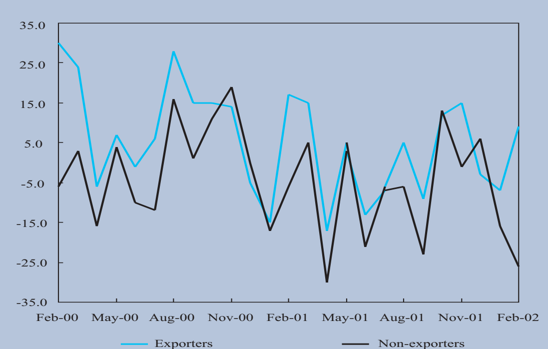
Source: Fedesarrollo, business opinion surveys.

FIGURE 53
CURRENT INVENTORY LEVEL
(BALANCES)



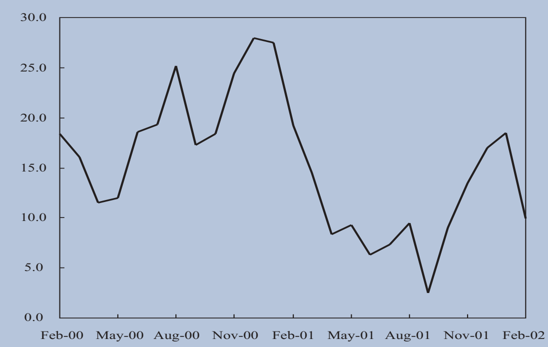
Source: Fedesarrollo, business opinion surveys.

FIGURE 54
PRODUCTIVE ACTIVITY
(BALANCES)



Source: Fedesarrollo, business opinion surveys.

FIGURE 55
BUSINESS CLIMATE
(BALANCES)



Source: Fedesarrollo, business opinion surveys.

There is less uncertainty about private construction, for judging by the building licenses referred to above construction will remain buoyant for much of the rest of this year. Moreover, the availability of subsidy funds for social housing will ensure continued growth of this subsector. Commerce and farming are also expected to expand this year. In contrast, declining oil production is seen as causing a large contraction again in mining and quarrying.

C. Wages and employment

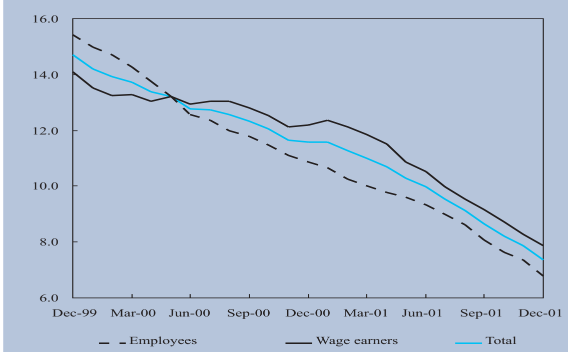
1. Industrial pay

In December 2001, nominal industrial pay rises continued the declining trend started in 2000. In the 12 months to December, they averaged 8.1% a year for all workers (employees + wage earners), a fall of 5.2 percentage points on a year earlier. This fall was 1.1 percentage points bigger than the drop in inflation over the same period, which meant a decline in real pay rises.

Industrial workers' benefits also continued to rise more slowly. In 2001, they grew by 6.4% for all workers, a fall of 2.9 percentage points on 2000 (9.3%).

Smaller rises in industrial pay and benefits have brought growth in total remuneration (pay plus

FIGURE 56
NOMINAL INDUSTRIAL RENUNERATION, LATEST 12 MONTHS
(ANNUAL % CHANGE)



Source: DANE.

benefits) more into line with inflation and the Banco de la República's target (Figure 56). In effect, the 7.4% increase in total remuneration last year was much the same as the rate of inflation (7.6%), whereas in 2000 remuneration had risen by 11.6%, which was 2.8 percentage points higher than inflation that year.

Last year's more moderate nominal pay rises, combined with an industrial wage earners' productivity close to the year before's, resulted in nominal labor costs per unit of output (unit labor costs) rising by a rate close to inflation. Thus, in real terms, unit labor costs in December 2001 were no higher than a year earlier (Figure 57). Since pay rises have begun to fall into line with the Bank's inflation targets, and productivity is likely to continue to show some growth either as a result of recent investments or through personnel cuts, unit labor costs will probably remain low this year and not exert any inflationary pressure

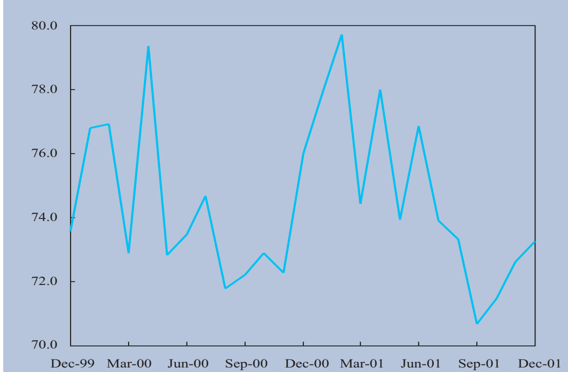
2. Employment

Unemployment for the 13 major urban areas was 18.8% in February, 1.2 percentage points lower than on a year earlier (Figure 58). For the country as a whole, it was 16.4%, a decrease of 0.9 points on February 2001.

The drop in unemployment for the 13 cities came from a decrease in labor supply. The global participation rate was 1.7 percentage points lower than in February 2001, which amply offset the 0.6 percentage-point fall in the employment rate (Figures 59 and 60).

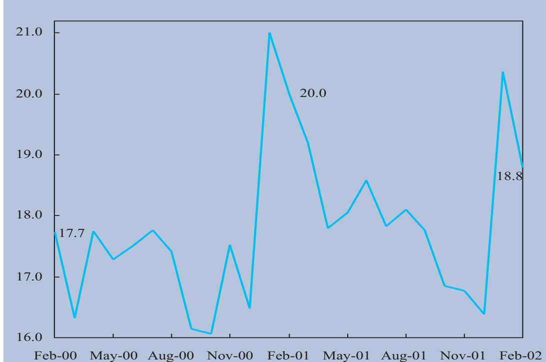
Growth in the labor supply, as measured by the global participation rate, has been one of the causes of rising unemployment in recent years. The sharp fall in labor supply early this year is puzzling, and may be transitory-but this still remains to be seen. If labor supply continues to fall, however, a possible explanation would be that household incomes have improved (through higher remittances

FIGURE 57
REAL UNIT LABOR COSTS, INDUSTRIAL WAGE EARNERS
(INDEX)



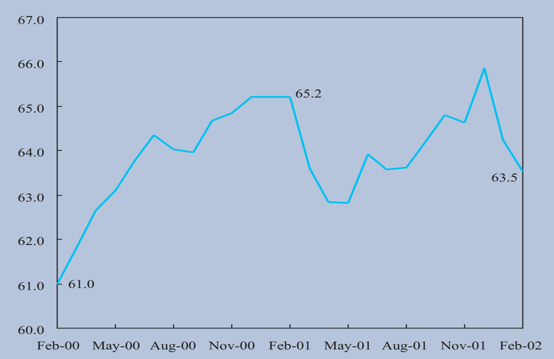
Source: DANE.

FIGURE 58
UNEMPLOYMENT RATE, 13 CITIES
(NEW METHODOLOGY)
(PERCENTAJE)



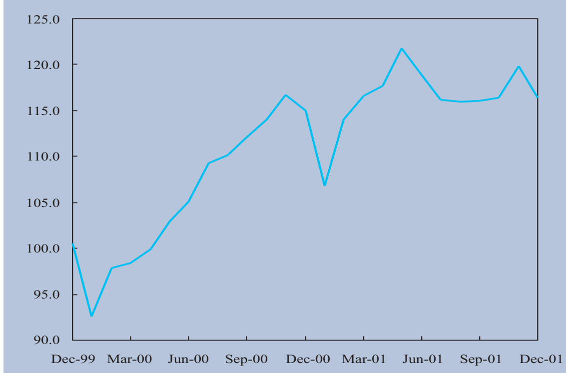
Source: DANE, continuing household surveys.

Figure 59
Global participation rate, 13 cities
(new methodology)



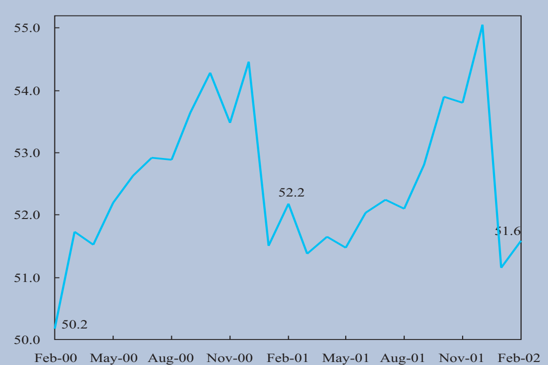
Source: DANE.

Figure 61
Temporary industrial employment index
(employees + wage earners)



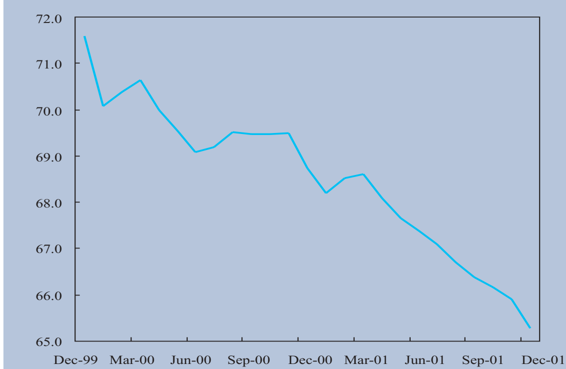
Source: DANE, monthly manufacturing samples.

Figure 60
Employment rate, 13 cities
(new methodology)



SOURCE: DANE, continuing household surveys.

