



INFLATION REPORT
SEPTEMBER 2001

BANCO DE LA REPUBLICA
(CENTRAL BANK)
COLOMBIA

PRESENTATION, SUMMARY AND CONCLUSIONS

✕ Annual consumer inflation was 8.0% in September, much the same as at the end of the second quarter (7.9%) but 1.2 percentage points lower than in September 2000 (9.2%). It was the lowest annual rate in any September since 1970. Consumer inflation has remained very stable since February, hovering around 8.0%. The accumulated rate for January to September was 7.0%, down from 7.7% for the same period last year.

✕ Prices rose by 0.7% over the third quarter, just as they had in the third quarter of last year but much more slowly than in either the first or second quarters of this year. This reflects the seasonal pattern of Colombian inflation, which has become more marked in the past two year, to the extent that about 60% of annual inflation is generated in the first half of the year.

✕ Food prices were most responsible for inflation in the third quarter, as they had been in the first half of the year, when the onset of the holding-back stage in cattle breeding had caused a surge in the prices of beef and other meat substitutes. These rose more slowly in the third quarter, which was to be expected, given their seasonal behavior, but they are forecast to continue to exert inflationary pressure in 2002, since the cattle-retention stage is expected to last another year.

✕ Education, which had also contributed largely to inflation in the first two quarters, no longer did so in the third. Neither did housing, clothing, health care, or culture and entertainment. The third quarter saw transport prices and diverse expenditures rising much more slowly and producing lower inflationary pressures. Transport prices have been going up more slowly since the beginning of the year, thanks to smaller rises in fuel prices.

✕ Annual inflation in tradables dropped over the third quarter, down to the rate of overall inflation (8.0%); it had been higher than the latter since 1999 but began to converge toward it from the beginning of this year. In contrast, inflation in nontradables went up slightly over the third quarter, running at 7.9% in September.

✕ Core inflation continued to decline over the third quarter. The three most reliable measures of core inflation calculated by the Banco de la República (non-food CPI, inflation nucleus, and the CPI excluding food staples, fuel and public services) averaged 7.0% in September, down from 7.6% in June. In September, none of these measures stood higher than overall inflation or the inflation target for 2001.

✕ Annual producer inflation converged with consumer inflation in September, at 8.0%, running 2.2 percentage points lower than in June and 4.9 points lower than a year earlier. Its steady decline from 11.1% in May brought it down to its lowest level in any September since 1970.

✕ The third-quarter drop in annual producer inflation resulted from smaller annual price changes in all PPI components, whether classified by origin of goods (domestically produced and consumed, and imports) or by ISIC economic activity (farming, mining, and manufacturing). This was possible thanks to lower prices in farming and mining, a smaller accumulated devaluation, and falling prices for the main internationally traded commodities.

✕ Forecasts by the Bank's Economic Studies Division (SGEE) suggest that inflation is highly likely to end the year close to the 8.0% target set for 2001. Similarly, on information to September, the central path of the transmission-mechanism model indicates that average inflation in the fourth quarter of 2002 will be 5.5%, much the same as the 5.3% rate forecast on information to June.

✕ The latest forecasts, like those reported in June, show an upward- sloping risk balance accompanying the central path projected by the transmission-mechanism model. The risk balance's upward slope captures greater uncertainty surrounding devaluation next year, in view of the world economic downturn and the possibility of a financial crisis breaking out eventually in some emerging countries. This uncertainty has definitely increased since the events of September in the United States. A new source of uncertainty taken into account in this Report is connected with the possible recurrence, from December this year, of the climatic condition known as El Niño, and its effect on food prices.

✕ According to the transmission-mechanism model's central path, non-food CPI inflation will be 6.8% in the fourth quarter of this year, and 4.4% in the fourth quarter of 2002. This year's fourth-quarter figure is close to the 6.5% core-inflation forecast calculated as the average of the three measures currently used by SGEE, employing alternative methods.

✕ Real-sector indicators available to date suggest that GDP growth in the third quarter was not much different from growth in the two previous quarters. This view is based on the fact that variables such as nontraditional exports and power consumption have remained stable. In addition, higher oil production between July and September, resulting from reactivation of the Caño Limón field, may have offset declining output in some other sectors, such as manufacturing. Prospects for growth over the rest of the year are not as good as they were thought to be in previous Reports, because of recent external events, sharply falling oil and coffee prices in recent months, unpromising behavior of manufacturing orders, and low expectation among manufacturers regarding the economic situation. Because of these factors, growth for 2001 as a whole is expected to be lower than the government's current target of 2.4%.

✕ Next year the economy is bound to weaken if the global downturn becomes deep and long and if, in addition, there is no lessening of internal security problems. Particularly if, at the same time, the economies of Venezuela and Ecuador show little or no growth, given that demand from these countries has so far been a major driving force of industrial production in Colombia. All these circumstances could limit the positive effect of lower domestic and foreign interest rates on the country's economy.

✕ Poor performance by the real sector is confirmed by recent months' decline in capacity utilization relative to a year earlier, which has left present levels well below historical averages. Consequently, no strong inflationary pressures are expected from demand during the rest of this year or early next year.

✕ Satisfactory inflation behavior allowed the Banco de la República to take a number of measures in the first half of this year to provide the market with ample liquidity. Such measures included notably: (1) reducing the Bank's intervention rates by 50 basis points in early March; (2) adjusting the reference line to accommodate a higher demand for cash that resulted from modification of the transaction levy; and (3) raising the pre-set amounts of liquidity Repos to avoid large interest-rate fluctuations and to offset the freezing of Treasury funds in the Banco de la República. Moreover, to improve the payments system, additional Repo operations were authorized to make it easier for banks to cover shortages in their accounts with the Banco de la República in the process of check clearance.

✕ The Bank continued to pursue this line of action in the third quarter, reducing the structure of intervention rates three times by a total of 200 basis points. Reduction of intervention rates led to a drop in both lending and deposit rates in the market. The average interbank rate was 9.3% in September, 2.1 percentage points lower than in June. The deposit rate dropped by 0.8 percentage points between June and September, to 11.9%, while the average lending rate calculated by the Banco de la República edged down by 0.1 points, to 18.5% in September.

✕ Throughout the third quarter, the monetary base remained below the reference line set in June by the Bank's Board of Directors. In September, in particular, the base's 20-day average ran 2.3% below the reference line's. To provide the economy with liquidity the Board began in August to make final purchases of TES¹ Treasury paper¹ and to raise substantially the amounts set for auctions of reserve-building options.²

✕ The financial system's loan portfolio continued to shrink in nominal terms over the third quarter. A breakdown, however, shows the loan portfolio of non-mortgage banks still growing at annual rates slightly above inflation, while the mortgage banks' portfolio continued to contract, but at a much slower pace during this period.

✕ The Bank's inflation-forecasting exercise confirms that this year's 8.0% target is very likely to be met, and that reaching a 6.0% target by the end of 2002 is feasible. But a high degree of uncertainty surrounds these scenarios for the following reasons: (1) annual food inflation has risen recently, and it may continue to do so next year because the climatic condition known as El Niño is highly likely to recur; (2) the exchange rate may become less stable next year, because the current-account deficit is

¹ By October 12, final purchases of Treasury paper totaled 60 billion pesos.

² The amount approved for reserve-building options in the third quarter was \$210 million (compared with \$90 million in the second quarter), but options worth only \$130 million were exercised in July and September.

expected to widen, and the government may find it difficult to finance the fiscal deficit, given the present climate of international uncertainty, and (3) inflation expectations in Colombia continue to have a large adaptative component, reflected particularly in labor agreements, so that inflation is still characterized by a high degree of inertia.

✕ In any case, output indicators continue to show a slow, though stable, rate of growth in Colombia, while the latest forecasts of world economic performance point to a faster slowdown than was initially expected. These circumstances work against any inflationary pressures occurring next year.

✕ In view of the foregoing, the Board of Directors decided at its meeting on October 12 to continue the strategy of constantly providing liquidity to the economy through final purchases of Treasury paper, and set an amount of 100 billion pesos to be so provided up to the end of November, over and above the 60 billion furnished up to October 12. To this end, too, the Bank is to hold an auction of reserve-building options for \$140 million. The Board also decided to reduce all the Bank's intervention rates by 25 basis points, effective from October 16, 2001. These rates now stand as follows: the Lombard expansion rate at 13.25%, the Lombard contraction rate at 6.75%, the auction expansion rate at 9.25%, and the auction contraction rate at 8.25%. The Board expects these measures will lead to further drops in market interest rates.

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INFLATION REPORT

SEPTEMBER 2001

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PRICE INDICES

A. CONSUMER PRICE INDEX

1. Overall behavior

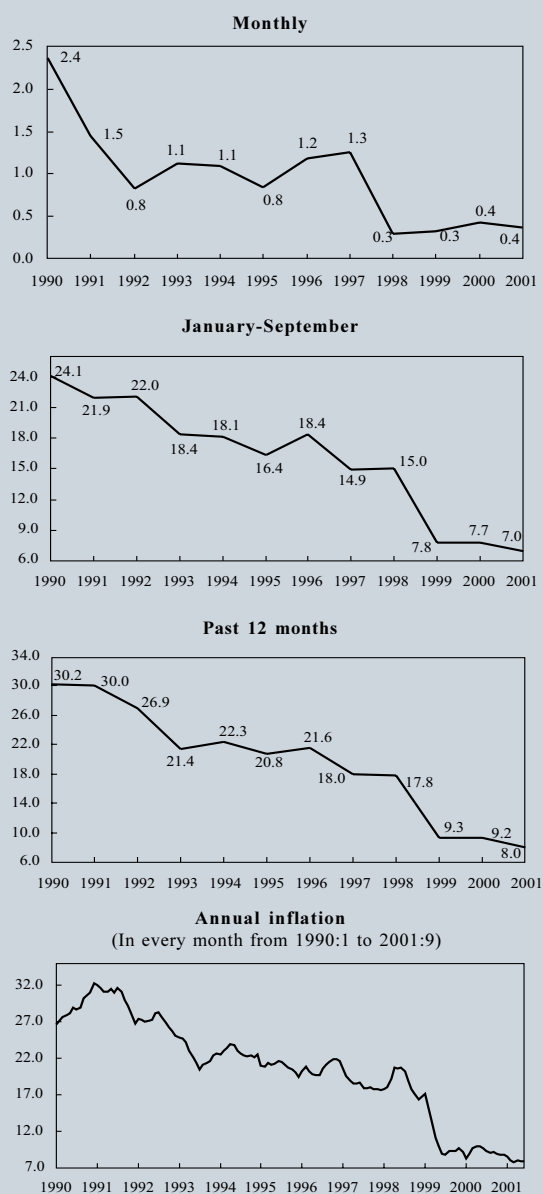
Annual consumer inflation, as measured by the Consumer Price Index (CPI) basket, was 8.0% at the end of the third quarter, much the same level as three months earlier (7.9%), but 1.2 percentage points lower than 12 months before, and the lowest rate in any September since 1970. Inflation from January to September of this year stood at 7.0%, down by 0.7 percentage points on the same period in 2000 (7.7%) (Figure 1 and Table 1).

Consumer prices rose by 0.7% over the third quarter, a smaller rise than in either of the two previous quarters but similar to last year's third-quarter increase, reflecting the seasonal pattern of quarterly inflation in Colombia: high in the first quarter of the year and getting smaller in the following ones.

Colombian inflation is strongly seasonal because food prices tend to rise more in the first half of the year than in the second, and also because most of the indexation schemes contained in prices and wages agreements come into full operation at the beginning of the year. And in recent years inflation has become even more markedly seasonal, as evidenced by the fact that from 1999 to 2001 about 60% of the year's inflation has been concentrated in the first quarter, compared with 35% before 1999.

At the end of the third quarter, the three measures of core inflation considered most reliable by the Bank stood lower than at the end of the second quarter,

FIGURE 1
CONSUMER PRICE INDEX
(PERCENTAGE CHANGE TO SEPT. 2001)



Sources: National Statistics Agency (DANE). Calculations by Banco de la República.

TABLE 1
INFLATION INDICATORS
(% CHANGE TO SEPT. 2001)

	Monthly			January-Sept.			Annual		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
I CPI	0.3	0.4	0.4	7.8	7.7	7.0	9.3	9.2	8.0
Food	0.1	0.3	0.5	6.0	6.7	9.8	4.2	8.2	10.6
Housing	0.2	0.4	0.4	4.7	4.7	3.6	8.6	5.8	3.8
Clothing	0.2	0.2	(0.1)	2.7	2.5	2.2	4.4	2.9	3.3
Health care	1.3	0.5	0.6	13.9	8.9	9.3	15.7	10.0	10.8
Education	1.2	0.9	0.9	12.1	9.2	10.1	12.4	9.5	10.4
Culture & entertainment	(4.4)	0.6	(0.0)	1.1	7.6	7.0	n.d.	8.9	11.2
Transport	1.6	0.6	0.0	15.7	14.2	7.8	18.9	17.2	9.8
Diverse expenditures	0.5	0.4	0.2	14.4	13.3	7.1	18.9	15.0	8.9
II Core inflation 1/	0.4	0.5	0.3	8.5	8.2	5.8	10.7	8.7	7.0
Non-food CPI	0.4	0.5	0.3	8.5	8.2	5.8	11.6	9.6	6.9
Nucleus 2/							10.5	9.1	7.8
CPI excl. food staples, fuel & public services							9.8	7.5	6.3
III PPI	1.5	0.8	0.1	10.0	10.2	7.2	10.9	12.9	8.0
By economic use or destination									
Intermediate consumption	1.3	1.1	(0.2)	8.9	9.4	7.1	10.6	12.8	8.6
Final consumption	1.1	0.7	0.2	9.7	10.6	7.6	9.1	13.3	7.9
Capital goods	3.7	0.1	0.9	16.2	12.2	6.3	20.1	11.7	5.0
Building materials	1.2	0.7	0.2	10.9	9.9	6.7	14.3	13.3	9.6
By origin									
Domestically produced and consumed	0.7	0.8	(0.1)	7.8	9.2	7.8	8.3	13.1	9.1
Imports	3.7	0.6	0.6	16.7	13.1	5.4	21.2	12.4	4.8
Exports 3/	2.7	2.5	1.7	21.0	15.3	(0.2)	30.0	20.7	(8.0)
By industrial activity (ISIC)									
Farming, forestry & fishing	(0.4)	1.1	(0.8)	6.4	7.2	8.1	2.5	12.6	6.8
Mining	0.3	5.4	(0.1)	28.6	29.7	5.3	43.1	32.2	3.4
Manufacturing	2.0	0.6	0.3	10.6	10.4	7.0	13.2	12.5	8.5

n.a. Not available.

