Bogotá, D. C., july 30, 2003

Honorable Chairmen and Members
Third Standing Constitutional Committees of
The Senate and
The House of Representatives
Bogotá

Dear Sirs,

Pursuant to Law 31 of 1992, Article 5, the Board of Directors of the Banco de la República hereby submits for consideration by Congress a report on the country's macroeconomic results for the year to date. The report also presents the targets set by the Board for 2003 and the outlook for the different macroeconomic variables. The final section describes the composition of the international reserves and discusses projections for the Banco de la República's financial situation for the year 2003.

Yours truly,

Miguel Urrutia

Miguel Urrutia Montoya
Governor

I

Introduction

The purpose of the report hereby submitted to the Honorable Members of Congress is to describe the implementation of macroeconomic policy and the economy's performance over the first months of 2003. Special emphasis is laid on the policy aspects that are the direct responsibility of the Bank, namely, monetary, exchange-rate and credit policy. On this occasion the report also describes the functions that current legislation assigns to the Banco de la República. Some of these are not sufficiently well-known to the public, such as the functions of managing the international reserves as an integral part of the strategy for conducting monetary policy, ensuring the proper working of the system of internal and external payments, constituting a knowledge enterprise, and helping to recover and conserve the country's historical and art heritage. This report also discusses in detail use of the Bank's resources, its financial statements, and the projection for profits from the Bank's operations this year.

The different functions performed by the Banco de la República aim to ensure the economy's stability from the viewpoint of monetary policy, as an essential requirement for economic growth and social development. This is the greatest contribution the Bank can make to Colombian society, and its efforts and policies are directed to this end.

Chapter II, on macroeconomic policy, shows that monetary policy can improve the path of long-term economic growth by lowering inflation rates and making real and nominal interest rates stable, such being the ultimate aims of monetary policy. Price and interest-rate stability promotes social welfare and economic growth by improving market efficiency, fostering stability in employment and output, and creating a climate of greater certainty for companies and households to make sound long-term decisions on investment and saving. Such decisions in turn allow a greater deepening and development of the financial system and capital markets.

Chapter II also discusses the short-term counter-cyclical role played by monetary policy when economic output has been below potential. In this case, a loose monetary policy as applied by the Banco de la República in recent years helps to increase growth and reduce unemployment. The country's monetary policy, it is shown, has continued to be counter-cyclical even under the adverse external conditions faced by the economy from the middle of 2002, which were reflected in considerably stronger devaluation, a development that has affected all countries of the region.

Exchange-rate policy, too, has helped to restore economic stability by avoiding excessive volatility in the exchange rate. Given Colombia's floating-rate regime, however, it is only possible and expedient to offset such fluctuations partially. A floating regime has great advantages, for it allows faster adjustments to the real exchange rate when the economy is subjected to an external shock, thereby helping to keep the exchange rate competitive and making it easier to conduct a counter-cyclical monetary policy. However, when the Board of Directors of the Banco de la República has felt certain that exchange-rate movements were excessive, it has responded firmly by intervening in the currency market with transparent and previously announced mechanisms and rules.

Chapter II also analyzes fiscal policy and its interaction with monetary policy. Although fiscal-policy management is not the responsibility of the Board, it has strong repercussions on the impact of monetary, exchange-rate and credit policies. In the long term, for example, the existence of an expected sequence of excessive fiscal deficits can reduce the credibility of monetary policy. In the shot term, hefty fiscal imbalances can affect credit, capital and exchange markets and thereby impair the outcome of monetary policy. For Colombia's economic upturn to grow stronger and continue to be boosted by monetary policy, fiscal policy must of necessity remain decidedly oriented toward reducing the public deficit. Meeting the consolidated fiscal deficit target for 2003, set at 2.5% of GDP, will be a step in this direction. Moreover, keeping the fiscal deficit low in future is equally vital for stabilizing public debt. The government and Congress must spare no effort to reach this target. Attaining it will help to clear the outlook for the country's public finances and raise confidence in the economy at home and abroad, bringing benefits in terms of investment growth and access to external savings. Furthermore, monetary policy will become more effective once economic agents have no reason to expect high inflation rates, and a counter-cyclical policy may be adopted when necessary.

The report goes on to assess in Chapter III the performance of economic activity, employment and the balance of payments in the first half of the year and the outlook for them for the rest of the year. This assessment aims to show the environment in which the macroeconomic-policy decisions discussed in Chapter II had to be taken and to explain the impact they had on the different economic variables. With economic activity in the first months of 2003 unfolding in a much more favorable environment than in previous years-an environment characterized by greater confidence among local and foreign agents-, the favorable impact of recent years' loose monetary policy on economic growth began to show more clearly. The economy expanded by 3.6% in the first quarter of 2003, exhibiting a definite acceleration, largely produced by internal demand. It is quite likely that by the end of the year economic growth will be higher than he 2% initially forecast. The first quarter also saw a slight improvement in employment indicators, attributable to the better performance of economic activity.

Chapter IV analyses another of the Bank's functions, namely, ensuring the working of the country's payment system. It defines what is meant by a payment system and describes the part played by the Bank in helping the system function properly in accordance with legislation in force in Colombia. The chapter ends by pointing out the main risks facing the payment system and the possible actions the Bank would have to take to avert them.

Chapter V discusses in detail the Board's management of Colombia's international reserves, expanding on the analysis presented in the March Report to Congress. It sets forth the basic principles governing such management, directed toward minimizing the impact of external shocks on the economy, and the administration criteria established for investing the reserves and ensuring their security, liquidity and profitability. A number of benchmarks are presented for comparing their current level with other countries'. The conclusion is that Colombia has sufficient international reserves to cover external obligations for at least a year, even if it were to face a complete shutdown of international credit markets. This level of reserves ensures access to external savings at reasonable interest rates, for it sends signals to potential investors and lenders that the country is in a position to honor its commitments, thus helping to raise confidence about Colombia in national and international circles.

The final chapter explains in detail how the Bank's resources have been used in recent years, describing the functions that the Bank performs. The Banco de la República not only carries out the duties of a central bank, it is also an economic knowledge enterprise, a banking-services enterprise, an industrial and precious-metal enterprise, a support services enterprise, a training enterprise and a cultural services enterprise. In the cultural field the Bank has also contributed to the recovery and conservation of part of the country's historical and art heritage.

Over the past ten years the Bank has made a very considerable adjustment in its expenses, striving for efficiency in each one of its functions. Thus, it has significantly reduced its labor costs and managed to make outsourcing even more efficient and transparent than in the past. Chapter VI presents the results of these efforts, gives a detailed description of the Bank's pay and pensions policy, and shows that its salaries, augmented by the different pay benefits it offers, are comparable with market levels for the highly qualified personnel it requires. Much of the adjustment in recent years has been made in the size of the Bank's payroll, without detriment to compliance with labor legislation. The Bank's financial statements for 2002 and its budget execution and projections for 2003 are discussed at the end of Chapter VI. They reveal that the adjustment process continues, and that the Bank is expected to generate profits amounting to 708.1 billion pesos. This is more than the 349.3 bn pesos forecast in March because the euro has performed better against the dollar than was assumed at the beginning of the year.