Figure 62
Permanent industrial employment index
(employees + wage earners)



Source: DANE, monthly manufacturing samples.

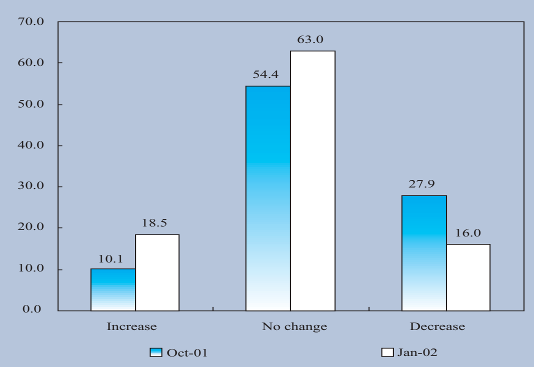
from abroad or higher and more stable income for the head of the household), thereby reducing the pressure or need for finding employment. A less optimistic explanation would be that high levels of unemployment have discouraged job-seeking by under-employed or underpaid people (for example, pensioners or students looking for part-time work).

DANE's monthly manufacturing sample of December 2001 pointed to a continued decline in industrial employment, with part-time jobs stagnating and full-time ones still falling (Figures 61 and 62).

Temporary employment began to weaken in the second half of last year, when, according to DANE's monthly manufacturing samples, industrial output started to deteriorate (Figure 50).

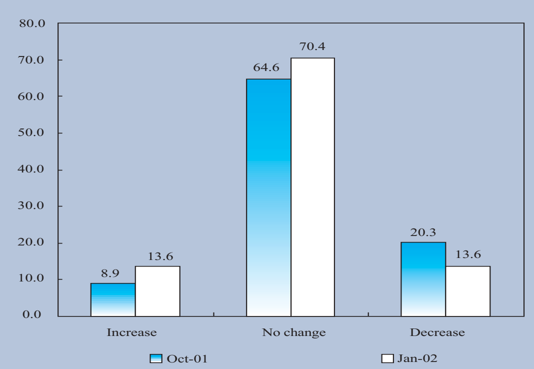
In 2002, further recovery in labor-intensive sectors such as construction and commerce should raise the level and possibly the rate of employment. This view is supported by the Bank's January expectations survey, which found 18.5% of respondents planning to hire more people in the following three months and another 13.6% expecting to do so within six months (Figures 63 and 64).

Figure 63
Corporate workforce plans for next 3 months
(percentage)



Source: Banco de la República, quarterly expectations surveys.

Figure 64
Corporate workforce plans for next 6 months
(percentage)



Source: Banco de la República, quarterly expectations surveys.

It is worth noting that, for the first time since the surveys were started in April 2000, the percentage of respondents planning to hire more people rose from one survey to the next. Specifically, it rose by 8.4 percentage points from October to January for the three-month time horizon, and by 4.7 points for the 6-month horizon.

3. Pay settlements

The minimum legal wage was raised by 8.0% for 2002. This increase is two percentage points higher than expected inflation for 2002 and 0.4 points higher than actual inflation in 2001. Though substantially lower than last year's 10.0% rise, it is still above the Bank's inflation target for this year.

Table 11 presents figures from the Ministry of Labor and Social Security on one- and two-year pay settlements.

The upper part of Table 11 shows, by pay-rise level, the percentages of workers covered by one-year pay settlements negotiated in the first three months of this year. The one-year pay rise was in the lower range, 6.5%-8.0%, for 28.7% of these workers, a much larger proportion than the 0.3% who had received a pay increase in this range in the first quarter of 2001.

In contrast, the percentage of workers getting a pay increase in the next higher range, 8.0%-10.0%, plunged by 38.5 percentage points, from 76.6% in the first quarter of last year to 38.1% in the same period this year. The foregoing may mean that the Bank's inflation targets have gained credibility. And it implies at the same time that there will be less inflationary pressure from labor costs in the coming months.

The bottom part of Table 11 shows, by pay-rise level, the percentages of workers receiving two-year pay increases negotiated between January and March this year. Almost half of these workers are

Table 11
Pay settlements: January-March 2002
% of beneficiaries by pay-rise level

One-year rises

<6.5	[6.5-8.0]	[8.0-10.0]	[10.0-12.0]
3.3	28.7	38.1	29.9

Two-year rises

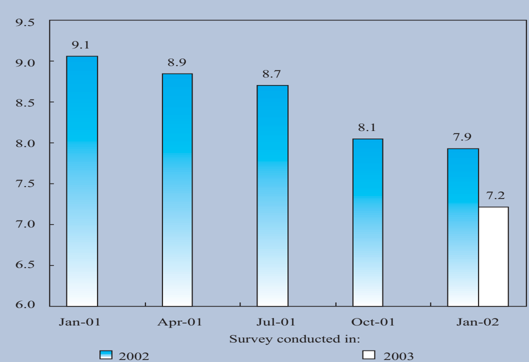
<6.5	[6.6-11.0]	CPI	[IPC + 0.5-IPC + 2.5]	MLW	Other
2.6	11.7	34.9	44.5	0.6	5.6

MLW: Minimum legal wage.
Source: Ministry of Labor and Social Security.

concentrated in a range between CPI+0.5% and CPI+2.5%. Their proportion is very close to what it was in the first quarter of 2001 (42.5%). The two-year rise was equal to CPI for another 34.9% of workers, a slightly lower proportion than last year's 32.6%. And only 2.6%-the same proportion as last year-saw their wages rising by less than 6.5%.

The Bank's January expectations survey reveals a reduction in expected pay increases (Figure 65). Respondents expect wages to rise by 7.2% in 2003. It is important to point out that expected pay rises have been systematically revised down since the beginning of last year.

Figure 65
Expected average pay rises for 2002 and 2003
(percentage)



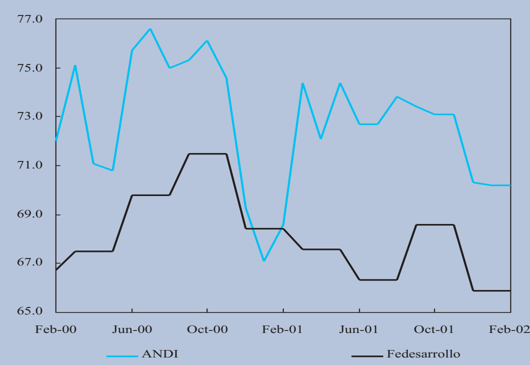
Source: Banco de la República, quarterly expectations surveys.

D. Capacity utilization and output gap

Both of the capacity-utilization indicators referred to in this Report showed utilization running below the average historical level for February.

According to Fedesarrollo's indicator, capacity utilization in the period December 2001-February 2002 was 4.3 percentage points below the average for these same months in the past ten years.

Figure 66
Capacity utilization
(percentage)



Sources: ANDI and Fedesarrollo.

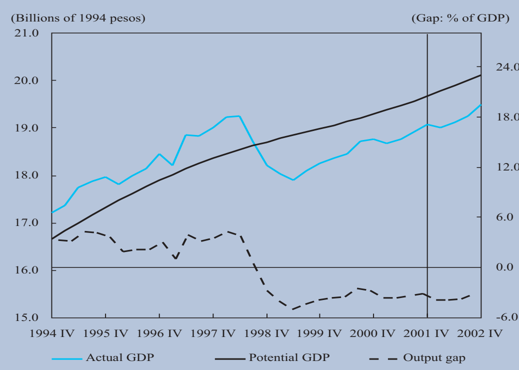
Similarly, in February ANDI's indicator stood 3.6 percentage points below the February average for the past seven years (Figure 66).

Lower capacity utilization appears to have stemmed from corporate over-investment, as explained in the section on Private Investment. Last year, the private sector made a significant investment effort, reflected in a large rise in total investment for the second year running, and a strong flow of capital-goods imports. This process not only enlarged the economy's installed capacity, but probably also raised the productivity growth of the different factors of production. But, since this greater corporate effort to expand productive capacity was not accompanied by recovery in demand, it translated into an increase in idle installed capacity.

The output gap, as estimated on the basis of supply of productive factors (production approach), confirms the existence of ample spare capacity in the economy as a whole. The output gap currently stands at 3.2% of GDP and is predicted to remain at this level for the rest of the year, assuming the economy grows by about 2.5% (Figure 67),

No inflationary pressure is therefore expected from demand this year, at least as far as industrial goods are concerned.

Figure 67
OUTPUT GAP:
(BILLIONS OF 1994 PESOS)



Sources: ANDI and Fedesarrollo.

E. Fiscal policy

At the end of the first quarter of 2002, the central government's cash operations showed a deficit of 431 billion pesos, equivalent to 0.2% of annual GDP (Table 12). Although these operations give an idea of the government's fiscal situation, it is important to note that the deficit they show reflects only revenue and expenditure flows through the Treasury. The fiscal deficit as measured on the entirety of the government's receipts and outlays has not yet been officially released.

Relative to the first quarter of 2001, revenues decreased by 3.6% and expenditures by 9.6%. The fastest falling revenue items were the gasoline tax, external VAT and income tax. The fall in the case of the gasoline tax came from reduction of the rate, and in the case of the external VAT from a weakening of imports and the peso's revaluation in the first quarter. Income-tax behavior was affected by a low level of economic activity in 2001, a number of adjustments to the tax calendar, and the long Easter weekend.[13]

On the side of expenditures, interest payments rose by 2.9%, while operating costs declined by 12.1% and investment by 23.9%. Among operating costs, general expenses shrank by 27.4% and transfers by 15.3%. Transfers decreased because a change of method in calculating municipal allocations caused payments due in the first quarter to be brought forward to December. Shrinkage of general expenses is largely attributable to Law 617 of 2000, which limits their average growth to 50% of the inflation target, except for those expenses connected with health care and the armed forces.

