27 March 2003
Bogotá D. C. (Colombia)

Honorable Chairmen and Members of the Third Standing Constitutional Committees of the Senate and House of Representatives Bogota, Colombia

Dear Sirs:

Pursuant to Article 5 of Law 31/1992, the Board of Directors of Banco de la República hereby submits to the Congress of the Republic of Colombia a report on the macroeconomic results of the year 2002 and 2003 to date, together with a description of the goals adopted by the Board of Directors for the current year and prospects for the various macroeconomic variables. The last section of the report contains information on the composition of international reserves and projections concerning the financial position of Banco de la República in 2003.

Sincerely,

Miguel Urrutia

Miguel Urrutia Montoya
Governor, Banco de la República

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Introduction

The following report, presented to the Congress of the Republic of Colombia, offers an analysis of the country's economic performance in 2002 and the macroeconomic policy implemented during that period. The Colombian economy faced in a particularly unfavorable international environment characterized by a combination of two negative shocks: a drop in external demand and less access to international markets for credit. Other Latin American countries were affected by these conditions as well, and their overall product rose by only 0.5% in 2002.

The Colombian economy, including illegal crops, grew at a rate of 1.50%. If these crops are excluded, the rate was1.90%, which is superior to the figure for 2001 (1.57%). Unemployment remained high. However, in the 13 major cities, it showed a tendency to decline and employment increased. The pace of annual inflation slowed during the first five months of 2002, but increased as of September and was 6.99% by the end of the year. This is above the target of 6.0% set by the Board of Directors of Banco de la República (BDBR) for 2002 and is less than inflation in 2001 (7.7%). The lag was essentially due to higher food prices brought on by supply problems. Core inflation was 5.6% at December, which is below the target. However, the speed at which the peso devaluated during the second half of 2002 implied high core inflation as of October.

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Chapter II offers an analysis of the macroeconomic policy applied in 2002. Monetary policy remained oriented to increase economic growth and meet the inflation target. During the first half of the year, the favorable trend in exchange stability and prices permitted a decline in the intervention interest rates charged by Banco de la República.

The adverse change in conditions for external financing and the acceleration in devaluation during the second half of the year obliged the Board of Directors to adopt supplementary policy measures, without changing the stance of the country's monetary policy. While the intervention rates remained unaltered, US$540 million (m) in put options were auctioned to control volatility of the change rate; US$141 m of these options have been exercised. By mid-August, the external environment had deteriorated even further and there was considerable uncertainty as to fiscal prospects in the short and mid-term. These factors led to an increase in the country's risk premium and in interest rates on government bonds (TES). Under these circumstances, the BDBR decided to move up its standing purchases of TES on the secondary market and authorized stockbrokers and trust companies to conduct temporary expansion operations with Banco de la República. These provisions, adopted at a time when the new administration was defining its the fiscal and financing strategy, helped to restore calm to the government bond market.

The rebound in core inflation due to increased cost pressure originating with the rise in devaluation necessitated a change in the stance of the country's monetary policy in January 2003. Accordingly, the BDBR increased the Bank's intervention rate by one percentage point. These same reasons led the Bank to announce in February that it would auction up to US$ 1 billion in put options on international reserves. It is hoped these measures will help to stabilize the exchange market and mitigate possible inflationary pressure on costs and expectations, which could jeopardize the inflation targets. Even though the Bank's intervention interest rates have increased, they are still at a historically lowest level, in real terms, and are among the lowest of the major Latin American countries.

Low interest rates enabled households and companies to continue to clean up their financial balances on a sound footing and to begin to demand credit in larger proportions than in previous years. The result was an increase of almost 11% in the portfolio of the banking system during 2002. This was accomplished at a time when the financial sector also experienced an important recovery, as reflected in higher profits and a sizeable decline in overdue portfolio rates. In this way, monetary policy aided the recovery in economic growth.

The external shocks to the economy also meant fluctuations in the exchange rate throughout 2002. Up until the first fortnight in May, the tendency was for the peso to appreciate, as it had since the end of 2001 due to low external interest rates and the expectations generated by foreign pre-financing of public sector needs for 2002. However, as of that point and until October, there was strong pressure for devaluation, aggravated by the "contagion" effect in Latin America, by less access to international credit and by the uncertainty provoked by the country's fiscal position. The exchange rate revaluated between October and November, when calm returned to the financial markets and the national government announced its program of fiscal adjustment. December 2002 saw a new trend towards devaluation of the peso, this time in response to the political and economic crisis in Venezuela. The nominal exchange rate on December 31 was 25.01% higher than at the end of 2001. The real exchange rate index was 131.5 at the end of the year, which is a historic high.

