

INTRODUCTION

The lower vulnerability of the Colombian economy to the negative external shock and the possibility of adopting a countercyclical monetary policy without jeopardizing the inflation target are the result of the implementation of prudential macroeconomic policies during the high part of the cycle.

The expansionary cycle of the Colombian economy, which stretched over a period of six years, reached its peak in 2007 (with a growth of 7.5%). In 2008, there was a more pronounced change in the trend than what had been initially anticipated. Last year, the economy grew 2.5%, a third of what was seen in 2007 and approximately half of what had been predicted—around 5%. In addition to the size of the slowdown, it is worth emphasizing the further deterioration of the situation. After an economic expansion of 8.1% in the last quarter of 2007, growth in the following quarters during 2008 was 4.1%, 3.9%, 2.9% and -0.7% respectively.

The slowdown in economic activity in 2008 was partly the result of monetary policy action which was oriented towards moderating the excessive growth in credit and in aggregate demand since 2006 in order to restrain inflationary pressures and to reach a path of sustainable growth. However, over the course of the year, other factors emerged that produced a sharper slowdown than what had been anticipated and one that was clearly undesirable. Among them it is worth mentioning the exchange rate upswing in the first semester which negatively affected production in the tradables sector of the economy. In 2008, the growth for this sector had been 1.8% in comparison to the 7.3% in 2007. In the second place, the slow progress on civil works, mainly on the part of local

governments, made this item of the demand fall 7.1% in 2008 when it had grown 21.5% in 2007. Likewise, the rise in the price for raw materials for a large part of the year raised the production costs for businessmen and affected industrial production which fell 2%. Also there were strikes (Cerrromatoso and the sugar cane workers) which affected economic activity. Finally, the jump in inflation, mainly in the food sector, hurt the household disposable income and this, added to the higher interest rates, caused a slowdown of 3.9% in the consumption of durable goods.

But without a doubt, the factor that accentuated the slowdown of economic activity was the worsening of the international financial crisis starting in September, 2008 through the reduction in foreign demand and smaller flow of workers' remittances. Thus, as a result of the sharp fall in the prices for oil and other commodities as well as the reduction in sales volume, mostly of industrial goods, the value of total exports in dollars went from growing at 38.5% annually between January and September to -0.6% annual growth in the last quarter. At the same time, the remittances from Colombians living abroad began to slow down and in the fourth quarter of 2008, there was a annual drop of 11.6%.

These first figures show that the international crisis has affected the Colombian economy and inevitably will continue to do so this year. That is why it has been so important make the effort in this report to understand and explain the international crisis, its origins, the measures that the developed countries have taken to face it, its effects on economic activity and the financial system as well as the effect that is now materializing in emerging economies.

The governments and central banks of the developed countries have adopted strong policy responses. However, that has not prevented the mortgage and financial crisis from extending into the productive sector of the economy and drastically squeezing consumption and private investment in those countries. Likewise, international trade, the main engine for growth during the last decade, is shrinking at a faster pace. This is affecting numerous economies, especially those of Southeast Asia which are the most open. In this context, various international entities such as the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) have revised downwards their forecast for world growth for 2009 on the last few months. For example, in their revision for last January, the IMF estimated that the growth of the world output would reach 0.5%, a forecast that was significantly lower than the one made in November (2.2%). In mid-March, for the meeting of the G20, the IMF again changed this forecast to a range of between -0.5% and -1%.

The pertinent question is how this crisis will affect the developing countries and, particularly, the Colombian economy. As discussed in this Report, the channels by which an international crisis is passed on to emerging economies may be real or financial in character. The weakening of exports, the fall in

remittances, and the loss of consumer and investor confidence is found in the first group. The reduction in capital flows and the difficulty in getting access to sources of foreign loans is in the second.

It is very probable that the slowing trend of in exports will become accentuated in 2009 just as the projection of the balance of payments shows in this Report. Something similar is occurring with the workers' remittances from Colombians who are abroad. These are concentrated in the United States and Spain, which are two of the economies that have been the most battered by the crisis. As a reflection of the progression of the crisis, the most recent surveys show a perceptible deterioration in business and consumer confidence. This will inevitably affect their decisions about investment and consumption. With respect to capital flows, it is doubtful that the high levels of foreign direct investment seen in the last two years, which in gross terms rose to approximately US\$10.0 million (m), will be repeated in 2009. Nevertheless, it must not be forgotten that a significant number of the projects which have foreign investment are now underway and stopping them would not be economically viable. Finally, the country still has access to capital markets as was demonstrated in January with the successful placing of US\$1,000 million in public debt bonds at reasonable rates.