The deficit was mostly financed from domestic loans. Net foreign borrowing showed a negative balance of 790 billion pesos, with disbursements of 41 billion and amortizations of 831 billion. Domestic borrowing amounted to 2,672 billion pesos, resulting from disbursements of 4,471 billion, against amortizations1,799 billion. Domestic credit included, notably, placement of "TES B" Treasury paper amounting to 4,246 billion pesos during the first quarter, 2,353 billion through auctions, 1,517 billion as agreed investments, and 375 billion as forced investments.

13 Tax revenues deposited in banks were not transferred to the Treasury until the month of April because of the long Easter weekend and displacements of tax dates by an average of two days.

Table 12
Central government
First-quarter cash balances
(Billions of pesos)

		2001	2002	Annual % change 2002/2001
I.	**Total revenues (A+B)**	8,033.0	7,741.0	(3.6)
	A. Tax revenues	5,994.0	5,796.0	(3.3)
	Income tax	2,335.0	2,162.0	(7.4)
	Internal VAT	1,867.0	1,935.0	3.6
	External VAT	707.0	646.0	(8.6)
	Customs	447.0	453.0	1.3
	Gasoline tax	270.0	238.0	(11.9)
	Financial-transactions levy	356.0	353.0	(0.8)
	Other	12.0	9.0	(25.0)
	B. Other revenues (*)	2,039.0	1,945.0	(4.6)
II.	**Total expenditures (A+B+C)**	9,037.0	8,172.0	(9.6)
	A. Interest payments	2,254.0	2,319.0	2.9
	External	828.0	947.0	14.4
	Domestic	1,426.0	1,372.0	(3.8)
	B. Operating costs	5,881.0	5,167.0	(12.1)
	Personal services	1,428.0	1,455.0	1.9
	General expenditures	492.0	357.0	(27.4)
	Transfers	3,961.0	3,355.0	(15.3)
	C. Investment	902.0	686.0	(23.9)
III.	**Cash deficit or surplus (I-II)**	(1,004.0)	(431.0)	(57.1)
IV.	**Financing (A+B+C+D)**	1,004.0	431.0	(57.1)
	A. Net external credit	1,408.0	(790.0)	(156.1)
	Disbursements	1,720.0	41.0	(97.6)
	Amortizations	312.0	831.0	166.3
	B. Net domestic credit	498.0	2,672.0	436.5
	Disbursements	4,056.0	4,471.0	10.2
	Amortizations	3,558.0	1,799.0	(49.4)
	C. Asset sales	181.0	0.0	(100.0)
	D. Other	(3,091.0)	(2,313.0)	(25.2)
V.	**Deficit as percentage of GDP**	(0.5)	(0.2)	-

(*) Includes 1,228 billion pesos of profits produced by the Banco de la República's operations.
Source: National Treasury Office.s

III

International context

A. Overview

The US economy performed better than expected in the fourth quarter of 2001, expanding at a faster rate (the highest in 2001) rather than shrinking, contrary to the previous Report's prediction (Table 13).

The economy of the euro area showed slight signs of weakening at the end of last year, as predicted, but is expected to return to its growth path in the first quarter of this year, as the world economy grows stronger too. In contrast, the economy of Japan was still submerged in long-lasting recession, and no trend change is expected in the short term.

Recently perceived productivity gains, particularly in the United States, and ample spare capacity suggest that expected higher growth is unlikely to generate significant inflationary pressures in any of the major economies, so that interest rates should remain low for the better part of the year, allowing stronger recovery.

Improvement in the international setting is expected to benefit Latin America. But economic developments in individual Latin American

Table 13
Actual and forecast growth (*)
For Colombia's main trading partners

	2001	2002		2003
		Dec/ 01 Forecasts	Mar/ 02 Forecasts	
World				
United States	1.2	0.7	2.3	3.4
Euro area	1.5	2.0	1.4	2.9
Japan	(0.4)	(1.0)	(1.0)	0.8
Latin America				
Argentina	(3.7)	(1.1)	(10.0) a (15.0)	0.0 a 3.0
Brazil	1.5	2.0	2.5	3.5
Chile	2.8	3.0	3.0	6.0
Ecuador	5.2	3.8	3.1	6.0
Mexico	(0.3)	1.2	1.7	4.9
Peru	0.2	3.7	3.7	5.0
Venezuela	2.7	1.8	(0.8)	1.3
Colombia	1.5	2.4	2.5	3.3

(*) IMF forecasts, March 2002.

countries will continue to be strongly influenced by internal (political) factors and by how exposed their markets are to the seriously troubled economies of the region.

In an international context in which other (equity) investments do not seem very attractive because of both over-valuation (particularly in the US) and lack of balance-sheet transparency (as in Enron), low interest rates might lead to higher capital outflows to Latin America or at least to its sounder economies. And, with Argentina-a major user of foreign capital-out of the market, more funds are available for the region's other economies.

On the basis of economic-growth forecasts for Colombia's main trading partners, discussed in detail below, the country's foreign trade is expected to show a 1.6% weighted overall expansion by volume in 2002, up from 1.4% predicted in the previous Inflation Report, and compared with 2.2% in 2001. The possible impact of external variables on Colombia's inflation and growth is considered in greater detail in Chapter IV.

1. United States

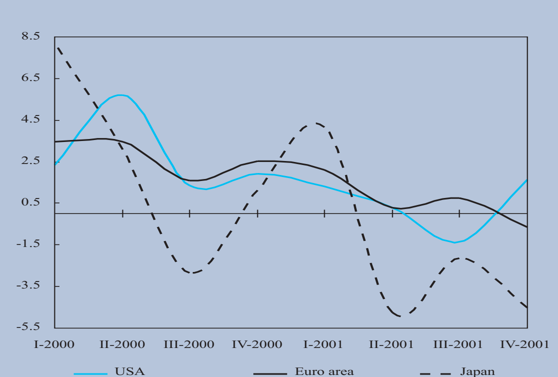
The US economy started to recover in the fourth quarter of 2001, with real GDP growing by an annualized quarterly rate of 1.7%, the highest for the year (Figure 68), thanks to a 10.2% increase in public spending on investment and consumption. Private consumption, driven mainly by demand for durable goods (39.4%), continued to show signs of strength, rising by an annualized quarterly rate of 6.1%, the highest since the second quarter of 1998.

It is notable that consumer confidence did not deteriorate irretrievably at any time last year. In effect, the September-11 terrorist attacks and uncertainty over the economy's resilience were transitory shocks that were already beginning to disappear by the end of the year (Figure 69).

Technically speaking, last year the US economy did not go into recession, commonly defined as at least two consecutive quarters of contraction. The US economy contracted only in the third quarter. Its growth for the year as a whole was 1.2%, higher than the 1.0% rate predicted three months ago, but the lowest full-year growth since the recession of 1991.

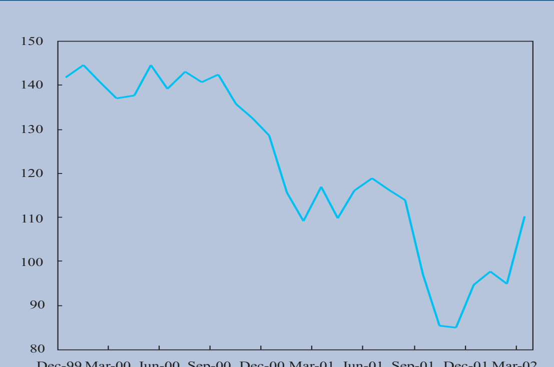
And contrary to predictions in the December Report, no discernible risk factors point to a slowdown in the first quarter of 2002. In fact, most indicators suggest that the economy continued to grow stronger. Various international analysts expect an annualized quarterly growth of about 4.5%, far higher than the 0.5% forecast at the end of December.

Figure 68
Annualized quarterly GDP growth: USA, Euro area, Japan
(Percentage)



Sources: Datastream and Bloomberg.

Figure 69
USA, consumer confidence index
(Percentage)



Source: Datastream.

The better outlook for first-quarter growth in particular, and for the year as a whole is based, among other things, on the strength shown by private-sector consumer spending, productivity gains, satisfactory labor-market figures and the end of the cycle of destocking.

Early figures available on first-quarter household consumer spending suggest that it was higher than the forecast made at the end of December, reflecting the positive effect of low interest rates, fiscal stimuli, and the successful US military campaign in Afghanistan. Actual retail sales grew by an annual rate of 5.9% in February. In March, the consumer confidence index stood at 110, its highest level in six months, and the index of expectations about the economy's future behavior was at 109.3, its highest point since September 2000.

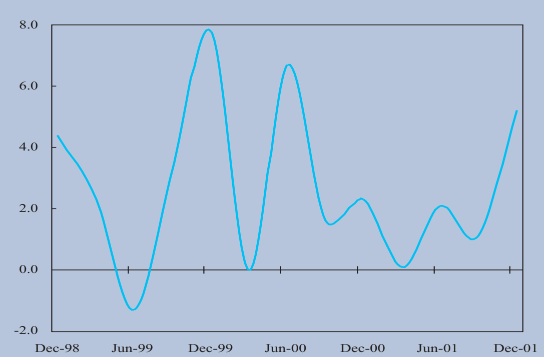
The pick-up in consumer confidence is partly attributable to a better labor situation, which showed signs of stabilization in the first quarter. The unemployment rate was 5.7% in March, 0.2 percentage points lower than in December, while labor productivity rose by 5.3%, its biggest rise since mid-2000 (Figure 70).

In addition, private demand may be boosted by fiscal policy. In early March, the US Congress approved a further fiscal-stimulus package of $51 billion for 2002 and $43 billion 2003, which included extension of unemployment benefits, higher investment spending, and reimbursements to firms incurring net operating losses. This new package and the previous stimulus plan together amount to some $132 billion. It is estimated that the net effect of these measures on the economy could stimulate economic activity, contributing over one percentage point to real GDP growth.