1/ The average of the three core-inflation indicators calculated by the Banco de la República.

2/ CPI excluding 20% of the weight of items showing the greatest price volatility between January 1990 and April 1999.

3/ The total PPI does not include exports. It is calculated from the weighted sum of domestically produced and consumed goods and imports.

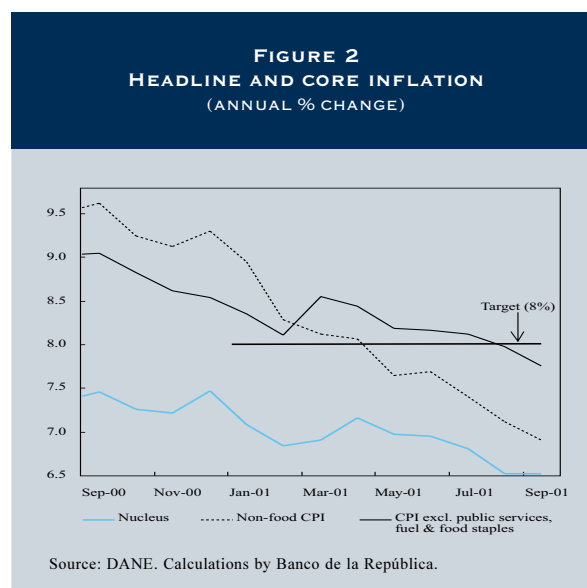
Sources: Economic Studies Division (SGEE) of the Banco de la República, and DANE's PPI and CPI Lists.

having dropped to the following levels: non-food CPI to 6.9%, inflation nucleus to 7.8%, and CPI excluding food staples, fuel and public services to 6.3%. Their average was thus 7.0%, down from 7.6% in June. And in September none of the three was running higher than either overall inflation or the inflation target for 2001. Core inflation has been falling without a break since the middle of last year (Table 1 and Figure 2).

The highest rise in consumer prices over the past 12 months occurred in the city of Cúcuta (10.4%), followed by Montería (10.0%) and Neiva (9.6%), and the lowest in both Pasto and Manizales (7.5%), followed by Bogotá (7.6%) (Table 2). Relative to inflation in June, the biggest increase was reported by Villavicencio, followed by Neiva, Barranquilla and Cúcuta.

2. Behavior of main components

Only two groups of the CPI basket registered higher inflation in September than in June: food (10.6%)



and health care (10.8%). All other groups showed annual price growth equal to or lower than their June rates.

The greatest inflationary pressures in the third quarter came from food prices, with vegetables and legumes rising sharply because of a seasonal reduction in

TABLE 2
CONSUMER PRICE INDEX, TOTAL AND BY CITY
(PERCENTAGE CHANGE TO SEPT. 2001)

	Monthly			January-Sept.			Annual		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
Total	0.3	0.4	0.4	7.8	7.7	7.0	9.3	9.2	8.0
Bogota	0.0	0.4	0.4	7.9	7.9	6.7	10.4	9.2	7.6
Medellin	0.4	0.5	0.6	8.0	7.2	6.3	9.7	9.2	7.7
Cali	0.7	0.6	0.7	6.4	6.9	7.3	7.2	8.0	8.5
Barranquilla	0.5	0.6	0.1	7.2	7.5	8.2	8.4	10.0	8.8
Bucaramanga	0.6	0.3	(0.0)	8.6	8.8	7.2	9.3	10.3	8.0
Manizales	0.7	0.3	0.3	8.3	7.3	6.6	8.9	9.2	7.5
Pasto	1.4	0.6	0.6	10.6	9.3	6.3	11.9	9.5	7.5
Pereira	1.1	0.3	0.3	9.0	7.5	6.3	10.0	8.8	7.8
Cucuta	0.0	0.3	0.2	8.2	9.5	9.4	10.0	11.3	10.4
Monteria	0.3	0.7	0.3	6.7	9.4	9.6	8.1	11.3	10.0
Neiva	0.7	0.1	(0.2)	8.5	7.4	8.5	8.6	7.9	9.6
Cartagena	(0.3)	0.2	(0.2)	6.4	8.2	8.4	6.9	9.8	8.7
Villavicencio	0.3	0.2	0.4	6.7	7.2	7.6	6.5	8.5	8.2

Source: DANE's Lists. Calculations by Banco de la República, SGEE.

supply. Some meat substitutes such as chicken and fish also rose substantially. And although the price of beef went up, too, it did so much more slowly than in the preceding quarters, as anticipated in the June Report.

This slower growth in the price of beef over the third quarter is explained by the seasonal nature of its supply, which tends to be abundant in the second half of the year. A similar explanation holds for the third-quarter drop in the price of potatoes, so that neither beef nor potato prices are expected to go up much over the rest of the year. Projections for next year, however, show the price of beef rising by more than overall inflation, because the current retention stage in Colombian cattle breeding-involving about two years of low beef supply-is expected to last through 2002.

The health-care group registered a slight pick-up in annual inflation over the third quarter. This pick-up was concentrated in health services, whose annual inflation edged up by 0.4 percentage points between June and September to 8.6%. In contrast, the price rise in medicines continued to decline, probably because of slower devaluation.

The third quarter saw no change in annual inflation of other groups such as housing (3.8%), education (10.4%), and culture and entertainment (11.2%). But within the housing group, the prices of water supply and sewerage did individually drive overall inflation in this period. As in the case of other public services in previous quarters, higher water-supply and sewerage prices in this quarter are connected with ongoing programs started a number of years ago to dismantle subsidies and update charges. It is also worth noting with regard to the housing group that annual inflation in rents rose a little over the past three months (1.2%), for the first time in several quarters. And, small as this rise was, it may mark the end of a stage of minimal rent increases.

In September, price rises in transport (9.8%) and diverse expenditures (8.9%) continued to be higher

TABLE 3
GREATEST CONTRIBUTORS TO THIRD-QUARTER
CONSUMER INFLATION, 2001

Item	Third-quarter price change	Contribution to inflation	
		Points	Percentage
Total	0.7	0.7	100.0
Other vegetable & fresh legumes	27.2	0.1	17.0
Water supply, sewerage & waste collection.	5.9	0.1	13.7
Chicken	7.0	0.1	13.0
Other fresh fruits	11.0	0.1	11.3
Imputed rent	0.5	0.1	9.0
Other	0.3	0.3	36.0

Source: DANE's Lists. Calculations by Banco de la República, SGEE.

than average annual inflation, but they were both lower than in June. The drop of two percentage points in transport inflation over the third quarter reflects a slower rise in domestic fuel prices, resulting from lower world oil prices and lower devaluation.

Table 3 is a summary list of the items that contributed most to inflation in the third quarter.

3. Alternate classification: tradable and nontradable goods

Table 4 and Figure 3 present CPI inflation under an alternate classification that divides the basket of goods into tradables¹ and nontradables, with the latter subdivided into indexed,² flexible³ and cyclical⁴ items.

¹ Tradables: textiles, footwear, tobacco, beverages, cereals, dairy produce, cooking fats, drugs, vehicles, electrical appliances, etc.

² Indexed items: rent, fuel, utilities, education, transport, and other items.

³ Flexibles: root crops, plantains, vegetables, legumes, and fruit.

⁴ Cyclical: meat, and meat products.

TABLE 4
CPI, ALTERNATIVE CLASSIFICATION

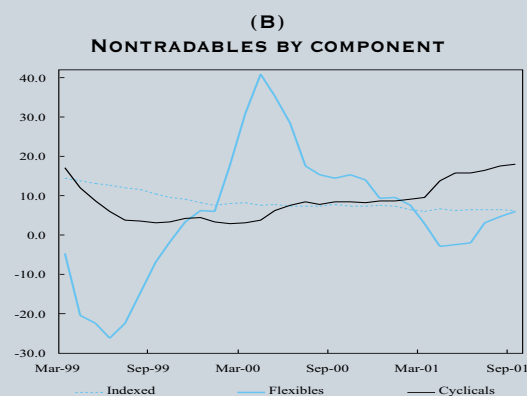
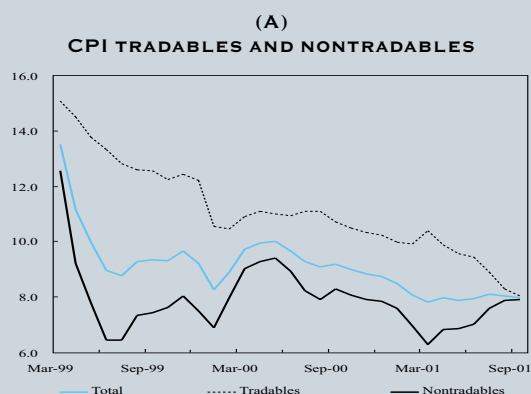
Item	12-month change		
	Sep. 2000	Jun. 2001	Sep. 2001
Total	9.2	7.9	8.0
Tradables	10.7	9.5	8.0
Nontradables	8.3	7.0	7.9
Indexed	7.7	6.4	6.3
Flexibles	14.4	(2.1)	6.0
Cyclicals	8.3	15.9	18.0

Sources: DANE's Lists. Calculations by Banco de la República,

As shown by Figure 3A, the most notable development in the third quarter was the fall in tradables inflation, which moreover made it converge with overall consumer inflation for the first time in many quarters.

Tradables inflation had been running above consumer inflation since 1999, probably because of the high rate of devaluation prevailing in the past three years. Lower devaluation from the second quarter of this year reversed this trend, with the result that annual inflation in tradables at the end of the third quarter (8.0%) was 1.5 percentage points lower than in June this year and 2.7 points lower than in September 2000.

FIGURE 3
CPI, ALTERNATIVE CLASSIFICATION



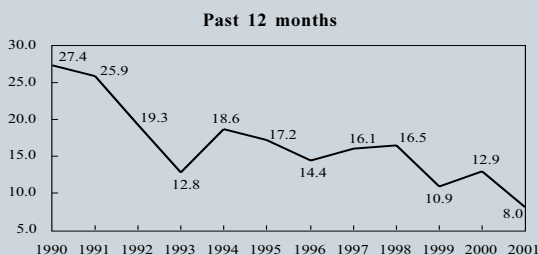
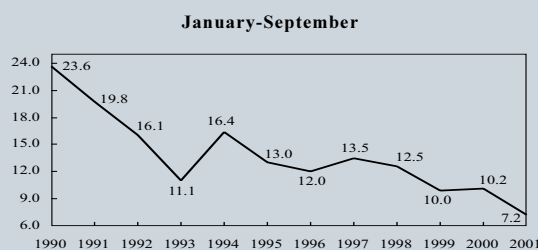
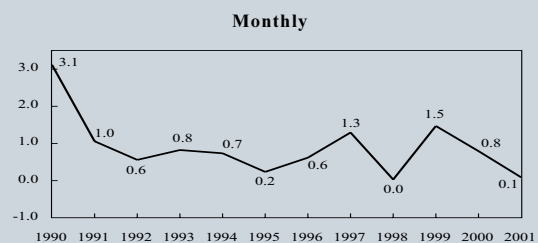
Source: DANE. Calculations by Banco de la República.

Nontradables inflation, too, was higher in September than in June and a year earlier. Among nontradables, cyclicals registered a marked rise in inflation, on account of higher beef prices (Figure 3B). Indexed and flexible items continued to show slow price rises, helping to reduce overall inflation.

B. PRODUCER PRICE INDEX

Annual producer inflation, measured by the Producer Price Index (PPI), was 8.0% in September, the same rate as consumer inflation. It was 2.2 percentage points lower than in June and 4.9 points lower than in September 2000, its steady fall since May this year (when it was 11.1%) having brought it down to the lowest September figure since the Index began to be recorded in 1970 (Figure 4). Producer prices rose by 7.2% from January to September this year, a significantly smaller rise than in the same period last year (10.2%) and, as in the case of the 12-month rate, the lowest January-September inflation since 1970.

FIGURE 4
PRODUCER PRICE INDEX
 (PERCENTAGE CHANGE TO SEPTEMBER)



Sources: Banco de la República, SGEE.

The third-quarter rise in producer prices was barely 0.5%, thanks to a 1.2% fall in farm prices and a 1.8% fall in mining prices. These price falls resulted, in general, from low devaluation over the quarter (1.5%), lower prices for the main internationally traded commodities, and the seasonal pattern of farm prices, which tend to rise most slowly in the third quarter of every year.

Breakdown of the PPI by origin of goods shows import prices rising much more slowly over the third quarter: at an annual rate 4.8% in September, down from 7.6% in June. Annual inflation in domestically produced and consumed goods also fell, though by less than inflation in imports, dropping from 11.1% in June to 9.1% in September.

Breakdown of the Index by ISIC economic activity reveals mining as the best performer, with a 12-month inflation of 3.4% in September, down by 20.1 percentage points on June (23.5%). This plunge stemmed from a similar dive in the annual price rise of oil extraction, which fell from 28.0% in June to 3.8% in September. Farming and manufacturing, too, saw annual inflation abating in the third quarter.

In the farming, forestry and fishing group the rate decreased by 3.0 percentage points, from 9.8% in June to 6.8% in September. In manufacturing the drop was from 10.0% in June to 8.5% in September.