To evaluate what this could mean for the Colombian economy in the absence of compensating fiscal or monetary policies, the Bank's technical staff forecasts that a reduction of 1 percentage point (pp) in world growth will shrink the growth of our non-traditional exports by at least 2pp and the growth of the Colombian gross domestic product (GDP) by slightly more than 0.5 pp. This is taking into account only the direct channel of lower demand. Obviously, as a result of the above, the Bank has lowered its growth predictions for 2009. In September, 2008, it was projected that it would be possible to grow at a rate within the range of 1% to 4% this year. The most recently published growth estimate in the *Inflation Report* places it between 1% and 3%. Currently this prediction range is undergoing revision and will probably be lowered.

This means that the economic slowdown will continue to deepen in 2009. Undoubtedly, this is a perspective that causes serious concern especially because of the social effects it will have in terms of an upswing in the rate of unemployment and poverty indices. Nevertheless, there is a high probability of achieving positive growth in the midst of what many analysts now consider the worst economic crisis since the Great Depression of the 1930s. This achievement would put the Colombian economy in a healthy position to initiate a rapid recovery once the foreign crisis is overcome. The specific value of the growth figure in 2009 will depend on the magnitude and length of the international crisis as well as the performance of the Venezuelan and Ecuadorian economies which receive 43% of this country's non-traditional exports. Also the fate of the economy will depend on the actions of monetary and fiscal policy and the response of the private sector to the challenges it faces.

The high probability of achieving positive growth in 2009 is related to the same factors that accentuated the slowdown in 2008 and that this year could be favorable. Additional to this is the margin of action that monetary policy has to be able to adopt a counter-cyclical stance. With respect to the factors that could help growth, the downswing in inflation of food prices should be pointed out. This fell from 13.2% at the end of 2008 to 9.5% at the end of February and it is predicted that it will continue falling. To the degree in which the lower inflation of food frees up the consumer's purchasing power for other goods, household disposable income will improve and consequently stimulate their consumption.

Another factor that will also contribute to smooth the economic cycle is the exchange rate. The peso has depreciated more than 40% in comparison to the lowest level reached in June of 2008 without undermining the inflation target nor financial stability. The return to an exchange rate that is more competitive will stimulate production in the tradable sectors and improve the purchasing power of workers' remittances. Also, the drop in the international price for commodities will reduce production costs for companies which will improve margins and encourage production. Finally, the Ministry of the Treasury and Public Credit calculated that public sector demand will grow 5.5% in real terms this year.

Currently there is also the possibility of adopting a counter-cyclical monetary policy that will help to partially compensate the effects of the negative external shock which are already under way. During the last few months of 2008, the marginal reserve requirement was eliminated and the ordinary reserve requirement was reduced. Between December and March Banco de la República's interest rate dropped by 300 basis points (bp). The change in the monetary stance has been transmitted to all of the interest rates. The possibility of extending this policy of monetary stimulus further will depend on the speed at which projections and inflation expectations fall.

As discussed in this Report, the lower vulnerability of the Colombian economy to the negative external shock and the possibility of adopting a counter-cyclical monetary policy without undermining the inflation target are the result of the implementation of prudential macroeconomic policies during the high part of the economic cycle. With respect to this, the Report analyzes the advantages of the inflation targeting regime that guides the monetary authority to make timely decisions on successively raising the interest rate at which it supplies liquidity to the banking system. That was how the policy interest rate was raised 400 bp between April, 2006 and July, 2008. This was complimented by an increase in the marginal reserve requirements in order to limit the lending capacity of the banking system. If it had not been for this policy, the private sector would be over-indebted today and the financial system exposed to the risk of incurring in huge losses.

Other institutional arrangements and policy decisions also contributed to reducing the vulnerability of the economy. On this point the Report highlights the advantages of the floating exchange rate and usefulness of capital controls. Floating the exchange rate reinforced the inflation targeting regime by giving the monetary policy the necessary autonomy to handle the interest rate. Also, the re-establishment of capital controls between May, 2007 and September, 2008 prevented excessive short term foreign indebtedness and prevented the economy from being exposed to the sudden changes of speculative capital. This was complemented by an intervention in the foreign exchange market oriented towards moderating the volatility of the exchange rate. In doing so, a considerable amount of international reserves were accumulated which currently provide significant support to the sustainability of the balance of payments. Today its balance is the equivalent of 11% of the GDP.

In addition to the analysis of the international crisis, its implications for Colombia and the detailed examination of the macroeconomic situation of the country, the Report undertakes specific and very important topics. Among them the handling of the international reserves should be highlighted. This is a topic that has acquired exceptional relevance in the current conditions of international crisis due to the higher risks associated with different portfolios and the need to have sufficient liquidity in case the international reserves have to be used.

The current report to Congress consists of five chapters in addition to this introduction. The world crisis and the channels of transmission to emerging economies are analyzed in the first. The macroeconomic management of the Colombian economy and the world crisis are discussed in the second. The Colombian economy in 2008 and its perspectives are analyzed in the third. The topic of international reserves and their management is discussed in the fourth and the financial situation of the Banco de la República is presented in the fifth chapter. In addition, this Report contains a series of boxes that delve into the technical analysis on topics that are important for the national and international situation.