As regards supply, on the basis of various indices, including inventory behavior, industrial production can be expected to show sustained recovery over the whole of this year. The US economy went through a strong destocking phase in 2001, but in January and February inventories were already beginning to show positive growth, while industrial orders rose by 1.6% in January. These recent developments have begun to stimulate industrial production, to the point that it showed a monthly growth of 0.2% in January and 0.4% in February, the first positive reports since September 2000.

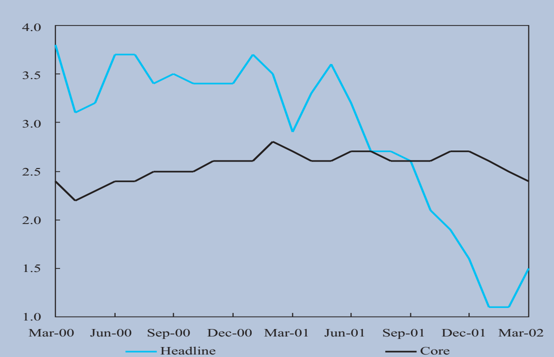
In January and February, annual headline inflation leveled off at 1.1%, the lowest rate since June 1953, while core inflation fell steadily relative to December, running at 2.6% and 2.5% respectively (Figure 71). In a context of price stability, given the large reported gains in labor productivity, and existing spare capacity-capacity utilization was 74.8% in February,

FIGURE 70
USA, LABOR PRODUCTIVITY
QUARTERLY GROWTH
(PERCENTAGE)



Source: Bloomberg.

FIGURE 71
USA,
INFLATION
(PERCENTAGE)

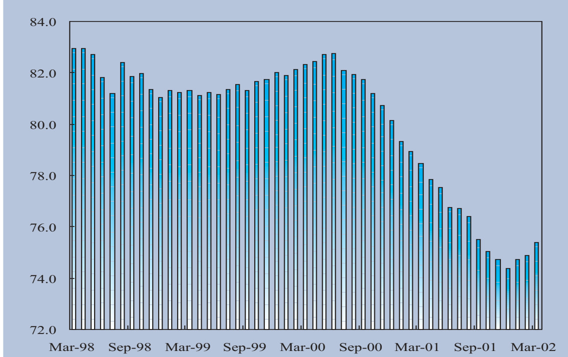


Source: Bloomberg.

still below the historical average (Figure 72)-, inflation is not expected to pick up significantly on the side of costs over 2002, even taking into account the better outlook for economic growth.

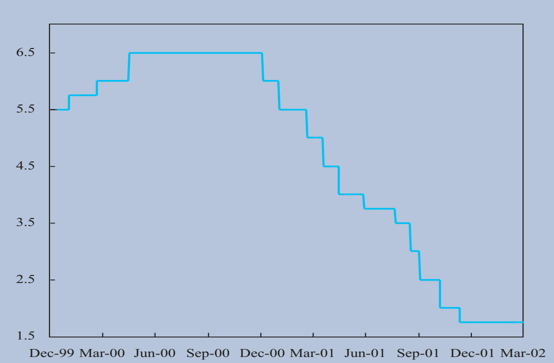
In the first quarter of the year, in view of the economy's incipient recovery and good inflation results, the Fed decided to keep its intervention rate unchanged at 1.75% (Figure 73), and no further cuts are expected in the coming months. On the contrary, the Fed is expected to start applying a more contractionary monetary policy, as unemployment continues to fall and economic recovery becomes stronger. Various international analysts see the Fed's

Figure 72
USA, capacity utilization
(percentage)



Source: Datastream.

Figure 73
USA,Federal funds rate
(percentage)



Source: Bloomberg.

intervention rate being raised initially by 25 basis points towards the end of June and eventually ending the year at around 3.0%.

Assuming these predictions are correct, the US economy should grow by about 2.7% in 2002 and faster in 2003. This new forecast for 2002 is considerably higher that the 0.7% predicted three months ago, when the US economy's prospects for recovery were less bright and there was greater uncertainty.

2. The euro area

Unlike the US economy, which touched bottom in the third quarter of 2001 and rebounded in the fourth, the euro economy did not contract until the fourth quarter (Figure 68). Its real GDP fell by an annualized quarterly rate of 0.7%, largely because of stagnating domestic demand. In effect, consumption grew by an annualized quarterly rate of 0.4%, while investment sank for the fifth quarter running, this time by 3.2%. The 12 euro-area countries grew by 1.5% in 2001, as predicted in the last Inflation Report.

Weak domestic demand was not however the only reason for this poor growth in 2001. These countries currently face a number of institutional rigidities that do not allow the economy to adjust quickly to the different internal and external shocks. In the first place, the European Central Bank (BCE), anxious to gain credibility by stabilizing inflation around 2%, confronted the dilemma of economic growth or inflation control by showing itself reluctant to reduce its interest rate drastically, even with the economy showing signs of deterioration. Moreover, the Stabilization Pact between the 12 countries imposes strict fiscal targets, preventing individual governments from stimulating their economies through tax cuts and higher public spending, as the United States has done.

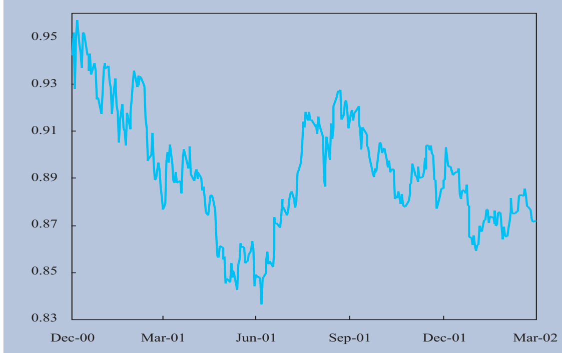
Though various indicators suggest that the region's economic growth reached a trough in the forth quarter of 2001, negative factors persist that make its performance in 2002 uncertain. The most important one is discouragement among consumers. In several countries, the consumer-confidence indicator remained negative in the first quarter, and its behavior was reflected in poor sales: real growth in sales was barely 0.7% in January. Unemployment has remained stable at 8.4% since last November and is not expected to decline, for there is little prospect of job creation. In fact, according to the BCE, unemployment might even go up because of the euro area's mismatch of supply and demand, generating greater uncertainty about consumption.

All the same, the euro economy is still expected to have expanded in the first quarter and should do so over the rest of the year. This expectation is supported by the satisfactory behavior of other indicators, particularly those of the industrial sector. In March, the manufacturing sector's sales index, PMI, was over 50 for the third month in a row, indicating an upturn in the sector. And all business-confidence indicators were up in March, particularly the IFO survey's current-conditions indicator, which broke the declining trend it had been displaying since October. Moreover, the US economy's recovery and the weakening shown by the euro should boost the region's growth through higher exports.

International analysts anticipate that positive factors will outweigh negative ones. This fact, the world economic upturn and the euro's recent devaluation (Figure 74) are grounds for expecting the euro-area economy to grow by 1.4% in 2002, a lower rate than predicted three months ago. For 2003, analysts forecast a 2.9% growth.

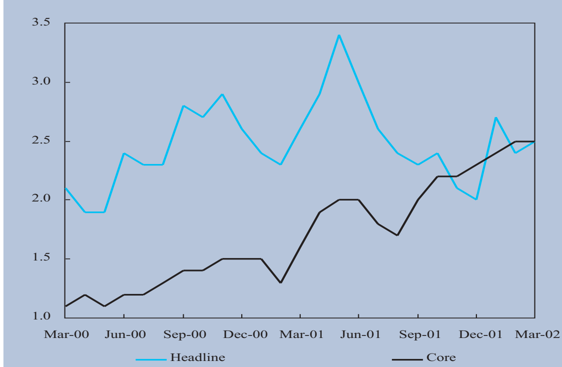
The BCE met its 2% inflation target in December 2001, as anticipated in the precious Report, only to see inflation rise sharply early this year, to 2.7% in January and 2.4% in February (Figure 75). The BCE and various analysts consider these results unsatisfactory but not disturbing, in that they were probably caused by transitory price rises, mostly in non-processed foodstuffs and energy.

Figure 74
Euro exchange rate
(dollars/euro)



Source: Bloomberg.

Figure 75
Euro area inflation
(percentage)



Source: Bloomberg.

In effect, capacity-utilization indicators suggest that there is ample room for output to expand without generating inflationary pressure. In March, the Eurosat regional indicator stood at 80.8, its lowest level since the first quarter of 1997 and still below the historical average.

Inflation is presently expected to stabilize at around 2.0% before the end of the year, thanks to lower inflation expectations and the existence of spare capacity.

The latest growth and inflation results led the European Central Bank on March 7 to leave its intervention rate unchanged at 3.25% (Figure 76). As in the case of the United States, no new cuts are currently expected. Several international analysts think the European monetary authority might decide to keep the rate at its present level until the end of the third quarter, then start raising it, up to about 4.0% by 2003.

3. Japan

Japan's economy continued to be the hardest hit of the developed economies, shrinking in the last three months of 2001 for the third quarter running, this time by an annualized quarterly rate of 4.5% (Figure 68). Over the year as a whole, the Japanese economy contracted by 0.4%, its largest contraction since 1998.

Most indicators suggest that domestic demand was still depressed over the first quarter of 2002. Industrial output, orders and capacity utilization not only continued below their historical levels but sank deeper. The consumer-confidence index fell again in January, reflecting lower household income and higher unemployment. In February unemployment rose by 0.2 percentage points to 5.4%, an all-time high for the series.