II

DETERMINANTS OF INFLATION

A. MONETARY AGGREGATES, INTEREST AND EXCHANGE RATES

1. Monetary-policy measures

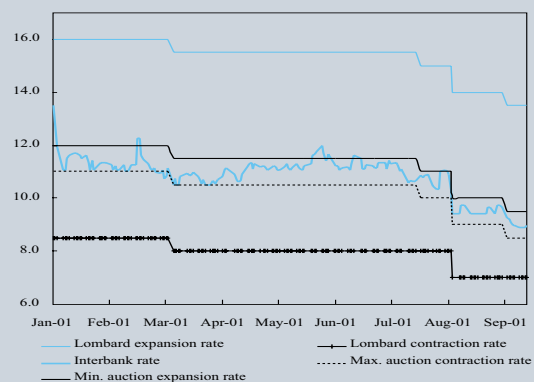
Satisfactory inflation performance allowed the Bank to take several measures in the first half of the year to ensure ample liquidity in the market. These measures included notably: (1) reducing the Bank's intervention rates by 50 basis points in early March; (2) adjusting the monetary base's reference line to accommodate a greater demand for cash that resulted from raising of the transaction levy to 3 per thousand; and (3) raising the pre-set amounts of liquidity Repos to avoid large interest-rate fluctuations and offset the freezing of Treasury funds in the Banco de la República. Moreover, to improve the payments system, additional Repo operations were authorized to allow banks to cover shortages in their accounts at the Banco de la República in the process of check clearing.

The Bank continued to pursue this line of action during the third quarter, since inflation was still behaving in a manner consistent with meeting the targets for this year (8%) and next (6%). Thus, the Board of Directors reduced intervention rates three times between July and September. All rates except the Lombard contraction rate were cut by 50 basis points on July 30, and by 100 points on August 17. On September 17 a 50-point cut was made in the Lombard expansion rate, the auction expansion rate, and the auction contraction rate. At the end of September, intervention rates stood as follows: the Lombard expansion and contraction rates at 13.5% and 7.0%, and the auction expansion and contraction rates at 9.5% and 8.5%, respectively (Figure 5).

Besides cutting rates, the Board decided in September to increase liquidity further by authorizing final purchases of Treasury paper; such purchases amounted to 20 billion pesos by the end of the month. In addition, the pre-set amount for auctions of reserve-building options was raised from \$90 million in the second quarter, to \$210 million in the third, but of this amount options worth only \$130 million were exercised in July and September.

Amounts were set for one-day Repo expansion and contraction operations by taking into account the level of monetary-base demand implicit in the reference line in effect since June 28, and constantly re-assessed conditions of monetary-base supply. In general, demand for Repo expansion transactions was lower than the pre-set amounts, with monetary-base demand running below the reference line during the third quarter. Specifically, the amounts set for one-day

FIGURE 5
BANCO DE LA REPÚBLICA'S INTERBANK
AND INTERVENTION RATES



Sources: Banco de la República.

Repo expansion operations averaged 994 billion pesos in July, 1,039 billion in August, and 685 billion in September, and the market made partial use of them in proportions of 66%, 71% and 54%, respectively. Similarly, pre-set amounts for one-day contraction auctions in July, August and September averaged 300 billion pesos, 283 billion and 282 billion, and the use made of them came to 16%, 65% and 81%, respectively.

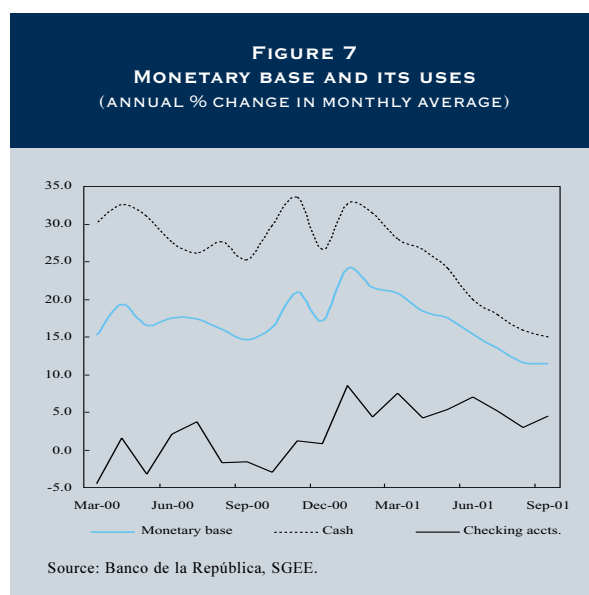
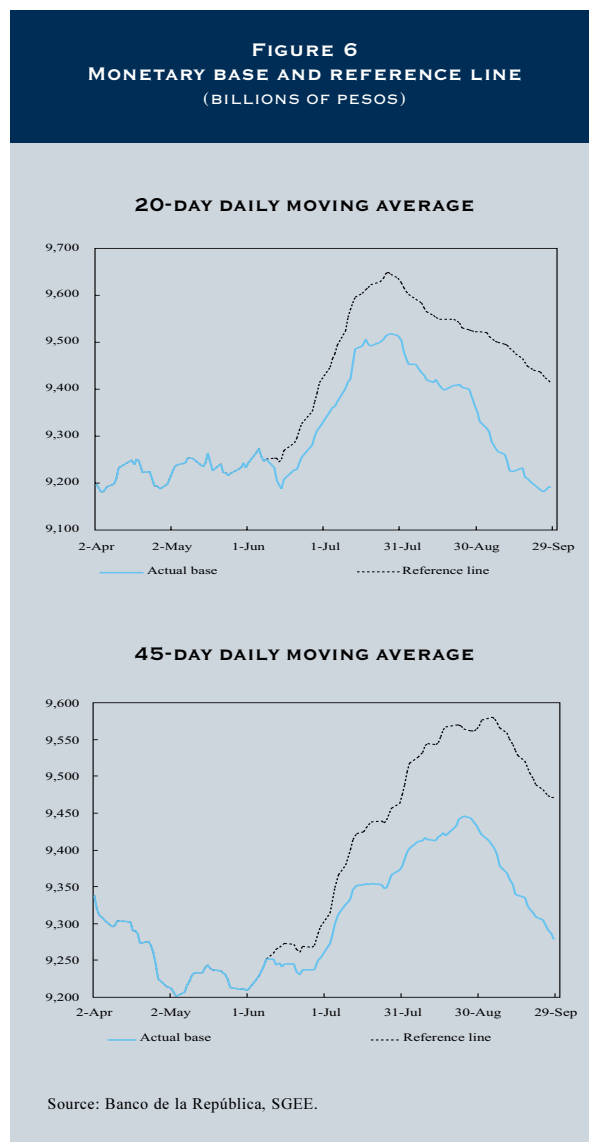
2. Monetary and credit aggregates

The monetary aggregates' behavior over the past three months is analyzed below by examining movements in the monetary base, M1 money supply, broad money M3, and the financial system's loan balance.

Monetary base

On September 28, the monetary base amounted to 9,014 billion pesos. The base's average balance showed a growth rate of 11.4% in September, 4 percentage points lower than in June. Its 20-day and 45-day moving averages stood respectively 2.3% and 2.0% below the reference line's (Figure 6). These third-quarter deviations from the reference line resulted from the average cash and reserve balances growing more slowly than was implicitly envisaged in the reference line. Specifically, their annual growth decreased over the quarter, to 14.9% and 4.5% respectively in September, as compared with 16.4% and 9.3% envisaged for them in the reference line. (Figure 7).

The monetary base been growing more and more slowly throughout the year, for several reasons. To begin with there was the statistical effect of a surge in cash demand in 2000 arising from the introduction of a transaction levy at the end of 1999 and its subsequent increase and extension. Accordingly, the base's growth far outpaced growth in nominal income in 2000. This statistical effect has been gradually disappearing. Then, at the beginning of this year, savings accounts under 4 million pesos were exempted from the levy, and demand for them rose at the expense of demand for cash and checking accounts. Lastly,



there is no disregarding the fact that business-cash demand has declined because of the economic slowdown.

By the end of the year the monetary should again be expanding at rates more in line with expected growth in nominal income. Falling interest rates throughout the year, and the systematic underutilization of pre-set Repo expansion amounts go to show that the market has abundant liquidity, and that the monetary base's slowing expansion stems from a weakening demand for liquidity.

M1 money supply

The M1 balance stood at 13,588 billion pesos on September 28. Annual growth in M1's average balance fell from 10.2% in June to 7.2% in September, because of slower expansion in cash holdings (as indicated above) and in checking accounts (1.1%, down from 2.7%) (Figure 8). Declining growth in checking accounts appears to be closely connected with the fact that savings accounts have been exempted from the three-per-thousand levy.

M3

M3, the broader measure of money supply, showed a balance of 63,560 billion pesos on September 28 (Figure 9). Annual growth in M3's average balance quickened between June and September, from 6.9% to 8.8%. M3 has recovered since the beginning of the year and is now expanding in real terms for the first time since 1998.

M3's recovery came from faster annual growth in liabilities subject to reserves (8.4% in September, up from 5.9% in June), which in turn stemmed from faster expansion in savings accounts (10.4%, up from 5.6%) and in CDs (9.1%, up by 3.7 percentage points on June) (Figures 10 and 11).

The average M3 multiplier went up between June and September, from 6.713 to 6.953, owing to a fall in both the cash ratio (from 0.113 to 0.110) and the reserve ratio (from 0.053 to 0.051) (Figure 12).

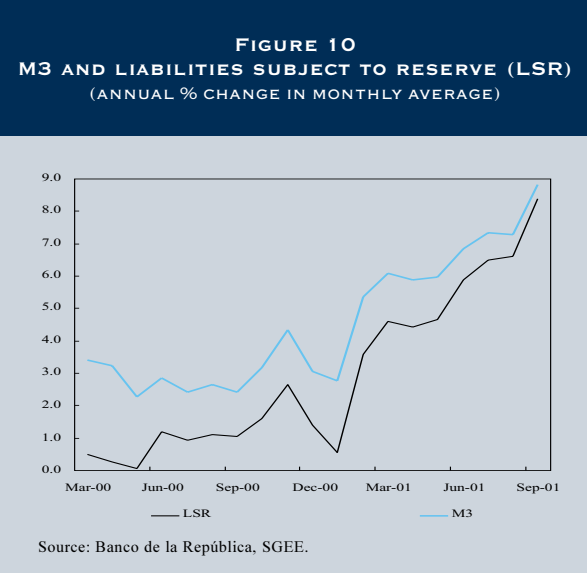
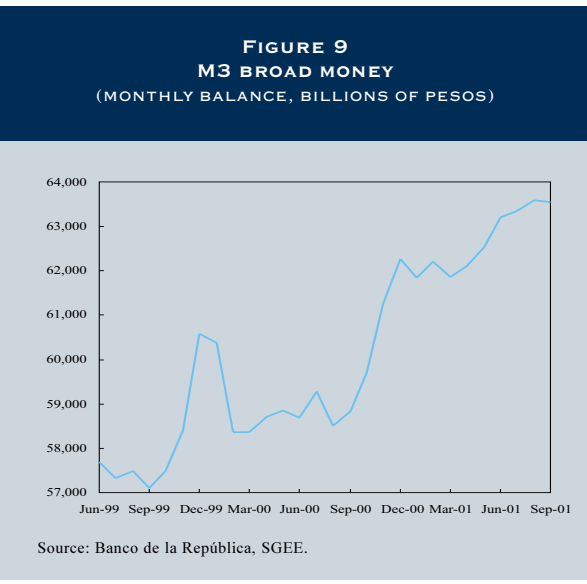
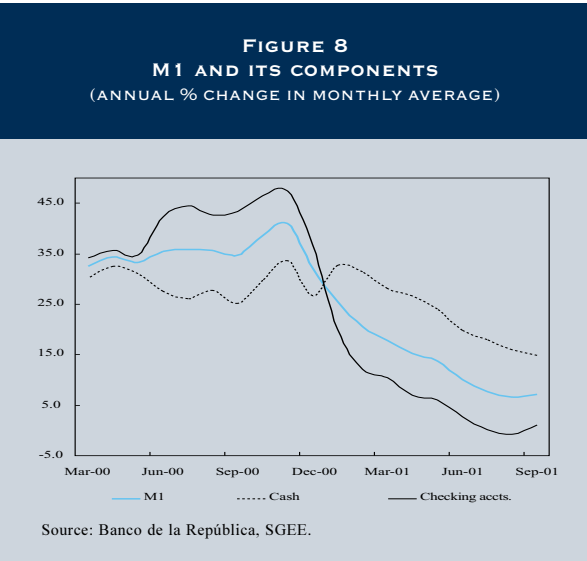
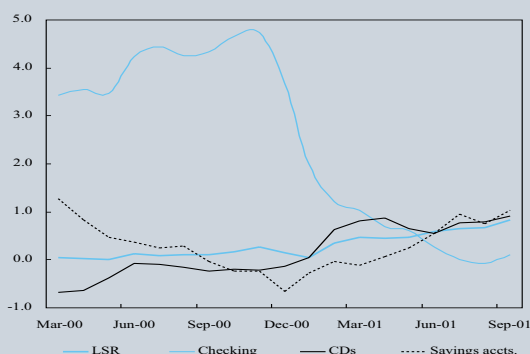
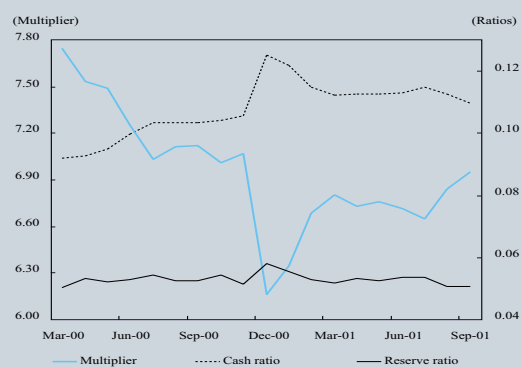


FIGURE 11
LIABILITIES SUBJECT TO RESERVE (LSR)
BY COMPONENT
 (ANNUAL % CHANGE IN MONTHLY AVERAGE)



Source: Banco de la República, SGEE.

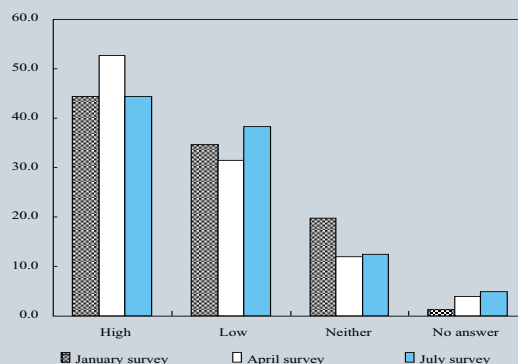
FIGURE 12
M3 MULTIPLIER



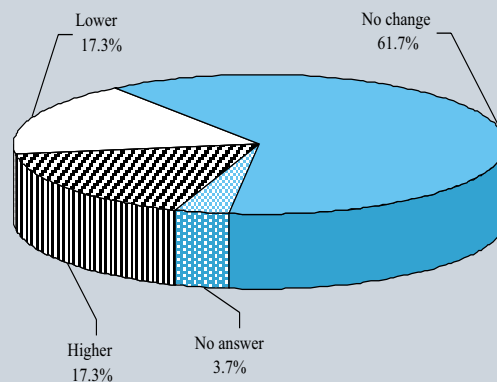
Source: Banco de la República, SGEE.