From its onset, the Uribe administration has undertaken a series of initiatives to address the country's fiscal problem. The one-time payment of a tax to finance a national security strategy was decreed with declaration of a state of "internal unrest", as provided for in the country's constitution. This levy is equivalent to 1.2% of net worth reported by companies and individuals, if in excess of Col$170 m at December 31, 2002. The declaration of a state of internal unrest and creation of the new tax were deemed lawful by the Constitutional Court. The revenue from this levy was used to finance the military budget for 2002 and to increase spending on the military and police in 2003. Actual revenue from this item will total Col$2.4 trillion (t) when collection concludes at the end of April 2003. This amount is superior to 1% of GDP.

In September 2002, the government presented Congress with a reform bill to increase tax revenue. It included a change in the value added tax (VAT) as of 2003 and 2005, a surcharge on income tax for 2003 and several other changes in tax legislation. The bill was passed into law in December, allowing for a tax increase equal to approximately 1% of GDP in 2003, 1.7% of GDP in 2005 and around 2.0% of GDP as of 2006.

The law convoking a referendum, which also obtained Congressional approval, considers a number of provisions intended to reduce spending. If the required majority of voters approve the referendum, special pension systems will be eliminated and a freeze placed on the wages and retirement pensions of public servants. The operating expenses of state agencies would be frozen as well. The Finance Ministry predicts the subsequent fiscal savings would amount to 0.7% of GDP in 2003 and 0.6% in 2004.

A pension reform bill was approved during the regular legislative session in 2002, raising pension contributions gradually as of 2004 and up until 2008. The positive fiscal impact of the reform is calculated at 0.32% of GDP in 2004 and will increase to 2.79% of GDP by the year 2010. Congress also passed a labor reform act to create jobs and ease conditions for work contracts and the dismissal of employees. It granted the President of Colombia special faculties to modify the organizational structure of central government administration. Use of these faculties would generate permanent fiscal savings on the order of 0.4% a year.

The consolidated public-sector deficit in 2002 was 3.6% of GDP. This is 0.4% of GDP more than during the same period in 2001, when the deficit was 3.2% of GDP. It is also 1.0 percentage point above what the government had scheduled at the start of the year. This imbalance, nearly 0.8% of GDP, is explained by less tax revenue than expected, which was partially due to poor economic performance in the early quarters.

A Stand By agreement was signed with the International Monetary Fund (IMF) at the beginning of 2003. It gives Banco de la República access to US$2.1 b in IMF resources to deal with external imbalances and makes it easier for other multilateral agencies to continue to support the country with credit resources. The agreement also sends a signal to private investors about the commitment to prudent management of public finances and the quality of the country's general macroeconomic policy. In the first quarter of 2003, the central government met all external financing requirements for the year.

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Chapter III of this report analyzes the trend in the major macroeconomic variables during 2002 and prospects for the current year. Low growth in the economy is associated with external and internal factors. The most important external factors include limited access to international financial markets during certain months of the year and the drop in external demand. The negative impact of these factors was magnified by internal ones, such as the slow growth in credit, persistent unemployment and the violence unleashed by criminal groups. Savings and investment are at extremely low levels, preventing an acceleration of economic growth in Colombia. According to government forecasts for 2003, the economy will grow by 2.0%. On the other hand, the current account deficit is expected to be 2.1% of GDP, which is similar to the deficit the year before. As to the trend in inflation, the BDBR has taken steps to make it compatible with the targets. These range between 5% and 6% for 2003 and 3.5% and 5.5% for 2004.

In response to a request from certain members of Congress, this report contains an in-depth and thorough analysis of the strategy adopted by Banco de la República and its Board of Directors to manage the country's international reserves. Chapter IV addresses this topic and highlights how important reserves are to organized management of the economy and their function in absorbing external shocks to the Colombian economy. The criteria and rules adopted in recent years by the BDBR to manage reserves are explained in this context. The conclusion is that current reserves are adequate and sufficient to deal with future eventualities in the external sector.

The report ends with a section on the financial position of Banco de la República. Due to increased yield on the country's international reserves and a decline in operating expenses (concentrated in personnel and general expenses), Banco de la República reported Col$2,071.3 b in profits for 2002. This exceeds the projection in the July 2002 Report Congress (Col$667 b.) and allowed Col$1,481.4 b in profits to be transferred to the national government in February 2003, including Col$651 b (US$220 m) delivered directly in US dollars. It is the largest amount ever transferred to the national government.