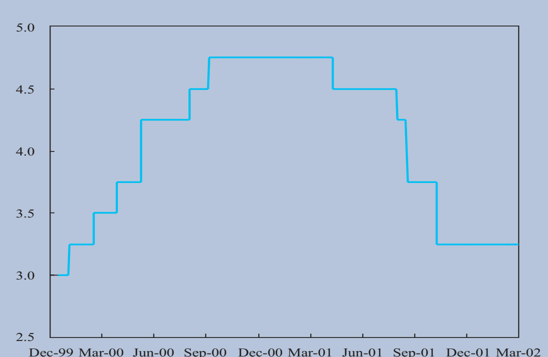
Depressed credit demand and the fall in share-price indices do not bode well for revival of internal demand, at least in the short term. Besides, the financial system continues in poor health, causing serious doubts about its capacity to sustain an economic recovery. High levels of bad debts and the elimination of insurance cover for term deposits have created further apprehensions among savers and lenders and raised ending rates.

Despite the bleak situation described above, exports improved in January and February, apparently for two reasons: economic upturn in the United States and some Asian countries; and the yen's recent depreciation (Figure 77). If this promising export trend continues, Japan's economic contraction might ease a little.

The long decline in domestic demand continues to be reflected in falling prices.

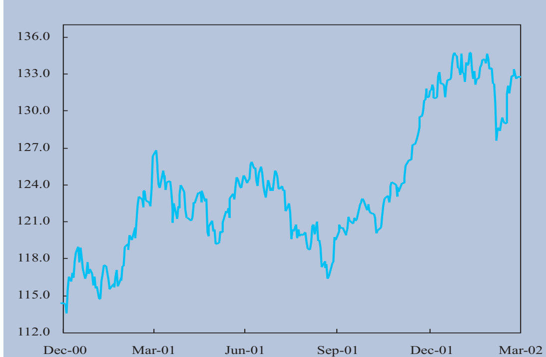
Despite devaluation of the yen, both headline and core inflation were still negative early this year, with overall consumer inflation running at -1.4% in January and -1.6% in February, while core inflation hovered around -0.8% (Figure 78). International analysts anticipate that expected devaluation of the yen and higher fuel prices may help to check deflation. But, since there is little prospect of recovery in economic activity, and wages are deteriorating and expectations are negative, Japan's economy will most probably continue on a deflationary spiral.

FIGURE 76
EURO AREA, REFI INTEREST RATE
(PERCENTAGE)



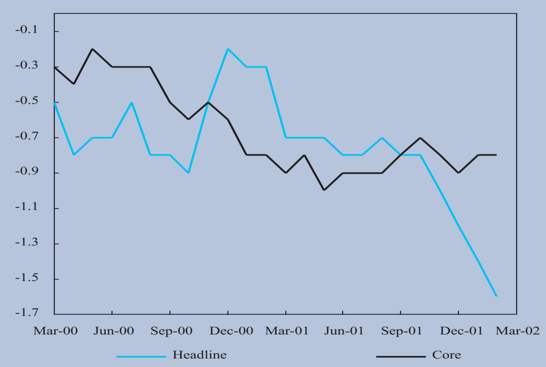
Source: Bloomberg.

FIGURE 77
YEN EXCHANGE RATE
(YEN/DOLLAR)



Source: Bloomberg.

Figure 78
Japan, inflation
(percentage)



Source: Bloomberg.

Lastly, another factor darkening the outlook for the Japanese economy is delay in the structural reforms announced by the Koizumi administration. The government has submitted a tax reform to Congress that includes lower taxes on corporate investment in capital goods and private investment in equities. But international analysts do not expect it to be approved and doubt it will prove effective, because of its negative effects on tax revenues.

In view of the situation described above, the Bank of Japan kept its intervention rate at 0% and tried to provide the economy with ample liquidity by leaving its monetary target unchanged at 15 trillion yen. Given the little effect these measures have produced, international analysts suggest that the Bank of Japan should adopt a more proactive policy and set a positive inflation target to reduce existing deflationary expectations.

Japan's economy is now seen as contracting by 1.0% this year, a stronger contraction than predicted three months ago, despite better external conditions and the possible boost to exports from the yen's devaluation.

4. Latin America

Latin America's growth prospects are now generally better than was forecast last December. Expected recovery in the US economy and recent increases in the price of oil and other export commodities (discussed in Section B) are major factors of improvement in the short-term outlook for some of the region's economies.

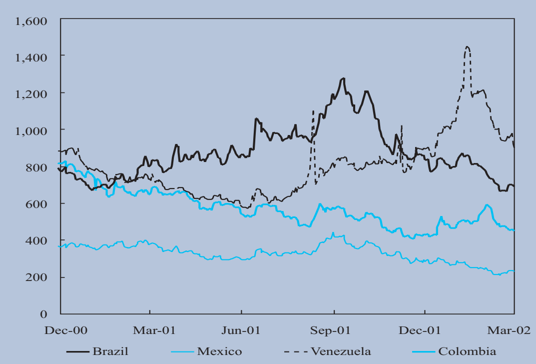
Moreover, the Argentine crisis has removed a major user of foreign capital from the market. This could make more funds available in the medium term for those countries of the region that manage to exhibit relatively stable economic and political conditions. Besides, capital flows to the region might be attracted by higher returns currently available in emerging markets, or prompted by loss of appeal of developed-market investments particularly because of doubts about major firms' financial positions, their lack of balance-sheet transparency, and their mediocre performance in recent months.

Economic prospects are mixed for the region's countries taken individually. Thus, Mexico, Brazil, Ecuador, Chile and Peru are expected to display better macroeconomic performances, while the outlook is bleak for Venezuela and especially Argentina (Table 13). It should be pointed out however that growth for the region as a whole will continue to be strongly influenced by individual countries' internal factors. It is therefore important that markets should continue to make a distinction between the state of affairs in Argentina and Venezuela and the situation in the other economies.

Brazil's economy grew by 1.5% in 2001. Though Brazil managed to weather the Argentine crisis (Figure 79), keeping exports buoyant, it saw domestic demand significantly weakened by a number of internal factors, including political uncertainty, high interest rates, low credit levels and nation-wide power rationing. This partly accounts for its low growth in 2001, down by 2.9 percentage points on 2000.

Brazil still faces a number of factors constituting big risks to its macroeconomic performance (a presidential election, the crisis in Argentina and higher oil prices), but international analysts are agreed that its economy may grow faster this year for several reasons.

FIGURE 79
SPREADS ON LATIN AMERICAN SOVEREIGN DEBT
(BASIS POINTS)



Source: Bloomberg.

In the first place, the fiscal discipline maintained up to now, the exchange rate's recently acquired stability, and the end of electricity rationing have begun to produce a positive effect on growth, as suggested by several indicators. In effect, the unemployment rate has dropped, industrial output has been rising continuously, and consumer-sentiment indices have turned up, reaching last May's levels.

Secondly, though inflation is still far above the central bank's latest target range (4.0% - 4.5%), it has been falling since January and could lead to a gradual reduction in interest rates in the coming months, thereby giving a further boost to the economy. Lastly, the export sector is expected to continue to perform well, thanks to the global economic upturn. If it does, Brazil's economy may expand by about 2.2% in 2002 and more strongly in 2003.

The critical economic and political situation besetting Argentina since the middle of last year grew worse over the first quarter of this year. The government of President Duhalde has decreed a new package of economic measures, including "pesofication" of the economy, fiscal discipline, and a floating exchange-rate system, but international analysts doubt whether the measures will prove effective or sustainable. In addition, the inflation rate has accelerated, the risk spread on the country's sovereign debt has worsened, and local and foreign investors have become distrustful. It is therefore impossible to expect any recovery, at least in the short term, and international analysts see Argentina's economy contracting strongly this year, possibly by about 10.0%, according to their consensus.

Venezuela's economy grew by 2.7% in 2001, one of the highest rates in all Latin America. Despite this and the recent rise in the price of oil, the economic and political situation in Venezuela has deteriorated significantly in the past few months. The level of economic activity is currently expected to fall during this year, mainly because of the country's serious political problems and its macroeconomic imbalances (Table 13).

As anticipated in the previous Report, the political crisis led to a fall-off in capital inflows to Venezuela, which resulted in exchange-rate instability. This in turn produced a sharp drop in international reserves, and caused the central bank of Venezuela to replace the exchange-band regime for a system of free floating exchange rate on February 12. Though international analysts thought this was the right thing to do, the measure soon led to a substantial increase in interest rates and inflation expectations, provoking further social discontent.

The above developments, together with commercial and fiscal imbalances, have caused Venezuela's external rating to be lowered and the spread on its sovereign debt to be widened. Its spread is now second only to Argentina's among emerging countries. Lastly, other developments, including imposition of a financial-transaction levy effective from March 16, extension of VAT coverage, and a crisis in the state-owned oil company (PDVSA), have increased social unrest and restrained domestic demand.

Recession therefore appears to be imminent in Venezuela. On average, the economy is forecast to contract by 1.6% this year, a downward revision of 3.4 percentage points of the growth forecast made only three months ago. Poor economic growth in

Venezuela is particularly critical to Colombia, given the two countries' close trading links.

Ecuador's economy continued on a path of recovery in 2001, growing by 5.5%, and is forecast to expand by about 4.0% this year.

It is not expected to encounter any major obstacles in future months, for several reasons. First, the oil sector should continue to be a powerful engine of growth, thanks to higher oil prices and investment in a further stretch of the national pipeline. Second, the US economy's upturn is expected to increase US-bound exports. Third, interest rates continued to fall, while credit expanded, largely driven by revival of private investment. Lastly, with dollarization, inflation has been falling so fast that it is expected to be down to almost 12.0% by the end of 2002, despite the elimination of some subsidies.

The Ecuadorian government's biggest challenge now is to make sure of the IMF agreement for 2002, which, among other things, calls for public-spending cuts of almost 2.0% of GDP, the creation of an oil stabilization fund, and signing of the Fiscal Responsibility Law, which requires the country to reach a 4.5% primary surplus before its debt-to-GDP ratio exceeds 40.0%. But, with the presidential election approaching, Congress is not expected by international analysts to approve the public-spending reduction, complicating matters for the agreement.