FIGURE 13
LIQUIDITY: 2001 EXPECTATIONS SURVEYS

(A)
CURRENT PERCEPTION OF LIQUIDITY



(B)
PERCEPTION OF LIQUIDITY IN 6 MONTHS' TIME,



The perception that ample liquidity has been available all through the year is borne out by the expectations surveys conducted periodically by the Bank. In July, 56.8% of respondents considered current liquidity to be high or sufficient. Similar percentages had thought so in the preceding surveys. And respondents did not expect liquidity to change much in the following months (Figure 13).

Credit

The financial system's overall net balance of local- and foreign-currency loans amounted to 45,671 billion pesos on September 28, showing a 12-month decline of 0.5%. In nominal terms, the average balance of the

gross portfolio (net portfolio plus provisions) of local-currency loans held by all financial intermediaries registered a 0.2% annual expansion in September, compared with a 1.1% annual contraction in June. Leaving out the mortgage banks shows the rest of the system registering a portfolio growth of 8.3%, down from 10.5% in June, while the mortgage banks' portfolio shrank more slowly in September (-11.7%) than in June (-16.5%) (Figure 14).

In real terms, the financial system's gross local-currency loan portfolio reduced its rate of contraction over the third quarter (from -8.4% in June to -7.2% in September), as did the mortgage banks' portfolio (from

-22.6% to -18.2%), whereas the non-mortgage banks' continued to expand but more slowly (by 0.3%, down from 2.4% in June) (Figure 15).

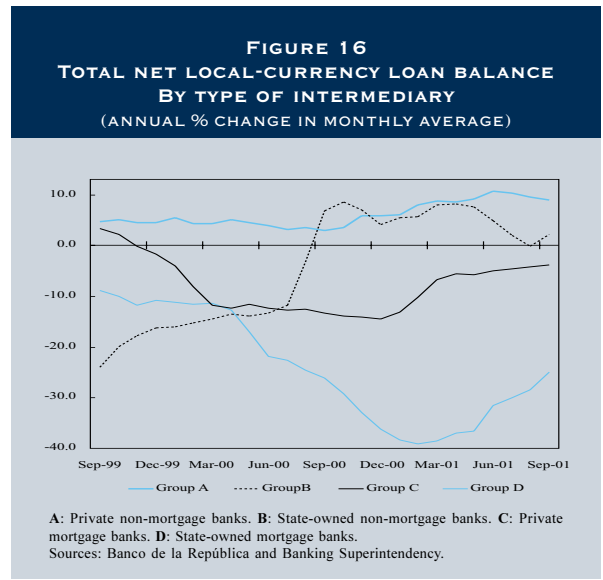
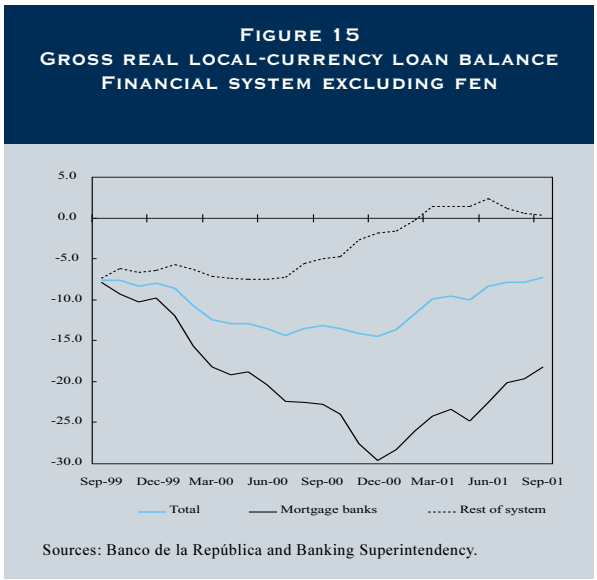
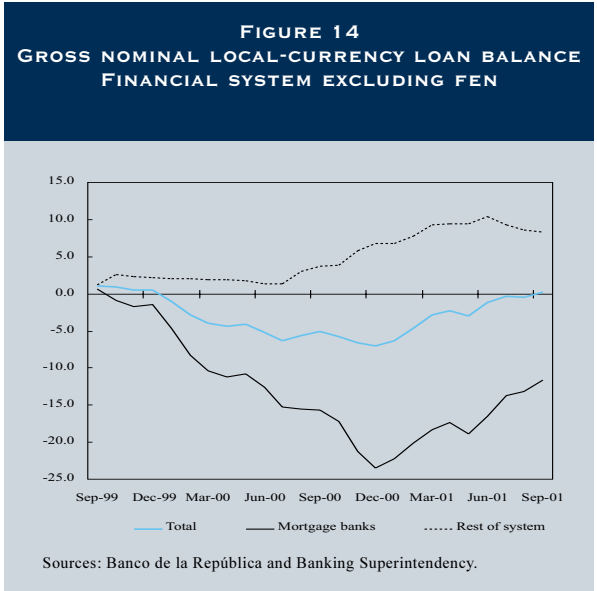
Slower expansion in the non-mortgage banks' portfolio may be partly connected with investors' and consumers' lower expectations of economic growth, while slower contraction in the mortgage banks' portfolio apparently resulted from the government's recent announcement of new financing schemes and higher subsidies, for housing.

A further breakdown, by public or private sector, shows slower annual third- quarter expansion in the average

non-mortgage loan balances of both private entities (9.0% in September, down from 10.8% in June) and public ones (2.1%, down from 4.9%). In contrast, mortgage banks continued to register slower contraction in both the private sector (-3.8% in September, down from -5.0% in June), and, more sharply, in the public sector (-24.8%, down from -31.4%) (Figure 16).

As pointed out in previous Reports, poor portfolio growth as described above is still partly accounted for by the statistical effect of loan removals from the financial intermediaries' balance sheets.⁵ By August the gross nominal portfolio, as corrected by these removals,⁶ was growing at an annual rate of 5.8%, the highest this year (Table 5).

Lastly, Figure 17 shows annual variations in the overall portfolio by type of loan (commercial, consumer or mortgage). Commercial and consumer loans, having grown gradually faster since February, reversed this trend in June, and by August their respective growth



⁵ These removals were brought about by the liquidation of a number of financial entities, the writing-down of unproductive assets, reductions by reason of property received in payment, loan securitizations and sales to institutions outside the system, and recalculations of mortgage loans.

⁶ The corrected portfolio is the gross portfolio as it would have been without those loan removals.

TABLE 5
FINANCIAL SYSTEM'S ADJUSTED GROSS LOCAL-CURRENCY LOAN PORTFOLIO 1/
(MILLIONS OF PESOS)

Period	Gross portfolio 2/ (a)	% Change	Loans removed 3/ (b)	% Change	Law 546 Treasury paper (c)	Corrected gross portfolio (d)	% Change
1999 Dec.	47,230,673	1.1	7,231,853	73.4		54,462,526	7.0
2000 Jan.	46,107,279	(1.4)	7,530,062	64.6		53,637,341	4.5
Feb.	45,444,189	(2.7)	7,608,283	60.7	188,984	53,241,456	3.5
Mar.	44,908,963	(4.3)	7,842,072	56.1	1,009,811	53,760,845	3.5
Apr.	45,047,163	(3.1)	7,735,471	53.8	1,424,182	54,206,815	5.2
May.	44,330,299	(4.9)	8,533,174	62.7	1,554,655	54,418,128	4.9
Jun.	44,405,167	(5.7)	8,549,994	56.7	1,606,548	54,561,709	3.8
Jul.	44,396,256	(4.5)	8,358,096	38.0	1,888,354	54,642,705	4.0
Aug.	43,866,250	(4.4)	8,411,890	35.2	1,875,198	54,153,338	3.9
Sep.	44,313,825	(5.3)	8,800,999	38.4	1,865,097	54,979,921	3.4
Oct. 4/	43,722,658	(5.7)	10,274,021	59.2	1,859,460	55,856,139	5.8
Nov.	43,725,868	(7.3)	10,179,676	56.8	1,888,094	55,793,637	3.9
Dec.	44,026,625	(6.8)	10,229,230	41.4	1,879,428	56,135,283	3.1
2001 Jan.	43,641,768	(5.3)	10,150,433	34.8	1,873,579	55,665,780	3.8
Feb.	43,594,076	(4.1)	10,085,970	32.6	1,939,551	55,619,598	4.5
Mar.	43,814,625	(2.4)	10,096,405	28.7	2,210,940	56,121,970	4.4
Apr.	43,550,702	(3.3)	10,437,012	34.9	2,231,097	56,218,810	3.7
May.	43,921,355	(0.9)	10,539,444	23.5	2,254,746	56,715,545	4.2
Jun.	44,429,267	0.1	10,425,008	21.9	2,254,775	57,109,050	4.7
Jul.	44,349,641	(0.1)	10,461,405	25.2	2,242,881	57,053,927	4.4
Aug.	44,490,932	1.4	10,566,004	25.6	2,227,388	57,284,324	5.8

(d) = (a) + (b) + (c).

Note: The loans-removed series was revised in January 2000 on new data from the BCH (state-owned mortgage bank). Moreover, on December 7, 2000 Coopcentral, a high-grade cooperative, bought loans held in administration for 3,255 million pesos.

1/ The information contained here is provisional, because some items are calculated on estimates, and because financial intermediaries are continually updating their financial statements.

2/ Starting from March 2000 the gross portfolio includes BCH's liquidation balances furnished by the Banking Superintendency.

3/ Portfolio adjustments were made on the following criteria:

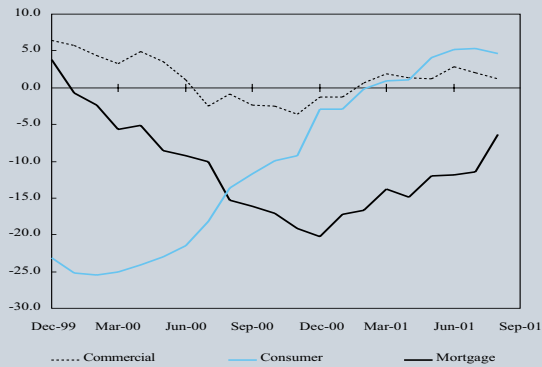
- Mortgage-debt relief does not include the financial system's accounts receivable from the government.
- The 1999 loan-administration portfolio held by Fogafin (state financial guarantee fund) is not included, because account 821905 was opened by the Banking Superintendency at the end of 1999 and has not been reprocessed backward in time.
- The loans of entities under liquidation figuring in the gross portfolio calculated by SGEE are included.
- Write-downs in respect of property received in payment are not included.

4/ Fogafin was authorized by government Decree 1814 dated September 18, 2000 to provide capital for public-law corporations principally engaged in acquiring, administering and disposing of unproductive assets owned by public-law credit establishments. Fogafin therefore created an entity for this purpose, called Central de Inversiones S.A. (CISA), which has carried out the following operations:

- In December 2000, Bancafé sold loans worth 1,153,000 million pesos, receiving payment for them in Fogafin bonds, but continues to administer the loans itself.
- In October 2000, Bancafé sold loans worth 33,600 million pesos to the National Coffee Fund.
- In November of the same year it sold loans worth 34,000 million to Finagro for cash.
- In April 2001, Bancafé sold to CISA a second lot of loans worth 350,061.9 million pesos and a trust fund worth 58,771.6 million.
- In June 2001, Banco Caja Social and Banco Colmena donated to Fundación Colmena written-down loans amounting to 102,352.6 million pesos

Source: Calculations by Banco de la República, SGEE, on balances provided by the Banking Superintendency and information obtained through telephone enquiries.

FIGURE 17
FINANCIAL SYSTEM'S TOTAL LOAN PORTFOLIO,
BY TYPE OF LOAN
(ANNUAL % CHANGE)



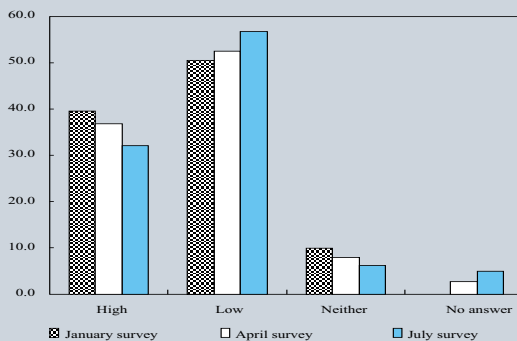
Sources: Banco de la República, SGEE

rates were 1.2% and 4.7%, down from 2.8% and 5.2% in June. In contrast, the mortgage loans' rate of contraction, which had been falling since February, did so more sharply between June and August, from -11.8% to -6.4%.

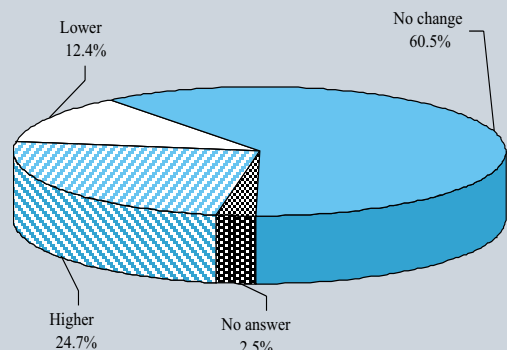
The loan portfolio's slow growth may be attributable not only to weaker demand but also to limited credit supply from the financial system, in response to the high risk premiums involved in intermediation and the abundant supply of Treasury paper. This view is supported by the Bank's expectations surveys. In July, 56.8% of respondents considered credit availability to be low at the time, while an even higher proportion thought that in six months' time it would still be low or drop even further (Figure 18)

FIGURE 18
CREDIT AVAILABILITY: 2001
EXPECTATIONS SURVEYS

(A)
CURRENT PERCEPTION OF CREDIT AVAILABILITY



(B)
PERCEPTION OF CREDIT AVAILABILITY IN 6 MONTHS' TIME, JULY SURVEY



3. Interest rates

The interbank rate fell gradually over the third quarter, as intervention rates were reduced. Its fall was made possible by the Bank providing ample liquidity to meet all the market's needs. At the end of September the interbank rate was 2.1 percentage points lower than at the end of June, this drop being equal to the cut made auction intervention rates. The interbank rate averaged 9.3% at the end of September, its lowest level since May 2000 (Figure 5). In real terms, the interbank rate's average for the third-quarter was 2.0%, and its average for September 1.2%; these rates were not only lower than the corresponding figures for the second quarter, but also amongst the lowest in ten years.

