

THE INFLATION SITUATION AND THE OUTLOOK

- ✧ The external context continues to stimulate growth in Colombia through stronger external demand and favorable terms of trade. World economic activity maintained its strong growth led by the United States and, to a lesser extent, Japan and China. In the case of Venezuela and Ecuador, Colombia's main trading partners in the region, growth continued to accelerate thanks to high oil prices. For the next few months, and in the medium term, the world economy can be expected to maintain a good rate of expansion.
- ✧ In some countries this situation has been accompanied by an upsurge of inflationary pressures, which increased the probability that central banks raise their interest rates. So far, all the signs are that interest rates will be raised gradually in the United States, with no significant effect on its growth rate, and without sharp rises in the financing costs of emerging countries.
- ✧ The growth of the world economy and the favorable trends in the terms of trade have had beneficial effects for Colombia, especially in relation to exports. The growth of traditional exports has speeded up, especially the recovery of coffee, ferronickel and coal. Non-traditional exports also grew strongly thanks to the recovery of demand in Venezuela, and the good performance of industrial exports to the United States, despite the trend of the real exchange rate in the first half of 2004. This trend in exports and favorable external conditions in general has contributed to the good growth of the tradable sectors, which grew 4% in the first quarter of the year.
- ✧ Domestically, increased consumer and investor confidence and better employment conditions are stimulating recovery of private demand, especially consumption. The growth of this variable in the first quarter of this year (4.6%) was the highest since 1995. This is accompanied by low real interest rates and the growth of disposable income at even higher rates than GDP. In these conditions, domestic demand in the last three quarters grew at an average annual rate of 4.8%, which is above the average for the last 10 years and above the growth rate of the economy since 1990 (about 3.5%).
- ✧ In this context, consumer inflation has fluctuated around 6.0%, with some temporary jumps generated by supply shocks and prices of regulated goods and services. After excluding the supply shocks, inflation was largely unchanged, which confirms the forecasts made in the last report. Core inflation remained at levels slightly under 6.0% during the second quarter of the year, continuing two opposing trends: on the one hand, the fall in tradables inflation

thanks to the accumulated appreciation of the exchange rate; and on the other hand, the slow rise in non-tradables inflation, explained mainly by higher rental inflation.

- ✘ The available indicators show that the economy still has spare capacity and that this will probably remain for the rest of the year. In this respect, demand-pressure inflation was contained in the first half of 2004. However, given that the output gap will continue closing, these pressures are likely to increase. Since estimates of the output gap are usually accompanied by a high degree of uncertainty, they must be periodically re-estimated as more recent information becomes available.
- ✘ Although no cost pressures were observed at global level, cost-pressure inflation is present in some sectors such as construction, where it has gained strength in recent months. With regard to wages, the unit labor costs indicator for industry does not seem to signal wage-pressure inflation.
- ✘ In general terms there are no strong indications of an upsurge in inflation expectations during the first half of 2004, but the downward trend after the important rise in 2002 and 2003 seems to have moderated or even halted.
- ✘ The appreciation of the currency this year is explained by the improvement in the terms of trade, the upturn in external demand and increased flows of public and private capital. These factors will probably be present in the next few quarters and could possibly result in a moderate depreciation in 2005. In this context, the Board of Directors of Banco de la República decided to strengthen the country's external liquidity position through intervention in the exchange market by means of foreign-exchange accumulation auctions for US\$850 million between April and July this year, of which US\$600 million were exercised. This intervention was consistent with the Bank's monetary policy stance and has not resulted in undesirable changes in its interest rates.
- ✘ Based on these considerations, the current situation and the macroeconomic outlook do not differ substantially from the diagnosis presented in the last quarterly report. The main differences relate to the existence of more severe supply shocks than expected, and the projection of a lower exchange rate in 2004 and 2005. The inflation forecast does not vary significantly from the last report because the effects of these two innovations are offset in 2005. However, inflation this year could end very close to the upper limit of the targeted inflation range.
- ✘ The last report stated that the inflation outlook for the medium and long term depended on two fundamental factors: the trend in the exchange rate and the speed of the closure of the output gap. Although this report suggests that these two factors are still important, the presence of stronger than expected shocks from regulated prices and food suggests that special attention should be paid to the future trend in inflation expectations.
- ✘ The higher inflation forecasts for December this year due to upward adjustments in food and regulated prices could keep inflation expectations at levels close to 6.0% even during part of

2005, in addition to a predicted contraction of spare capacity in the next few quarters and possible increases in production costs stemming from the higher prices of imported raw materials.

- ✘ In this context, the central prediction model maintains the requirements of an increase in interest rates in the future to prevent inflation overtaking 6.0% and to facilitate convergence with long-term targets. The break in the trends of domestic rates would be in accord with the new international conditions and the process of normalization of productive activity. Based on this trend in interest rates, the Bank's central model projects declining inflation in 2005 and 2006. These long-term forecasts assume that food inflation converges with non-food inflation at the end of next year, and do not include the effect of a possible change in the VAT regime in 2005.
- ✘ As usual, considerable risks surround these forecasts: in 2004 appreciation could exceed the forecast in the central scenario, contributing to lower inflation this year, while in 2005 the bias could be toward greater depreciation, given the risks that weigh on world inflation and external rates. The gap could close more rapidly than expected as the latest data on productive activity suggest. Although the estimate of the current level of the output gap is uncertain, this report assigns the same probability to under or over estimation. Also, some price increases in the rest of 2004 could be higher than expected, especially food and fuel. Finally, production costs could increase more than expected due to higher international prices and the possible appearance of bottlenecks in some sectors.
- ✘ Based on this balance of risks, inflation this year has less possibility of being below 6.0% than in the last quarter. However, the probability of inflation below 5.5% in 2005 increased slightly in relation to the previous results.
- ✘ Based on these considerations, the Board of Directors of Banco de la República maintained its intervention interest rates unchanged in the second quarter of 2004. Although the Board is confident about meeting the inflation target this year and next, it will continue to watch closely the trend in prices in the coming months in order to adopt the necessary measures. Likewise, it will ensure that its monetary policy stance is consistent with the new international situation and the normalization process of productive activity.

Board of Directors of Banco de la República