Argentina aside, the region's worst-hit economy in 2001 was Mexico (Table 13). But now, in view of the US economy's early recovery and the recent rise in oil prices, international analysts expect an economic upturn in Mexico, particularly in the second half of this year.

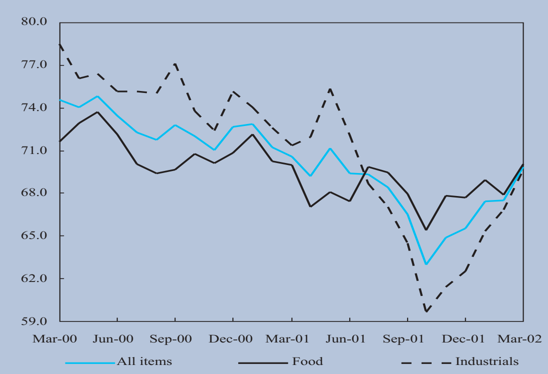
Three factors lend support to the improved outlook for growth in Mexico. First, given Mexico's close trading ties with the United States, the export sector is expected to expand at a good pace, becoming firmly established as the engine of economic growth.[14] Second, the rise in oil prices might allow a higher level of public spending than originally planned, which would give a further boost to economic growth. Lastly, thanks to implementation of sound macroeconomic policies, prices are expected to remain relatively stable in 2002, even as economic growth gathers pace. For this same reason, the exchange rate and the spread on sovereign debt should also remain stable. The central bank could then apply a relatively loose monetary policy. If all this comes to pass, Mexico's economy would grow by about 1.7% in 2002 and at a faster pace in 2003.

B. Commodity prices

The prices of major commodities displayed an upward trend over the first quarter of 2002. The Economist's overall commodity price index rose by 6.6% between December and March but was still 1.0% lower than a year earlier (Figure 80).

[14] Mexico's finance ministry estimates that a one percentage-point increase in the GDP of the United States causes Mexico's GDP to go up by almost 0.75%.

Figure 80
Monthly commodity price index
(1995 = 100)



Source: *The Economist.*

Industrials were largely responsible for this rise. Having fallen sharply last year because of the world economic slowdown, they are now going up again, thanks to the US upturn. At the end of March they stood 11.3% higher than in December.

According to various analysts, if demand goes on improving, commodity prices may continue the rising trend shown in the first quarter and could end the year higher than in December 2001.

This Report resumes the practice of earlier Reports of presenting the price index for Colombia's main commodity exports. The index incorporates price information on coffee, oil, ferronickel, sugar, coal and bananas, which on average make up 51.0% of the country's total exports (Figure 81).

Last year the index fell by 13.3%, chiefly because of steep drops in the price of coffee (-29.4%) and oil (-14.6%). On projections from several export associations and international analysts, the index is forecast to fall by a further 2.9% this year because average prices for coffee, oil and sugar are expected to decrease.

Though the price of oil was expected to rebound from its year-end level, the average currently forecast for this year ($25 a barrel) is lower than last year's posted average ($25.9). As for sugar, in a context of very weak growth in demand, the production increases predicted for Brazil and Thailand are likely to translate into lower prices. In the case of coffee, with inventories still high in consuming countries, no price recovery is expected in the short term.

1. Oil

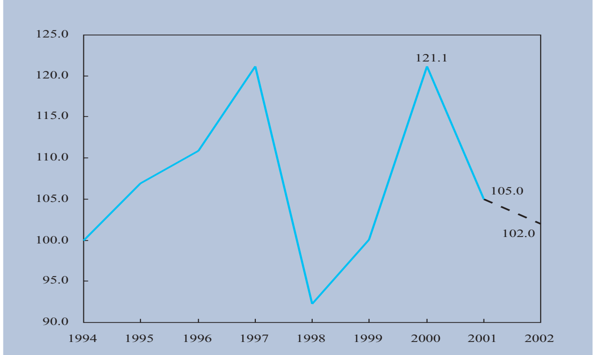
Effective from January 1, OPEC's daily production was cut by 1.5 million barrels and that of a group of non-OPEC producer countries[15] by 460,000 barrels, in an effort to boost the price of crude, which had fallen in the fourth quarter of 2001. But high oil stocks kept the price around its year-end levels during January and February, despite the production cuts. Not until March did the price of crude begin to show sustained growth, rising to peaks not seen since September 2001[16] (Figure 82).

The recent recovery in oil prices may be attributed to three factors: signs of upturn in the US economy; uncertainty generated by tensions in the Middle East; and, to a lesser extent, the producing countries' cuts in production. For OPEC, however, it has been essentially the outcome of a war premium, and this is why its member countries together with Russia, Norway and Oman decided to extend the cuts started on January 1 to the second quarter of the year.

15 Russia, Norway, Oman, Mexico and Angola.

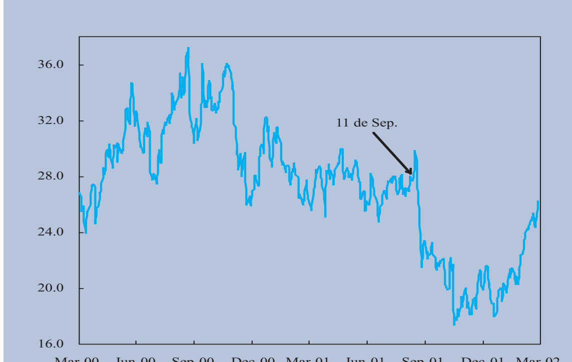
16 The price of oil rose by 17.6% between February and March.

Figure 81
Colombia
Main commodity export price index
(1994 = 100)



Source: Banco de la República, on information from exporters' associations and international analysts.

Figure 82
WTI oil price
New York Stock Exchange
(Dollars/barrel)



Source: Bloomberg.

Consequently, price movements over the rest of the year will depend to a great extent on developments in the Middle East conflict and on how fast stocks decrease, particularly in the United States. Extension of the productions cuts, combined with the US upturn, will most probably lower inventory levels, and so maintain upward pressure on prices. If these predictions are correct, the price of crude could oscillate around $26 a barrel in the coming months and end the year higher than in December 2001. The average price for this year is forecast to be $25, which is higher than the $23 predicted three months ago, but still lower than last year's average of $25.9.

The prices of forward sales contracts on the New York stock exchange bear out the above predictions of oil-price tendencies. They rose significantly between January and March, suggesting that the market was expected to be less well supplied over the rest of the year. At the end of March, the price of one-year forward sales contracts stood at $24.4 a barrel, higher than three months earlier ($20.8) (Figure 83).

2. Coffee

Though the world price of coffee picked up a little at the end of March, this year's first-quarter average (66.6 cents a pound) stood 13.4% lower than last year's. For some analysts the pick-up was the outcome of seasonal conditions, rather than a sign of sustained recovery (Figure 84).

The prices of forward sales contracts signed in March support this view. At the end of March, 12-month contracts were being made for 62.1 cents a pound, a higher price than in December (56.4 cents) but lower than actual prices today (Figure 85).

As explained in previous Reports, the sharp fall in world coffee prices over the past two years has been caused by overstocking in consuming countries, particularly the United States, and by expanding supply from Brazil and Vietnam. Coffee supply is still not expected to decline in the short term, so the price is again forecast to average around 70 cents a pound this year.

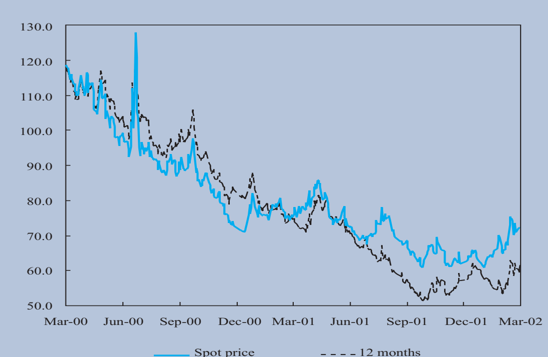
FIGURE 84
COLOMBIAN ARABICA COFFEE PRICE
NEW YORK STOCK EXCHANGE
(CENTS/POUND)

Source: Bloomberg.

FIGURE 83
WTI OIL FORWARD SALES PRICES
NEW YORK STOCK EXCHANGE
(DOLLARS/BARREL)

Source: Bloomberg.

FIGURE 85
ARABICA COFFEE FORWARD SALES PRICES
NEW YORK STOCK EXCHANGE
(CENTS/POUND)



Source: Bloomberg.

IV

Inflation forecasts

This chapter presents inflation forecasts for the rest of 2002 and for 2003, together with the main assumptions on which they were calculated by the Bank's Economic Studies Division. A discussion is also provided of the major risks that the Board of Directors' s inflation-reducing policy will face this year and next.

A. Forecasting assumptions

As discussed fully in the preceding chapters, the first quarter has brought new internal and external developments that have a bearing on the outlook for inflation in the next seven quarters. For this reason, a number of important changes have been made to the inflation-forecasting assumptions.

On the external front, given the US economy's better prospects compared with three months ago, its expected growth for 2002 has been raised by two percentage points to 2.7%, and for 2003 to 3.5%.

The US economy's performance affects the Colombian economy's through three main channels. The first is demand, which acts through both exports and the terms of trade. Since a large part of Colombia's exports goes to the US market, a change in the growth of the US tends to affect our export volumes, especially of industrial goods, and this in turn impinges directly on industrial activity and GDP. Moreover, as the US is the biggest world market, its economic performance affects other foreign markets important to Colombia and influences the prices of our export products, such as oil and coffee, thereby producing an impact on the country's income and spending.