Market interest rates also dropped over the third quarter, in response to lower intervention rates and higher liquidity provided by the Bank, but their drop was even smaller than the interbank rate's. The average DTF deposit rate stood at 11.9% at the end of September, down by 0.8 percentage points on June. The average lending rate calculated by the Banco de la República⁷ ended the third quarter at 18.5%, down

⁷ The overall lending rate calculated by the Banco de la República includes consumer, common, preferential and Treasury rates, weighted by the total amount of loans.

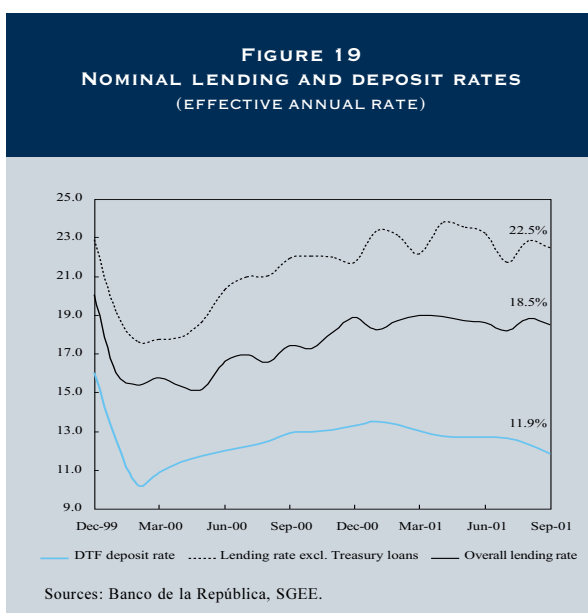
by 0.1 percentage points on three months earlier, and this lending rate excluding Treasury loans fell by 0.7 points, from 23.2% in June to 22.5% in September (Figure 19).

Nominal interest rates, by type of loan, also decreased over the third quarter, notably those of common loans (by 2.1 percentage points, to 21.8% in September), consumer loans (by 1.7 points, to 32.3%), and credit cards (by 2.0 points, to 34.6%). The preferential lending rate remained unchanged at 16.7% (Figure 20).

According to some econometric studies that have analyzed the transmission mechanisms of monetary policy in Colombia, it takes two quarters for the DTF deposit rate to feel the full effect of changes in the intervention and interbank rates.⁸ Consequently, as long as monetary conditions do not change substantially, the DTF can be expected to continue declining for the rest of the year.

The smaller drop in the leading rates calculated by the bank compared with the fall in the DTF deposit rate widened the rate differential. The difference between the lending rate calculated by the Bank and the DTF rose by 0.7 percentage points over the third quarter, (Figure 21) to 6.6% at the end of September, while the difference between this lending rate excluding Treasury loans, and the DTF edged up from 10.5% in June to 10.6% at the end of the third quarter.

Market interest rates also declined in real terms over the third quarter. The real (ex-post) deposit rate fell from 4.4% in June to 3.6% in September, the real lending rate calculated by the Bank dropped from 9.9% to 9.7%, and this lending rate excluding Treasury loans decreased by 0.8 percentage points over the quarter, to 13.4% at the end of it. (Figure 22).



⁸ See Javier Gómez (2001), *Forecasting and Policy Analysis with the Transmission Mechanisms Model in Colombia*, mimeo, Economic Studies Division, Banco de la República.

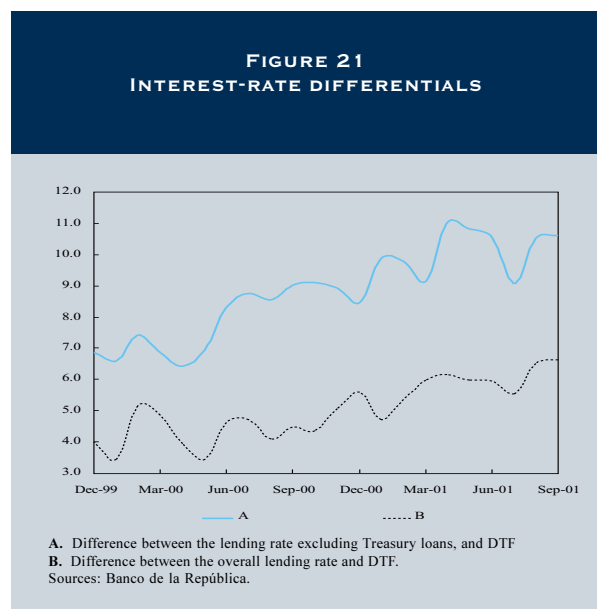
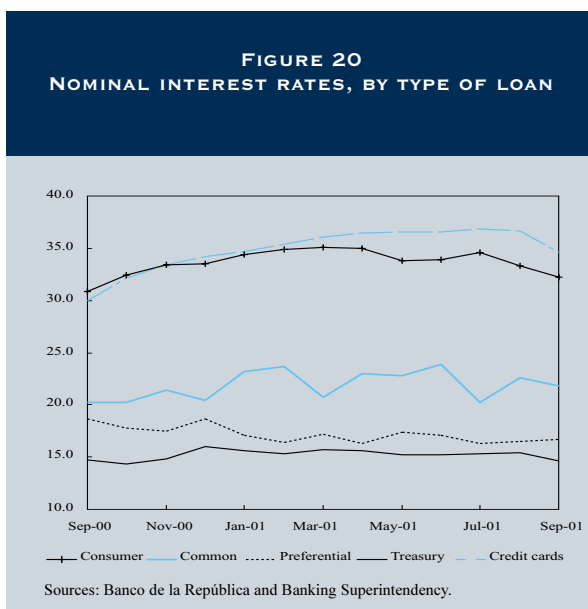
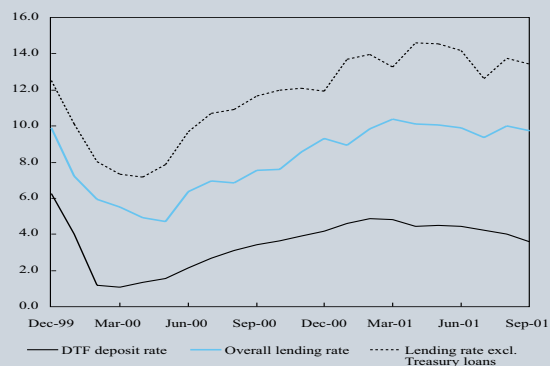


FIGURE 22
REAL DEPOSIT AND LENDING RATES

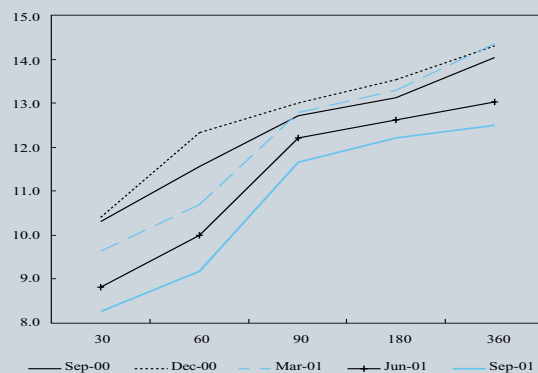


Sources: Banco de la República.

Figure 23 shows how the yield curve of the basic interest rates calculated by the Banking Superintendency (TBS rates) for different maturities has evolved over the past 5 quarters. TBS rates for all maturities have been falling sharply all year long. The slope of the third-quarter yield curve, however, is not much different from the second quarter's. As in the June Report, therefore, the market may be expecting no significant changes in nominal interest rates in the coming months.

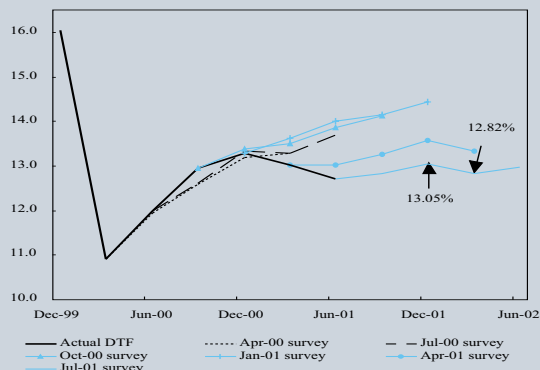
Further information about interest-rate expectations is provided by the Bank's quarterly surveys. The latest

FIGURE 23
BASIC DEPOSIT RATE (TBS) FOR DIFFERENT MATURITIES, CALCULATED BY BANKING SUPERINTENDENCY



Sources: Banking Superintendency.

FIGURE 24
ACTUAL AND EXPECTED DTF DEPOSIT RATES (ANNUAL EFFECTIVE RATE)

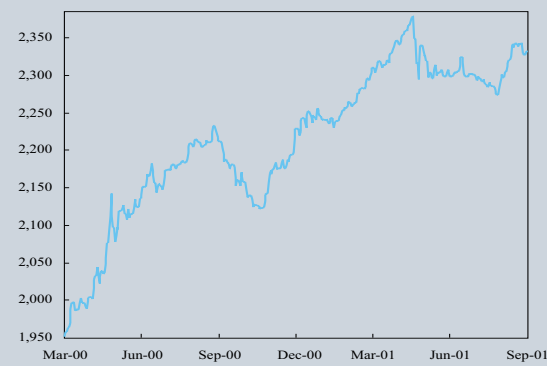


survey, conducted in July, shows that the DTF deposit rate is expected to be around 13.0% by December, down from 13.6% predicted in April (Figure 24). It is to be noted that the July survey was conducted before the Bank's intervention rates were cut in July and September.

4. Nominal exchange rate

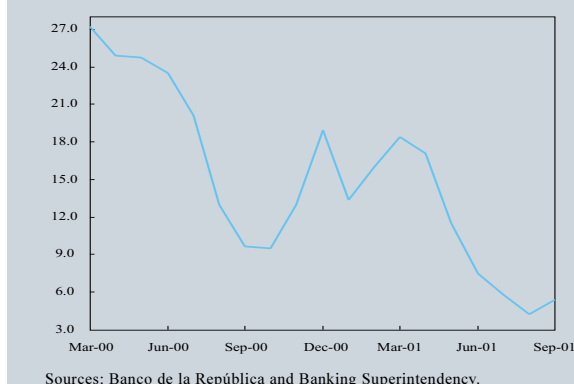
At the end of September, the nominal exchange rate stood at 2,332.2 pesos to the dollar, 33 pesos higher than at the end of June. The peso depreciated by 5.4% in the 12 months to September, and by 4.6% from January to September (Figures 25 and 26).

FIGURE 25
MARKET EXCHANGE RATE (PESOS TO THE DOLLAR)



Sources: Banco de la República and Banking Superintendency.

FIGURE 26
NOMINAL ANNUAL DEVALUATION



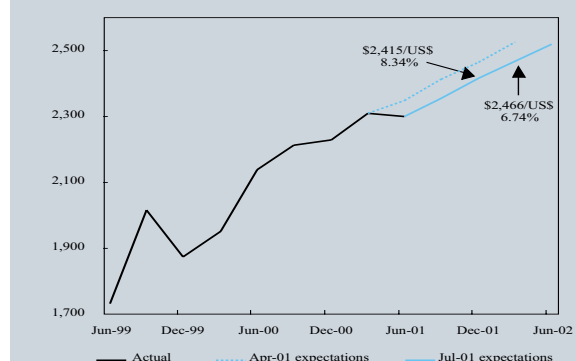
The rising trend shown by the peso since May began to reverse in the last week of August, as a result of the Bank's raising pre-set amounts for put options and cutting intervention rates.

The exchange rate rose by 40 pesos in the first two weeks of September, because of demand from the financial sector to cover its position, and also because of uncertainty arising from the terrorist attacks in the United States on September 11. But, at the beginning of the last week of September the supply of foreign exchange made available by the Treasury caused the Colombian currency to appreciate by 13 pesos.

Three important factors suggest that the peso might begin to rise again in October: (1) the fourth quarter is historically a period of abundant foreign-exchange supply from the real sector; (2) the government is due to make available further supplies of foreign exchange; and (3) the FAEP (oil stabilization fund) and Ecopetrol (state oil company) are likely to bring foreign exchange to the market in the last three months of the year.

Although the peso has remained relatively immune to external uncertainty so far this year, several local analysts believe such immunity will not be sustainable for much longer. This might mean reversal of the peso's rising tendency referred to above.

FIGURE 27
ACTUAL AND EXPECTED NOMINAL EXCHANGE RATES
(PESOS TO THE DOLLAR)



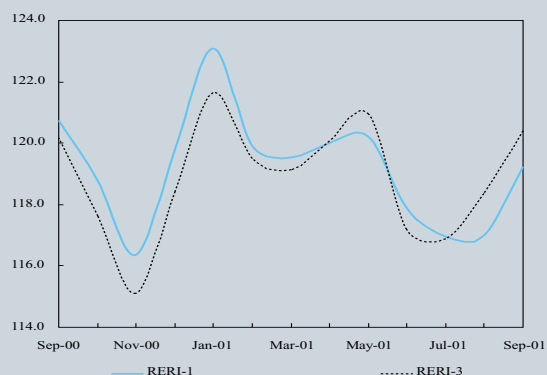
The Bank's July expectations survey shows respondents predicting a nominal exchange rate of 2,415 pesos to the dollar by December, in which case nominal annual devaluation would be 8.3%, down from 10.5% predicted in April (Figure 27).

