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Introduction

The Report presented to the Congress of the Republic analyses the results of the economy in 2003 and the outlook for 2004. Last year was characterized by more vigorous economic growth fuelled by stronger domestic demand and the gradual recovery of external demand. As a result, the tradable and non-tradable goods sectors both expanded strongly. Colombia enjoyed one of the highest growth rates in Latin America, 3.74% against 1.5% for the region. Gross domestic product (GDP) per capita increased 1.8 percentage points, after over five years of negative growth. After excluding illegal crops from the calculation, GDP grew over 4.0% in 2003.

The domestic recovery, which is basically attributable to the trend in the private sector, was partly due to increased confidence in the economy, result in turn of the present Government's democratic security policies, the continuation of the fiscal adjustment, and the monetary policy of the last five years, which has maintained low interest rates for a long period. Thanks to these factors, investment grew sharply to 15.6% of GDP, higher than the 13.0% recorded between 1999 and 2002. Although, this investment rate is still lower than the average (18.5%) of the last three decades, this expansion is one of the most promising factors in the current recovery of growth, since it indicates that agents' expectations are positive and that high growth rates could persist over the next few years.

The reactivation of external demand in the second part of the year was due to the economic upturn in the United States and other countries, which counteracted the negative impact of the contraction of the Venezuelan economy, whose product shrank 9.5% in real terms in 2003. Non-traditional exports, including gold and emeralds, grew 5.3% in dollars, although the drop in sales to Venezuela was over 39.0%. The external environment was also characterized by generally stronger demand and higher commodity prices. Traditional sales grew over 12.9% in nominal terms in 2003. The dollar value of remittances from Colombians resident abroad increased 24.1% and the country-risk premium fell significantly. The trend in external conditions was mainly determined by the expansionary economic policies of the United States and the devaluation of the dollar against other currencies. The encouraging trend in exports and the increased flows of transfers and capital led, as in other emerging countries, to a nominal appreciation of the exchange rate of around 5.42% from June 30, 2003 to March 24, 2004. Even so, the real exchange rate is at an historically high level following the major devaluation of late 2002 and early 2003.

In a relatively favorable external context and with the recovery of the confidence of economic agents, the results of monetary policy, which in recent years had been rather counter-cyclical, began to be felt. The policy of maintaining historically low real interest rates for a long period reduced the risk of non-payment and released funds for debt refinancing, which led to the recovery of the financial sector simultaneously with progress in the area of democratic security and the fiscal adjustment process, as well as restoring confidence in the economy. This combination of factors determined that, after several years of negative growth, loans grew 3.2% in real terms in 2003. Commercial loans and consumer credit recovered at en even higher rate.

The higher economic growth in 2003 was accompanied by much more vigorous creation of employment than in recent years. Although unemployment continues high in the country, its growth rate slowed by over three percentage points during the year from 15.6% to 12.3% in December 2003 against the same month in 2002.

While the economy picked up, inflation dropped from 2002 levels, with a change in the consumer price index (CPI) of 6.49% against 6.99% the year before. However, this rate was still above the inflation 5% to 6% target fixed by the Board of Directors of Banco de la República (the Board) for 2003. The items that pushed prices up were related to sectors with controlled prices which experienced temporary supply shocks, mainly food and those affected by the reform of the value added tax (VAT) in early 2003.

The outlook for 2004 is for stronger growth. According to the Government's latest projections, the growth rate could be 3.8% or even higher. The tradable sectors are expected to continue growing as a consequence of the persistently high level of commodity prices and the fast growth of the GDPs of our trading partners, while non-tradables will benefit from buoyant domestic demand, led by high investment rates in construction and other sectors. Also this year, private consumption is expected to grow over 3.0% in real terms, a trend that is already reflected in most of the surveys on this variable. The higher rate of economic growth will sustain rising employment in a context of lower inflation.

Following the forecast of lower inflation, partly due to the appreciation of the exchange rate, the Board cut intervention rates by 25 basis points (bp) in February and March 2004 on each occasion. Also, recognizing the benefits of accumulating international reserves in order to reduce the vulnerability of the economy, the Board bought US$500 million on the exchange market in December and January, and announced on March 19 a new intervention of US$700 million maximum for the coming months.

Although the economic outlook is positive, the risks that the country could face in the coming months should not be underestimated. The main risk is the possibility of a substantial change on the external front, which could reverse current trends in capital flows. If this occurs, there are still weak aspects in the Colombian economy that would be negatively affected by an abrupt reversal. The country is characterized by the serious structural problem of a very low savings rate which increases dependency on external financing, which is volatile by nature. Part of the problem of the low level of domestic savings is associated with the high deficit on public finances. Although the target agreed by the International Monetary Fund (IMF) was achieved with the 2.8% deficit of GDP in 2003, the outlook for public finances is still troubling, and a significant fiscal adjustment will have to be put through in 2004 and future years to reduce the economy's vulnerability. The National Government and the Congress of the Republic will have to continue working together in the search for solutions through structural reforms, to consolidate a 3.0% primary fiscal surplus, which would guarantee a reduction in public borrowing to below 45.0% of GDP in the medium term.

Chapter IV of the report analyses the current level of the international reserves, as is customary in the reports of the Board of Directors to the Congress of the Republic. On this occasion, the report includes the analysis, made by the Bank at the Government's request, on the use of a portion of the international reserves to pre-pay part of the country's external debt. The technical study of this proposal took into account various opinions that are synthesized in this chapter. The study concludes that the level of reserves is adequate and recommends that no more than US$500 million should be used to pay external debt because of the risks involved.

Since the analysis, the country's external situation has improved considerably, which led the Bank to intervene in the foreign-exchange market and build up reserves. Despite these positive external developments, the conclusions of the document are still valid, and have even been strengthened. Although the external situation looks very favorable, this does not mean that the country is immune from a crisis in the medium term, which is the main criterion used to reach the conclusion that the current level of international reserves is adequate. In fact, this risk has increased since the favorable external situation could be a temporary phenomenon associated with the expansionary policies of the United States that are not sustainable in the medium term. Even if they were, as already mentioned the Colombian economy has structural weaknesses that have still to be resolved. In these conditions, the risk of a possible sudden reversal of capital flows is significant.

Finally, Chapter V contains the financial statements of Banco de la República. Consistent with the austerity policy, which has characterized the Bank in recent years, the results show that expenses declined for the third consecutive year in real terms. As a result of this and the trend in the euro and the yen, which overtook forecasts, the Bank reported profit of 1.4 trillion pesos, higher than the projections of 660 billion pesos in July 2003. Out of these profits, 802.8 billion pesos were transferred to the National Government after creating the legal reserves. For 2004, profits of 335.4 billion pesos are projected, down from 2003 because of the expected lower revaluation of the euro and the fall in international interest rates.