Interest rates are another channel, for variations in US interest rates affect net capital flows to Colombia and lead to movements in the rate of devaluation, domestic interest rates, growth and prices. Lastly, variations in US economic growth are accompanied by changes in US inflation, which eventually affects the prices of tradables in Colombia and the country's inflation in general.

Forecasting for this Report assumes that there is very little risk of US interest rates rising substantially this year, and not much likelihood of US inflation doing so either. Both these assumptions are fully supported in Chapter III. So demand is assumed to be the only channel through which US economic performance may affect Colombia's in the next several quarters. Higher US growth is expected to reduce the falls occurring in the volume of nontraditional exports to the United States since the second half of 2001. Similarly, higher US demand will stop further deterioration of the terms of trade, thereby reducing contraction in the dollar value of traditional exports, especially oil.

In short, higher growth in the US is expected to have a positive net impact on economic growth in Colombia without leading to higher inflationary pressure, at least in 2002. The models used by the Economic Studies Division, which partly capture some of the mechanisms of transmission described above, predict that a 1% rise this year in US GDP could generate a 0.12% rise in Colombia's GDP.

Another external development in the first quarter was that Venezuela's growth prospects altered relative to predictions reported in the December Report. Based on various factors, including political ones, the Venezuela economy is now expected to deteriorate more strongly, causing slower growth in Colombia's nontraditional industrial exports this country and in the Colombian economy as a whole.

Internally, as in the previous Report, growth this year is still expected to be driven by private consumption and private investment, because interest rates are expected to be low, the exchange rate relatively stable and construction in a state of recovery. A further reason is that in the previous quarters household debt declined in real terms and employment went up. Exports, however, will now be affected by lower expected demand in Venezuela, as mentioned above, in addition to still feeling, at least for the first half of this year, the effect on US-bound exports of slow US growth in 2001 and of uncertainty and delay regarding approval of the Andean trade preference scheme.

Moreover, growth in the short term may receive a negative impact from the fact that the large public-spending cuts required to meet the targets of the financial adjustment program are now even larger than originally envisaged. Furthermore, the breakdown of peace talks with armed insurgent groups, recent public-order events, and news reports on the size of the country's public debt may have reduced investor and consumer confidence, thereby affecting prospects for growth in the coming quarters.

Despite the above considerations, this Report's conclusion is that it is feasible for the economy to expand this year, albeit at a slow pace, and to improve on this pace in 2003. It should be pointed out, however, that these forecasts come with a higher degree of uncertainty.

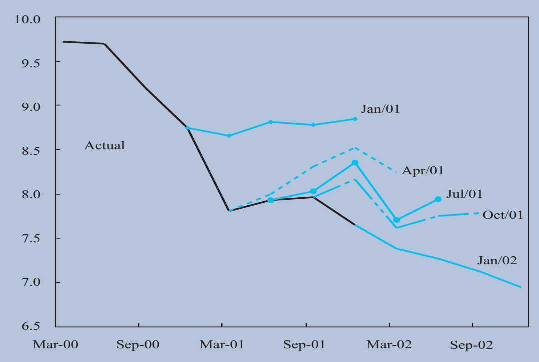
In the coming quarters, therefore, demand pressure should not be so strong as to jeopardize this year's 6% inflation target. This view is reinforced by indicators pointing to an increase in the economy's productive capacity last year, as evidenced by a large expansion in imports of capital goods, revival of private investment in 2000 and 2001, and a continuing rise in labor supply to judge from the high rate of global participation. This evidence suggests that actual GDP continues to be lower than potential GDP and very likely to remain so for the rest of the year.

Forecasting for this Report is also based on the assumption of a significant drop in expected inflation for both this year and the long term. Expectations have usually been a strong determinant of inflation in Colombia, where a fair proportion of wage and price agreements are automatically indexed to past inflation. Inflation in highly indexed goods such as utilities, education and rent has decreased significantly in recent years, especially in the first quarter of this year, suggesting that expectations have been losing ground as a determinant of inflation.

Moreover, the fact that the Banco de la República has consistently met its inflation target has raised the credibility of monetary policy. It has also caused a break in expectations tendencies. This is evidenced by the findings of the Bank's January survey, which clearly show that, for the first time in the history of these surveys, respondents expect inflation in the following quarters to be lower than the year before and falling (Figure 86). This break in expectations tendencies has brought further falls in inflation, with no detriment to growth.

The exchange rate is still assumed to remain relatively stable in 2002, among other reasons because the government has access to foreign funds to meet its financing needs for this year, remittances from abroad are on the rise, and slower growth in imports will offset the loss of pace in exports, precluding any significant current-account imbalances in the balance of payments.

FIGURE 86
ACTUAL AND EXPECTED INFLATION



Source: Banco de la República, quarterly expectations surveys.

B. RISKS

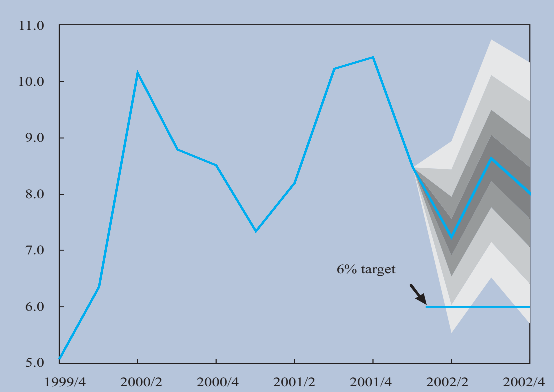
As was the case three months ago, the main risks to meeting this year's 6% inflation target are connected with supply. The most important one is still the possibility of the Niño climatic condition emerging in the second half of this year and extending well into 2003. According to the experts, weather conditions in the Pacific in March were continuing to evolve towards the Niño's emergence, making it more likely this year. But there is still doubt about its degree of intensity, though most experts think it will most probably be moderate to low.

As explained in previous Reports, the Niño is usually attended by food-price increases, caused by a reduction in supply both because producers plant less knowing weather conditions are going to be bad and because the decrease in rainfall reduces crop productivity and volumes. In the present circumstances, the Niño's undesired price repercussions might be reinforced by the fact that, in the past six months, relative prices for food crops in general, and for potatoes and some other crops with a heavy weight in the consumer basket in particular, have been very low, discouraging their planting. Moreover, the retention cycle of cattle-breeding is still expected to last until the end of this year, so beef supply will continue to be limited and prices high.

All the above factors point to big food-price increases in the second half of the year, bigger than anticipated three months ago, because this time food prices have been projected assuming a 75% probability of the Niño occurring and doing so with moderate intensity, whereas in December the probability assigned to its occurrence was much lower, 25%.

The central path of the food satellite model forecasts an average food inflation of 8.0% for the fourth quarter of 2002 (Figure 87), up from 7.0% projected three months ago. As in the previous

FIGURE 87
FOOD-INFLATION FORECASTS FOR 2002
(CENTRAL SCENARIO AND RISK BALANCE)



Source: Banco de la República.

Períod	90%	50%	25%	Central			
Mar-02	8.5	8.5	8.5	8.5	8.5	8.5	8.5
Jun-02	5.5	6.5	6.9	7.2	7.6	7.9	8.9
Sep-02	6.5	7.8	8.2	8.6	9.0	9.5	10.7
Dec-02	5.7	7.1	7.6	8.0	8.5	9.0	10.3

Report, the central path comes with an upward-biased risk balance. This bias is justified because there is still a possibility of a strong-intensity Niño occurring, with even less favorable repercussions on price stability.

Lastly, this Report takes into account a new source of inflationary pressure, which is connected with the recent rise in world oil prices and was not envisaged in December. The international price currently forecast for the rest of the year (Chapter III) is three dollars higher than that predicted three months ago. If this current forecast proves correct, the increase will eventually be passed on to the domestic price of fuel and, through production costs, to all other prices in the economy. And, since the price of fuel is an important benchmark price for consumers and producers, its increase might raise inflation expectations. According to exercises conducted by the Economic Studies Division, leaving aside the expectations channel, a one-time 10% increase in the domestic price of gasoline tends to raise consumer inflation by about 1% in a year at the latest.

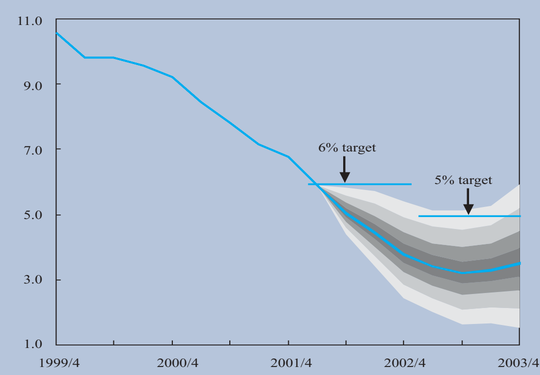
B. Inflation forecasts

The forecasts of fourth-quarter headline and core inflation for this year and of fourth-quarter core inflation for next year are significantly lower than those presented in the December Report. They suggest it is highly probable that this year's 6% target will be met and very possible that inflation will continue to fall in 2003 in a manner consistent with meeting the Board of Director's long-term inflation objective of 3%.

Figure 88 shows the central path and risk balance of core inflation (non-food CPI) projected by the Bank's model. Core inflation is forecast to average 3.8% in the fourth quarter of 2002 and 3.5% in the fourth quarter of 2003. These forecasts are respectively 1.5 and 1.0 percentage points lower than those presented in the previous Report. Their downward revision is significant and reflects a 0.6 percentage-point overestimation of average first-quarter core inflation projected on the basis of actual figures registered up to December 2001.

The Bank's forecasting suggests that core inflation may continue to fall sharply in each one of the three remaining quarters of this year and may stabilize around 3.5% all through 2003.

Figure 88
Non-food inflation forecasts for 2002 and 2003
(central scenario and risk balance)



Source: Banco de la República.