5. Real exchange rate

According to the RERI-1 real exchange rate index (1994 = 100), which is based on Colombia's Producer Price Index and those of its 20 trading partners, the peso appreciated by 0.5% in January-September, and by 1.3% in the 12 months to September: But according to the RERI-3 index (1994 = 100), which is based on Consumer Price Indices, the peso's annual devaluation in September was nil, while its devaluation in January-September was 1.7% in (Figures 28 and 29).

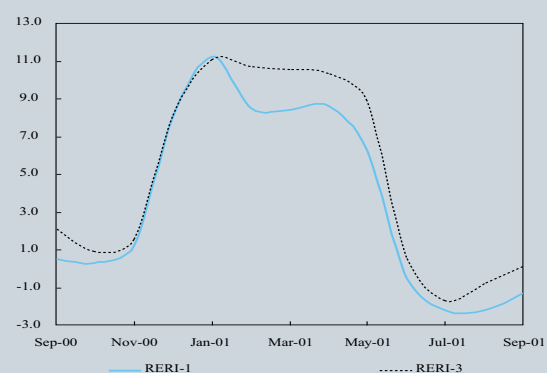
The real exchange rate may be disaggregated into two components: a domestic component, determined by the nominal domestic devaluation-to-inflation ratio; and an external component, determined by the external devaluation-to-inflation ratio. The external component exerted devaluatory pressures, because devaluation among Colombia's trading partners was lower than external inflation. But these pressures were offset by the revaluatory effect of the internal component, dominated by a domestic inflation rate that was higher than the peso's average nominal devaluation.

FIGURE 28
REAL EXCHANGE RATE INDICES
RERI-1 AND RERI-3 (1994 = 100)



Source: Banco de la República, SGEE.

FIGURE 29
REAL ANNUAL DEVALUATION RATE
RERI-1 AND RERI-3 (1994 = 100)

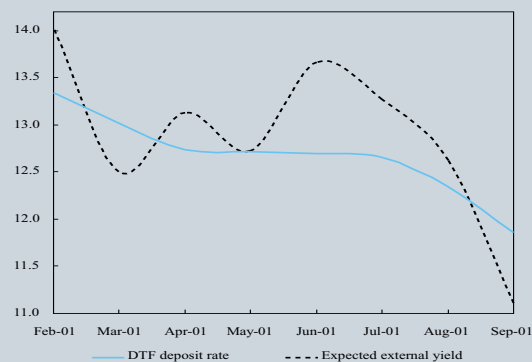


Source: Banco de la República, SGEE.

6. Yield differentials

This section deals with the difference between external and domestic yields. External yield is defined as the return that local investors expect to obtain if they decide to invest in dollar-denominated assets. It is estimated on the basis of an external interest rate of reference, and devaluation expectations. The devaluation expectations used for this purpose are those implicitly contained in the financial system's forward (80- to 100- day) dollar sales contracts. The external reference rate is the 90-day CD rate in New York. The DTF deposit rate is used as the domestic rate of reference.

FIGURE 30
DOMESTIC AND EXPECTED
EXTERNAL YIELDS:



Source: Banco de la República.

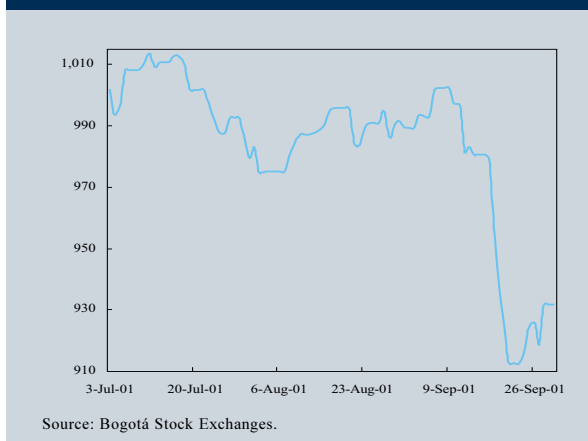
Figure 30 shows expected external yield, and the actual rate of return on domestic investments. At the end of September, expected external yield stood at 11.1%, some 0.8 percentage points below the DTF rate. The fact that devaluation expectations were falling since the beginning of the year worked against the expected external yield, while favoring investments denominated in pesos. Analysis of 80- to 100-day forward contracts revealed an expected devaluation rate of 8.2% for September, the lowest since April. Lower devaluation expectations, combined with a rapidly falling external interest rate, caused expected external yield to run below domestic yield despite a fall in the DTF rate.

7. Asset prices

A description follows of a number of variables that indicate the price behavior of certain assets in Colombia. The first is the General Colombia Stock Exchange Index (IGBC), an aggregate measure of price movements in a basket of the market's most representative shares, selected every three months. (Figure 31).

The IGBC's behavior in the third quarter of 2001 can be divided into two periods: before and after the terrorist attacks in the United States. Before September 11, the IGBC remained relatively stable

FIGURE 31
COLOMBIA STOCK EXCHANGE GENERAL INDEX

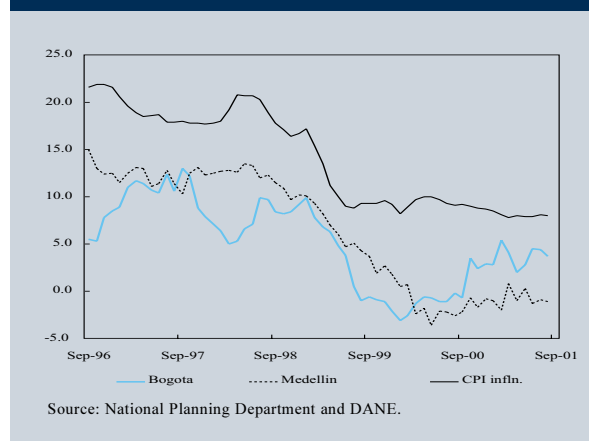


between 975 and 1,014 points, largely reflecting stability in the market for fixed-income securities. Trading volumes were low in this period, for the Colombian market, like those of other emerging countries, failed to become a strong attractive alternative in the context of economic downturn in the United States, Japan and Europe. This was another reason why the IGBC index showed no significant pick-up.

After September 11, with the New York Stock Exchange temporarily closed, the IGBC fell steeply, on account of economic and political uncertainty on the world stage. But, given the sound fundamentals of Colombian companies, local analysts expect to see trading volumes on the Colombian stockmarket beginning to rise in the short term as confidence is restored in foreign markets. This should produce a pick-up in the IGBC.

Another indicator of asset-price behavior is the National Planning Department's monthly housing-price index for Bogotá and Medellín. Figure 32 shows housing-price movements for Bogotá and Medellín, together with consumer-price inflation. Housing-price inflation in the two cities has been running below CPI inflation since the second half of 1995, indicating that the real value of housing in Colombia began to fall steadily from that point on, the fall being steeper in Bogotá than in Medellín.

FIGURE 32
HOUSING-PRICE INFLATION IN BOGOTÁ AND MEDELLÍN AND CPI INFLATION



On available data to August, housing prices have risen in Bogotá this year, at a nominal annual rate of 3.7%, but are still shrinking in Medellín (-1.1%). These rates are similar to those registered in the second quarter and show that housing prices have continued to fall in real terms.

8. Monetary Conditions Indicator

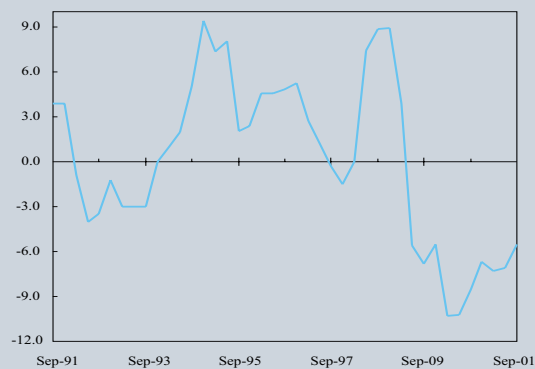
Monetary policy continued to be loose over the third quarter with respect to demand, as evidenced by the Monetary Conditions Indicator for Aggregate Demand. The Indicator was still running below its base-period level (1998:01 = 100) in the third quarter, signifying that monetary conditions were looser than at the beginning of 1998. As in the second quarter, this behavior resulted from falling interest rates and the relative effect of real devaluation (Figure 33).

B. SUPPLY AND DEMAND

1. General considerations

DANE's latest GDP figures show the economy continuing to grow at a slow pace in the second quarter. Sectoral data suggest that this pace may have been maintained over the third quarter. Prospects for the fourth quarter are less clear, largely because of lower

FIGURE 33
MONETARY CONDITIONS INDICATOR (MCI)
FOR AGGREGATE DEMAND
(PERCENTAGE)



Source: Banco de la República, SGEE.

expectations of global growth in the wake of September's events in the United States. It is presently feasible to expect growth for the whole of 2001 to be similar to growth in the first half of the year,⁹ and somewhat lower than the government's revised target of 2.4%.

Annual GDP growth in the second quarter was 1.6%, much the same as in the first quarter (1.8%) but lower than last year's rate, confirming a downturn in 2001. Seasonally adjusted GDP was up by 0.12% in June relative to March, a positive development considering that it had declined in the first quarter relative to last year's fourth quarter.

As in the first quarter, weak growth in the second is attributable to low domestic demand and low traditional exports (coffee and oil exclusively) (Table 6). Nontraditional exports continued to show great dynamism, partly offsetting weakness in other sources of demand.

Though expansion in final demand was sluggish during the first half of the year, it outpaced GDP growth, causing a deterioration in the balance of trade. The

⁹ The latest growth forecasts by local and foreign analysts are presented in the Box at the end of this Report. The analysts, on average, have forecast a growth of 2.1% for 2001 and 3.0% for 2002.

difference between domestic supply and aggregate demand has tended to be covered with imports, which have expanded strongly (by 16% in January-June), in contrast to their poor performance over the past two years.

Second-quarter growth was mediocre in most sectors of production, including manufacturing. Only private construction stood out for its high rate of growth, though, it should be noted, this resulted largely from comparison with a very low level [12 months before?]. As in the first quarter, growth in the second quarter was minimal or negative in mining (because of falling oil production) and in sectors connected with public spending, such as civil works and government services. Manufacturing, too, performed very poorly, growing far more slowly than in previous quarters, because of contraction in meat and food processing. The second quarter also saw a contraction in farming, mainly caused by lower coffee production (Table 7).

Several factors previously reported as being responsible for slow growth earlier in the year still existed in the second and third quarters. They included: low consumer confidence, owing to high unemployment rates and job insecurity; downturns in the world economy and particularly in the US economy; uncertainty about the peace process, which discourages investment and consumption; public-order problems, which have caused some regional markets to become disconnected from the rest of the national market; and the nervousness felt today in world capital markets about the problems facing several emerging economies (in this regard, see Chapter III).

But some of the negative supply shocks that had curbed growth earlier in the year no longer existed by the second or third quarter. The most notable development in this connection has been an upturn in oil production from the Caño Limón field. According to Ecopectrol, crude extraction from this field has been rising since the end of the second quarter, reaching an average of 100,000 barrels a day in the third quarter, substantially higher than in the second quarter or in last year's third

TABLE 6
DEMAND VIEW OF GDP GROWTH
(ANNUAL % CHANGE)

	2000 (*)					2001	
	I	II	III	IV	Annual	I	II
Gross domestic product	1.7	3.2	3.5	2.9	2.8	1.8	1.6
Total imports	3.6	6.6	8.8	3.9	5.7	10.9	21.1
Total final supply	2.0	3.6	4.3	3.0	3.2	3.2	4.4
Final consumption	1.8	1.1	1.0	0.2	1.0	1.3	1.5
Households	2.2	2.6	3.0	2.2	2.6	2.2	1.7
Nondurables	2.3	1.5	2.1	(0.3)	1.4	0.2	(0.8)
Semidurables	4.1	7.5	8.6	10.7	7.5	6.7	6.0
Services	0.6	1.3	2.1	1.7	1.4	2.3	2.4
Durables	12.0	14.5	6.6	7.5	10.0	8.1	5.6
Government	1.3	(2.2)	(3.2)	(3.7)	(2.0)	(0.7)	0.3
Gross capital formation	0.7	23.1	24.6	14.3	14.9	9.5	13.8
Gross fixed capital formation	(10.7)	(2.1)	4.1	9.5	(0.2)	3.9	12.2
Farming, forestry, hunting & fishing	(7.1)	2.5	(8.7)	(6.0)	(4.8)	(15.5)	6.4
Machinery & equipment	(15.2)	(4.8)	13.6	18.5	1.9	17.2	36.1
Transport equipment	(5.8)	10.3	3.6	0.3	1.9	30.4	33.0
Buildings	(20.2)	(10.2)	8.8	12.2	(3.5)	9.2	14.8
Civil works	(0.6)	3.7	(4.8)	4.2	0.6	(12.7)	(9.8)
Services	(3.6)	(0.4)	0.9	3.9	0.1	0.0	0.8
Inventory changes	(746.1)	(235.0)	(336.7)	111.2	(482.3)	60.7	25.9
Subtotal: final domestic demand	1.7	3.8	3.8	2.0	2.8	2.4	3.2
Total exports	3.8	2.9	6.8	8.2	5.5	7.1	12.5
Total final demand	2.0	3.6	4.3	3.0	3.2	3.2	4.7

(*) Change in flow variables.
Source: DANE.

quarter. This improvement should help growth, particularly over the second half of the year.¹⁰

In the wake of the terrorist attacks in the United States, all the adverse external factors referred to above have grown worse. Colombia will be affected not only by the recession that the US economy is bound to suffer in the coming months, but also by a possible downturn in Venezuela resulting from the expected fall in oil

prices. This Venezuelan risk, already discernible in the bolívar's faster depreciation, would be sure to curb Colombia's nontraditional exports and hence its GDP growth.

It is not therefore feasible to expect economic growth to improve significantly in the coming months. But neither is growth expected to decline significantly over the second half of the year, for domestic demand may maintain its current pace of expansion by inertia for some months yet. Moreover, exports still do not represent a major component of

¹⁰ Extraction of Caño Limón crude was brought to a stop again in the first weeks of October by public-order problems. So, it might not continue to be a factor of growth in the fourth quarter.

TABLE 7
QUARTERLY GDP, BY SECTOR : SEASONALLY ADJUSTED SERIES
(ANNUAL % CHANGE)

Sector	2000					2001	
	I	II	III	IV	Full year	I	II
Farming, forestry, hunting & fishing	1.17	7.21	4.00	8.50	5.18	3.16	(0.26)
Untoasted, uncaffeinated coffee	(16.78)	29.63	(8.45)	35.52	6.92	20.45	(11.64)
Livestock and animal products	4.41	0.60	4.21	1.30	2.61	(1.95)	(1.84)
Forestry products and logging	1.90	4.87	1.09	0.56	2.09	0.58	(4.99)
Mining and quarrying	(1.16)	(7.74)	(7.34)	(5.53)	(5.45)	(4.41)	0.73
Electricity, gas and & water	4.98	1.83	0.68	1.79	2.30	1.22	3.07
Manufacturing	8.52	11.26	13.06	6.81	9.88	2.37	0.33
Meat and fish	8.05	0.86	7.86	1.99	4.61	(2.42)	(4.02)
Sugar	3.61	0.78	(1.48)	0.72	0.89	(0.79)	(11.24)
Beverages	(0.56)	(1.95)	(5.19)	0.02	(1.95)	(10.25)	(5.30)
Construction	(7.23)	(2.10)	(0.17)	5.97	(1.06)	(3.48)	0.34
Construction work & buildings	(14.80)	(9.14)	5.78	8.02	(3.04)	8.96	14.16
Civil-engineering work & projects	(0.69)	3.76	(4.91)	4.32	0.58	(12.68)	(9.72)
Commerce, repairs, restaurants & hotels	1.57	6.37	7.65	4.72	5.06	3.94	1.87
Transport, warehousing & communications	3.48	3.85	3.91	3.20	3.61	2.07	2.26
Financial, insurance and real-estate firms	(1.58)	0.01	1.16	(0.61)	(0.26)	1.10	(0.65)
Social, community & personal services	0.64	(1.91)	(1.28)	(1.59)	(1.05)	(0.22)	0.67
Government services	1.44	(2.19)	(1.62)	(2.15)	(1.15)	(0.69)	0.26
Gross Domestic Product	1.70	3.16	3.54	2.86	2.81	1.79	1.55

Source: DANE.

final demand, so that the effect of international downturn will be centered at first on Colombia's industrial performance and only subsequently on the rest of the country's economy.

External factors are expected to play an important part in next year's rate of economic expansion. The possibility of regaining higher growth rates in 2002 will depend on how deep the global downturn becomes, but more particularly on how long the potential US recession lasts and how strongly Venezuela's economy holds up.

Naturally, the fate of Colombia's economy next year will also be closely linked to internal factors. Of special importance will be the internal factors that determine the mood of local and foreign investors. They include progress of the peace process, and successful implementation of the adjustment program. The latter involves specifically the steps taken for the structural reforms envisaged in the program to be approved and carried out. Lastly, satisfactory inflation has so far allowed the Bank to maintain a policy stance conducive to growth next year by significantly reducing its intervention rates,

thereby helping to reduce the entire structure of market interest rates.

2. Third quarter of 2001

The latest data suggest that the economy continued to grow slowly over the third quarter, much as it had in the preceding quarters. Incomplete data on some sectoral indicators, such as oil production and electricity demand, even seem to indicate a slight acceleration of the pace. But figures for September are needed to confirm whether this really happened, since external events may have seriously hurt growth in some sectors.

Nontraditional exports were still the main driving force of expansion between June and August, especially in manufacturing. In terms of 12 months' accumulation to August, overall nontraditional exports grew by 15.7%, relative to a year earlier, while manufactured nontraditionals expanded by 19.1% (Figure 34). The overall rate was slightly lower than at the end of the second quarter because of a decline in August. This slower growth may either be the result of comparison with a higher base last year, in which case it would be transitory, or it may signify a trend break in the nontraditionals' long-standing expansion, caused by the global downturn.

Nontraditional exports to the US market did slow down in July and August (Figure 35), largely because of a fall

in nontraditional farm exports, headed by flowers. But there is also evidence of unusual behavior by manufactured nontraditionals, with several months' contraction in exports of leather, textiles and (mainly) industrial chemicals.

Nontraditional exports to Venezuela and Ecuador, Colombia's other two most important trading partners, continued to grow at a healthy pace in August (Figures 36 and 37). Any slight drop in the annual growth rate over the past few months would be strictly the statistical outcome of comparison with a higher base, for there was no drop in terms of value.

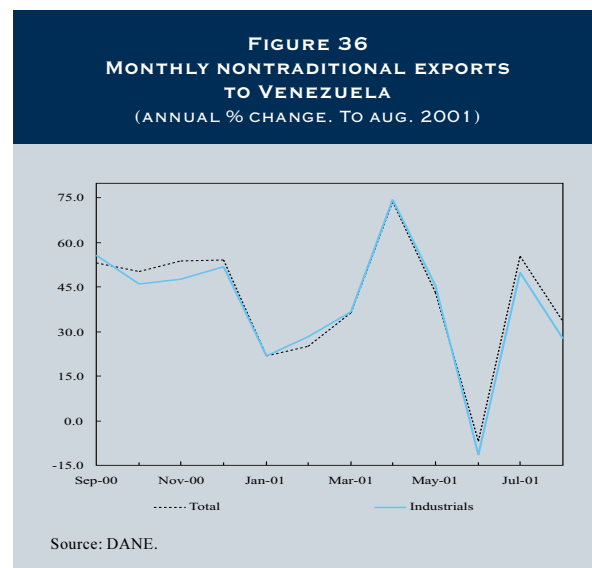
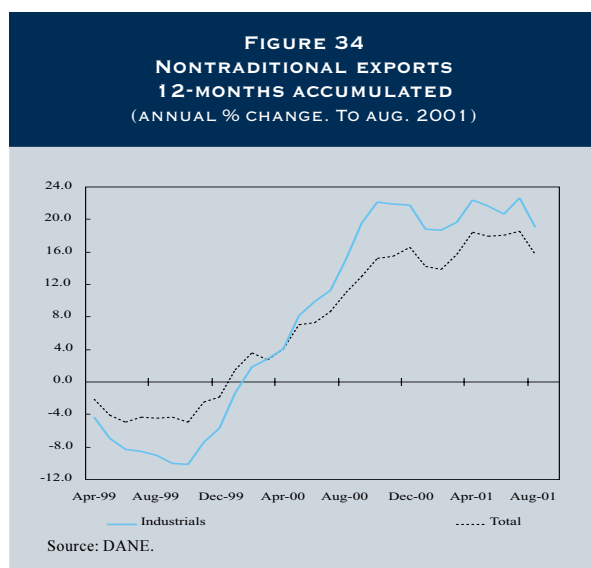
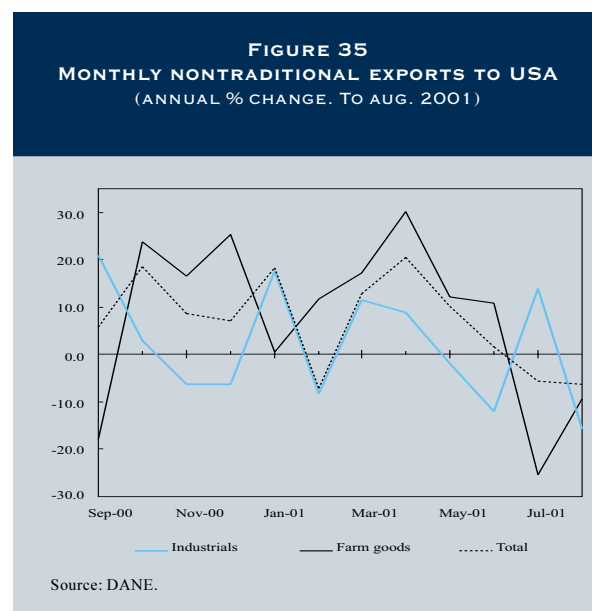
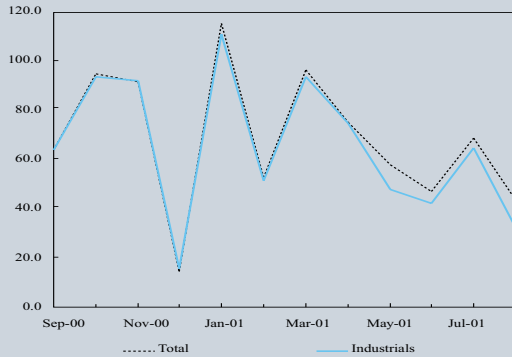
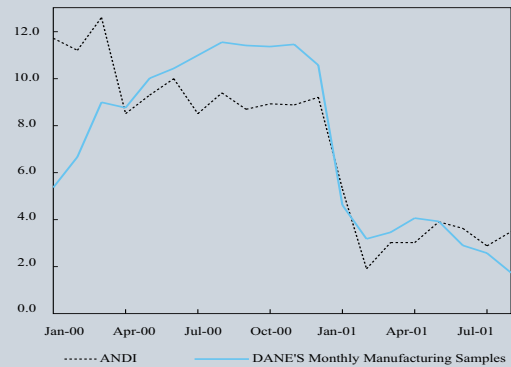


FIGURE 37
MONTHLY NONTRADITIONAL EXPORTS
TO ECUADOR
 (ANNUAL % GROWTH, TO AUG. 2001)



Source: DANE.

FIGURE 38
REAL INDUSTRIAL PRODUCTION INDEX,
TO AUGUST 2001
 (ANNUAL % CHANGE, JANUARY TO DATE)



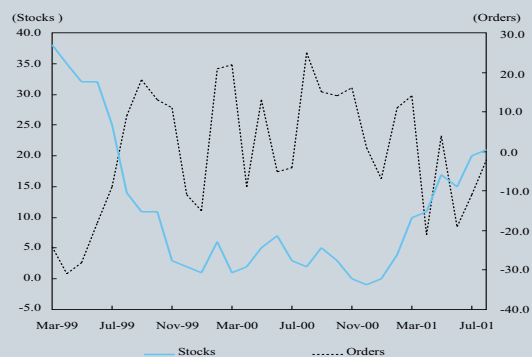
Sources: ANDI and DANE.

Colombia's sales to Venezuela and Ecuador have been largely driven by highly entry-elastic exports such as motor vehicles, which makes them particularly vulnerable to falling expectations of growth. Hence, any downturn in these economies caused by recent external events or the unwinding of oil prices may adversely affect Colombia's industrial growth, to an extent hard to predict today. Recent developments such as shrinking car sales in Venezuela in the past few months may foreshadow a trend break in the growth of Colombian exports to this market. In addition, Venezuela has lately been suffering from exchange instability.

Buoyant external demand allowed industrial output to keep on growing over the third quarter, partially offsetting the weakness of domestic demand. Data to August from ANDI (the major business association) indicate that from January to August accumulated industrial output (excluding threshed coffee) grew by an annual rate of 3.5%, much the same as the June rate (3.6%) and higher than the July rate (2.9%) (Figure 38). DANE's figures to August were not so encouraging, though they too showed industry expanding: by 1.9% from January to August. According to ANDI, growth in industrial output has been essentially sustained by external sales, since domestic sales have continued to shrink.

As regards industrial production in September and the following months, the inventories and orders indicators of the Business Opinion Surveys conducted by Fedesarrollo (an important private research institution) do not point to any strong trend breaks in growth. Inventories continued to rise in July and August, either suggesting involuntary stock accumulation, which would be bad for growth in the coming months, or partly reflecting normal seasonal stocking by industry to meet higher demand at the end of the year. Orders picked up in July and August, but only feebly, considering the time of year (Figure 39).

FIGURE 39
BUSINESS OPINION SURVEY
 (BALANCES - TO AUG. 2001)



Source: Banco de la República-SGEE, on figures from Fedesarrollo's Business Opinion Surveys.

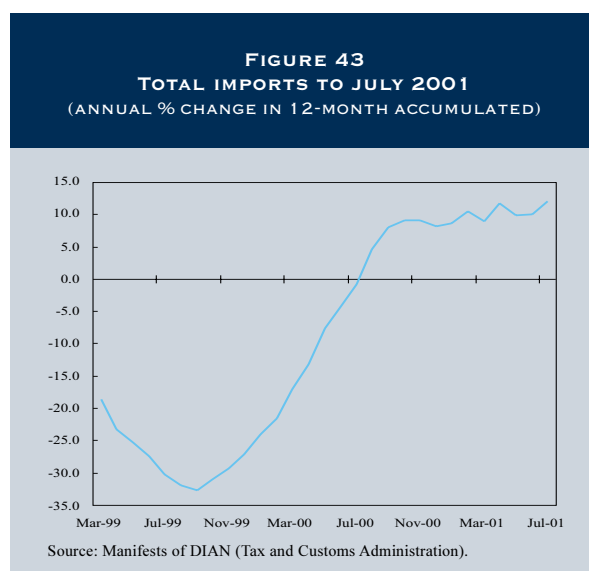
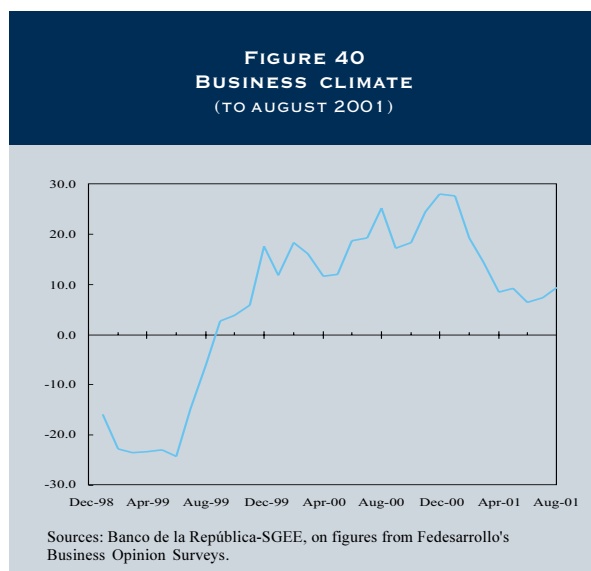
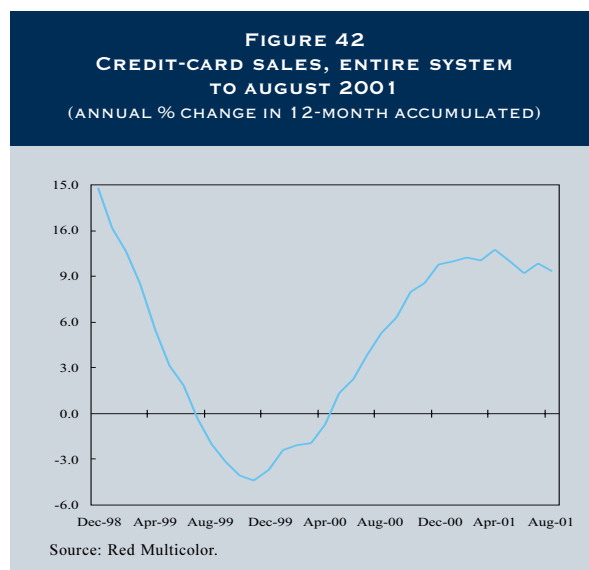
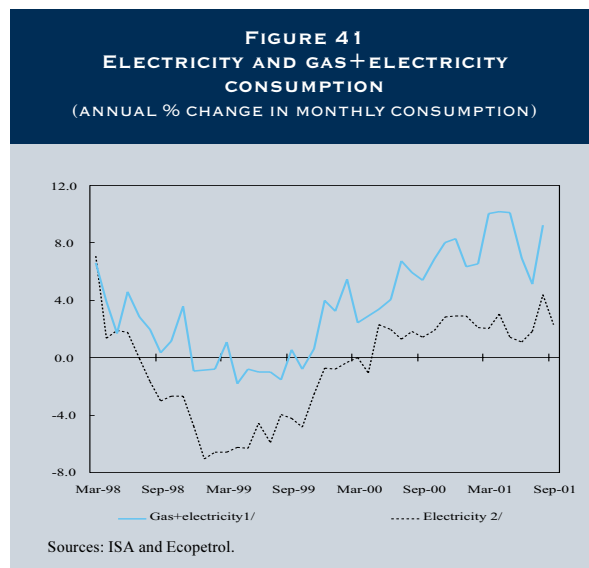
The manufacturing sector's current perception of the economy and expectations of it in six months' time improved slightly in July and August, as evidenced by the business-climate indicator (Figure 40). But they are still below levels registered during much of last year.