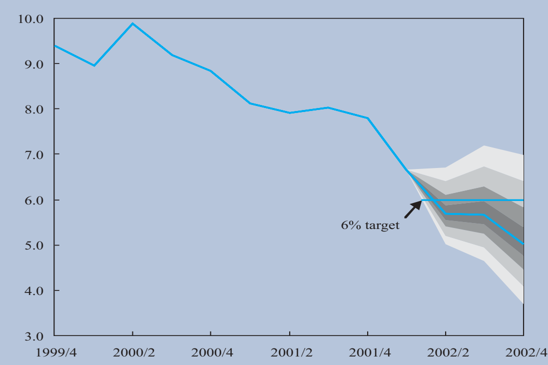
Períod	90%	50%	25%	Central			
Mar-02	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Jun-02	4.4	4.8	4.9	5.0	5.2	5.4	5.8
Sep-02	3.4	4.0	4.2	4.4	4.7	5.0	5.7
Dic-02	2.4	3.2	3.5	3.8	4.1	4.5	5.4
Mar-03	2.0	2.8	3.1	3.4	3.8	4.1	5.1
Jun-03	1.6	2.5	2.9	3.2	3.6	4.0	5.1
Sep-03	1.7	2.6	3.0	3.3	3.7	4.1	5.3
Dic-03	1.5	2.7	3.1	3.5	4.0	4.5	5.9

The fall in projected core inflation for 2002 is explained by a widening of the output gap resulting from faster growth in potential GPD and slower expansion in demand, and helped by devaluation running very low or at zero since the middle of last year.

As regards headline inflation, the central path of the forecast shows it averaging 5.0% in the fourth quarter of 2002, down by 0.8 percentage points on the forecast made in December (Figure 89). As in the case of core inflation, headline inflation for March was overestimated (by 1.4 percentage points).

The central path of the forecast for headline inflation also has an upward-biased risk balance, intended to represent the major risks that the possible occurrence of the Niño may cause to food inflation and headline inflation in the coming months.

Figure 89
Consumer inflation forecasts for 2002
(Central scenario and risk balance)



Source: Banco de la República.

Períod	90%	50%	25%	Central			
Mar-02	6.7	6.7	6.7	6.7	6.7	6.7	6.7
Jun-02	5.0	5.4	5.6	5.7	5.9	6.1	6.7
Sep-02	4.6	5.2	5.5	5.7	6.0	6.3	7.2
Dic-02	3.7	4.5	4.8	5.0	5.4	5.8	7.0

Local and foreign analysts' forecasts for main macroeconmic variables

The latest forecasts by local and foreign analysts for Colombia's main macroeconomic variables in 2002 and 2003 are reviewed below. Local analysts were aware of the official figure for inflation in the first quarter of 2002 at the time of presenting their forecasts.

Forecasts for 2002

Table 1 shows forecasts for 2002 in detail. The biggest change to local analysts' predictions reported in December is in inflation. The average of their inflation forecasts for 2002 has come down from 6.9% to 6.6%, after release of official figures for the first quarter of this year. It is noteworthy that two of the five local analysts are forecasting inflation rates close or equal to this year's 6% target, which implies that the Bank's inflation targets have gained credibility. Indeed, this is the first time since these quarterly Inflation Reports first began to be prepared that local analysts expect inflation to be on or below target.

In line with lower inflation expectations, interest rates are, on average, expected by local analysts to be lower over the rest of the year. The forecast for the nominal DTF rate is down by 100 basis points, from 12.2% last December to 11.2%, because local analysts expect not only lower inflation but also an easing of monetary policy over the rest of the year.

The nominal exchange rate is another macroeconomic variable whose forecasts have been revised down by local analysts. Devaluation is now expected to be lower, on the basis of the exchange markets' behavior over the first three months of this year.

Table 1
Forecasts for main macroeconomic variables in 2002

	Forecast date	Real GDP growth %	CPI Inflation %	Nominal exchange rate (year-end)	Nominal DTF deposit rate %	Déficit (% of GDP): Fiscal 1/ (% del PIB)	Currt. acct.	Unemployment %
Local analysts								
Revista Dinero	19-Abr-02	1.8	6.0	2.474	11.5	-3.5	-2.8	6.7
Suvalor-Corfinsura	25-Abr-02	2.1	5.7	2.456	10.3	-3.0	-3.2	n.d.
Corfivalle	15-Ene-02	2.2	7.2	2.516	11.7	-3.6	-3.0	17.0
ANIF	01-Abr-02	2.0	7.0	2.474	12.0	-3.0	-3.2	17.5
Fedesarrollo	15-Abr-02	1.7	7.0	2.497	10.7	-3.0	-3.2	n.d.
Average		**2.0**	**6.6**	**2.483**	**11.2**	**-3.2**	**-3.1**	**17.1**
Foreign analysts[2/]								
Goldman Sachs	05-Abr-02	1.0	7.0	2.450		-3.9	-2.3	
IDEA global	25-Mar-02	2.6	6.0	2.415		-2.9	-2.3	
J. P. Morgan	04-Abr-02	2.0	7.0	n.d		-2.8	-3.7	
ABN Amro Bank	03-Abr-02	2.0	8.0	2.414		-2.6	-2.6	
Salomón Smith Barney	20-Mar-02	2.7	7.2	2.427		-2.9	-3.1	
Deutsche Bank	04-Abr-02	1.8	6.5	2.371		-4.8	-2.6	
Merrill Lynch	15-Abr-02	2.2	6.5	2.525		-3.0	-3.0	
Average		**2.0**	**6.9**	**2.434**		**-3.0**	**-2.8**	

n.a. Not available.

1/ The fiscal-deficit average does not include Deutsche Bank's forecasts because they refer to the central government, not the non-financial public sector.

2/ ¿Cómo nos ven afuera?" Report by the Banco de la República's Monetary and Reserve Division. March 11, 2002.

Lastly, local analysts have left unchanged their other macroeconomic forecasts for this year, in the case of growth because DANE has yet to release figures on industry and retail sales.

Foreign analysts' forecasts, except for inflation, are markedly different from what they were in the fourth quarter of 2001. Public-order events seem to have strongly influenced their growth predictions for 2002, which now average 2.0%, down by 0.6 percentage points on December. Yet, two of the seven analysts still think it is feasible to meet this year's official growth target (2.5% to 3.0%).

The breaking-off of peace talks has, among other things, caused foreign analysts to predict a considerable deterioration in the country's fiscal accounts this year. They see the nonfinancial public-sector deficit widening by 0.4 percentage points to 3.0%, from 2.6% forecast three months ago.

Foreign analysts have cut their forecast of devaluation from 10. 2% to 5.8%, which will mean a worsening of the current-account balance; the deficit is expected to expand to 2.8%, from 2.3% predicted in December.

Forecasts for 2003

Table 2 shows forecasts for 2003 in detail. Inflation forecasts by both local and foreign analysts average to 6%, which is within the Bank's 4%-6% target range for 2003. On setting the range in November 2001, the Bank explained that it would be fixing a specific level within that range later in 2002. The fact that both local and foreign analysts are forecasting inflation rates within the Bank's target range suggests that the process of disinflation is gathering strength in Colombia. It also indicates a break in the pattern of expectations, thanks to the credibility that the Bank's policy has gained during this process.

Growth in 2003 is expected to be higher than in 2002 by both local analysts (3.0%) and foreigners (3.3%), though these forecasts are lower than the 3.5% rate of growth envisaged in the draft budget for 2003 submitted to Congress lately.

As regards nominal devaluation in 2003, there is a striking difference between local and foreign analysts, the former expecting a considerably higher devaluation (7.7%) than the latter (5.3%), relative to their average exchange-rate forecasts in December 2002.

Table 2
Forecasts for main macroeconomic variables in 2003

	Forecast date	Real GDP growth %	CPI Inflation %	Nominal exchange rate (year-end)	Nominal DTF deposit rate %	Déficit (% of GDP): Fiscal 1/ (% del PIB)	Currt. acct.	Unemployment %
Local analysts								
Revista Dinero	19-Abr-02	2.5	6.0	2.720	13.0	-3.0	-3.0	16.0
Suvalor-Corfinsuar[2/]	25-Abr-02	3.0	4.0	2.694	9.9	-2.1	-3.5	n.d
Corfivalle	15-Ene-02	3.3	7.0	2.624	12.4	-3.3	-3.0	16.0
ANIF	01-Abr-02	3.0	6.0	2.648	11.0	-2.5	-3.3	17.6
Fedesarrollo	15-Abr-02	3.4	7.0	2.682	10.0	-3.5	-3.9	n.d.
Average		**3.0**	**6.0**	**2.674**	**11.3**	**-2.9**	**-3.3**	**16.5**
Foreign analysts[3/]								
Goldman Sachs	05-Abr-02	3.0	5.0	2.534		-4.2	-2.4	
IDEA global	25-Mar-02	3.5	5.0	2.560		-2.1	-2.9	
J. P. Morgan	04-Abr-02	3.1	6.0	n.d		-2.5	-3.6	
ABN Amro Bank	03-Abr-02	3.5	8.0	2.558		-2.6	-2.6	
Salomón Smith Barney	20-Mar-02	3.2	7.0	2.568		-2.4	-3.3	
Deutsche Bank	04-Abr-02	3.2	5.0	2.514		-4.1	-4.1	
Merrill Lynch	15-Abr-02	3.5	6.0	2.650		-2.8	-3.2	
Average		**3.3**	**6.0**	**2.564**		**-2.8**	**-3.2**	

n.a. Not available.

[1/] The fiscal-deficit average does not include Deutsche Bank's forecasts because they refer to the central government, not the non-financial public sector.

[2/] Suvalor's fiscal-deficit forecast for 2003 envisages a new tax reform by the incoming administration.

[3/] ¿Cómo nos ven afuera?" Report by the Banco de la República's Monetary and Reserve Division. March 11, 2002.

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