Other real-sector indicators, such as electricity consumption, credit-card sales and imports, showed no big trend changes over the third quarter relative to the first and second. On provisional data, growth in electricity consumption in the past three months averaged 2.8% at annual rate, up from 1.8% in the previous quarter (Figure 41). Credit-card sales continued to grow in August, by an annual rate of 9.3% for the 12 months' accumulated, similar to the June rate (9.2%) (Figure 42). Lastly, all types of imports continued to expand at significant annual rates in July (Figure 43).

Similarly, sectors such as private construction that started to recover in the first quarter (Table 7, on page 30) appear to have grown at a decent pace in the third quarter, as shown by such sectoral indicators as real-estate transactions, mortgages and building-license approvals.

3. Consumption

Of the three large components of total demand (consumption, investment and exports), consumption

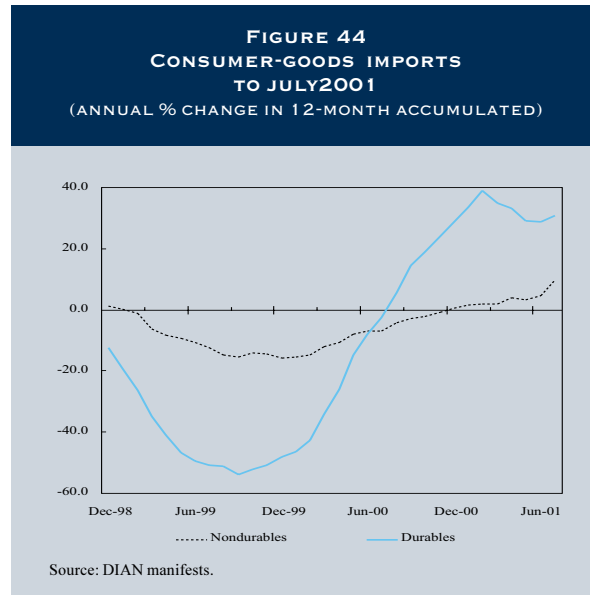


has been the slowest grower since January and the most responsible for the economy's sluggish expansion.

According to DANE, consumption rose by an annual rate of 1.5% over the second quarter, slightly faster than in the preceding quarters. The pick-up in consumption in recent quarters has come from the government, since the household rate has tended to decline (Table 6, on page 29). Nevertheless, up to June, household consumption was still growing at higher annual rates than government consumption and remained the strongest booster of this type of demand and of GDP in general.

It is worth noting that slow growth in household consumption has largely stemmed from very poor performance by nondurables. Since the middle of last year, demand for nondurables has expanded much more slowly than overall household consumption and even contracted by an annual rate of 0.8% in the second quarter. The nondurables' performance is in sharp contrast to growth trends in durables, semi-durables and even services, which have not changed significantly in the preceding 12 months, running consistently above overall household consumption. Durables and semi-durables, in particular, have been notably dynamic in the past few quarters, with annual growth rates still higher than 5.0%, though declining (Table 6).

No substantial changes are expected to have occurred over the third quarter in consumption growth. Household consumption could not have grown much faster than it has recently, in view of high unemployment rates, and a climate of job insecurity generated by economic uncertainty. Yet, some other indicators do give hopes of slightly better performance in the third quarter. Thus, credit-card sales continued to grow in July and August at much the same as in previous months' rates, as mentioned above. Similarly, imports of both durable and nondurable consumer goods have performed satisfactorily all year long, particularly in July, the latest month for which data are available (Figure 44).



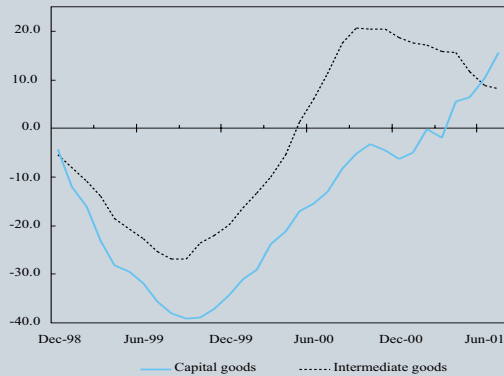
4. Investment

Investment became the most dynamic component of demand in the second quarter, with an annual growth of 13.8%, higher than the first quarter's already decent rate of 9.5%, and coming on top of last year's second-quarter surge in investment (Table 6).

As in the first quarter, investment growth in the second came exclusively from private investment. Public investment does not appear to have performed well, judging by the contraction in public-works spending. Besides private investment, inventory changes too continued to stand out in the second quarter, with an annual expansion rate of around 25.9%. This year's recovery in inventories, however, still does not make up for last year's strong contraction, leaving inventory levels still far below previous years'.

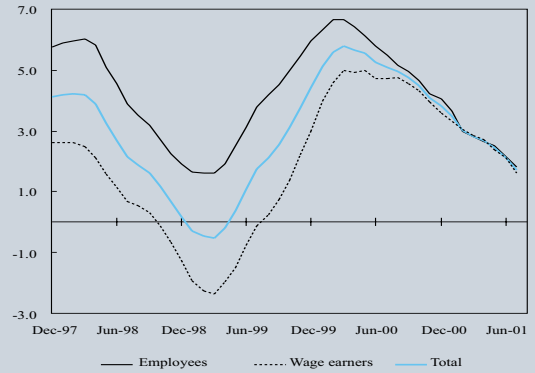
In the third quarter, inventory recovery by itself is expected to have improved investment performance. Moreover, buoyant growth in capital-goods imports suggests that investment continued to expand at about the same rates as in the first half of the year (Figure 45). But, in view of greater uncertainty in today's economic environment, caused by the adverse factors discussed above, investment is expected to grow more slowly in the fourth quarter of this year and first quarter of next.

FIGURE 45
CAPITAL AND INTERMEDIATE GOODS IMPORTS
TO JULY 2001
 (ANNUAL % CHANGE IN 12-MONTH ACCUMULATED)



Source: DIAN manifests.

FIGURE 47
REAL MANUFACTURING PAY
TO JULY 2001
 (AVERAGE ANNUAL % CHANGE IN PAST 12-MONTHS)



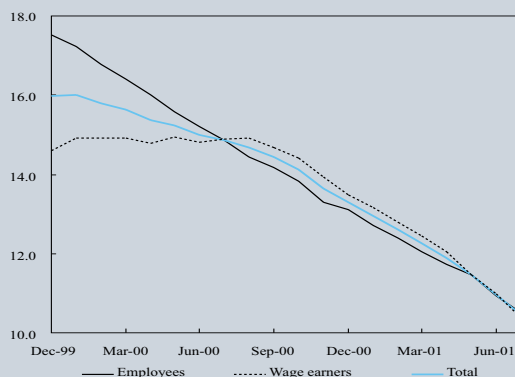
Source: DANE's Monthly Manufacturing Samples.

C. WAGES AND EMPLOYMENT

1. Industrial pay

Nominal industrial pay rises continued to grow smaller up to July. In the 12 months to July, they averaged 10.4% a year for all workers, down from 12.2% three months earlier. Relative to July last year, the fall was four percentage points, much bigger than the drop in inflation, so that pay rises also declined strongly in real terms (Figures 46 and 47)

FIGURE 46
NOMINAL MANUFACTURING PAY
TO JULY 2001
 (AVERAGE ANNUAL % CHANGE IN PAST 12-MONTHS)



Source: DANE, Monthly Manufacturing Samples

As in the past twelve months or more, falling pay rises in the industrial sector have been accompanied lately by declining benefits. With the result that total remuneration (pay plus benefits) has been rising at rates more in line with inflation. Average remuneration in the 12 months to July grew by 9.5%, down from 10.7% three months earlier and from 12.7% in July 2000.

In contrast to pay rises, which were similar for wage earners and employees, nominal rises in benefits have been much higher for wage earners (11.8%) than for employees (8.5%). According to DANE'S Monthly Manufacturing Samples, the difference is accounted for by the fact that industrial wage earners have been more successful than employees in conserving their benefits, perhaps because they are more unionized.

So far this year, smaller pay rises have not brought down labor costs per unit of output, to judge from the Unit Labor Cost indicator, which takes into account changes in labor costs after deducting changes in work productivity. This year, implicit productivity changes have been either zero or negative, which means that nominal pay rises have brought equal or larger rises in labor costs.

In the three months to July, Unit labor Costs registered an average annual rise of about 10.0% (Figure 48). This

FIGURE 48
NOMINAL UNIT LABOR COST
INDUSTRIAL WAGE EARNERS TO JULY 2001
 (ANNUAL % CHANGE)



Source: DANE. Calculations by Banco de a República, SGEE.

was higher than inflation in manufactured goods at the end of the third quarter,¹¹ suggesting that labor costs are rising faster than the prices of goods supplied by manufacturers and thereby reducing their profit margins. If Unit Labor Costs keeps on climbing at this rate, next year may see inflationary pressures in manufacturing, because companies might try to regain profit levels by raising their prices far above the 6% inflation target.

2. Employment

No major changes occurred in the country's employment situation over the third quarter. Urban unemployment continued to hover around 18.0%, higher than a year earlier. In August, unemployment in the 13 major cities was 18.1%, up from 17.2% in August last year, but down from 18.6% in June this year. The unemployment rate for the country as a whole stood at 14.6% in August, and it, too, was lower than in June this year (15.1%).

Unemployment rates usually fall between the end of the second quarter and end of the third, both because the economically active population tends to decrease when school vacations are over, and because labor

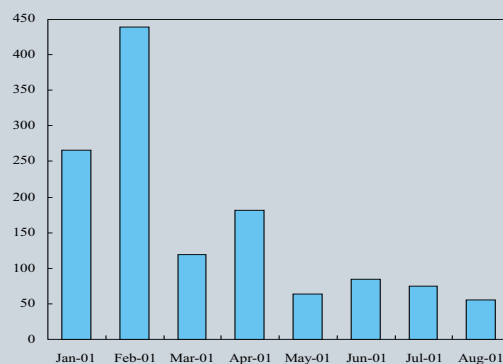
demand generally rises at this time of the year as production is increased to meet larger sales at the end of the year. Lower jobless rates in the third quarter should not therefore be interpreted as an improvement in employment.

As regards labor supply, expansion of the overall participation rate slowed somewhat this year, as evidenced by the rate's fractional decline from 63.9% in January-August in 2000 to 63.6% over the same period this year, though it did pick up slightly between the end of the second quarter and beginning of the third, the period of students' mid-year vacations.

Employment for the 13 major cities, as measured by DANE's Continuous Household Survey, rose again in July and August relative to the same months last year, by some 65,000 new jobs. Although, according to this Survey, urban employment has increased steadily all through the year, it has done by worryingly smaller and smaller amounts. (Figure 49).

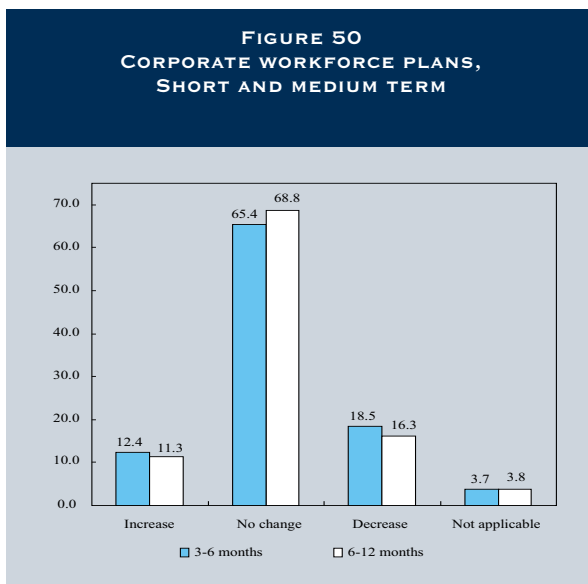
Since the economy is expected to slow down during the rest of this year and over next year, there is little of substantial improvement in employment levels. This is borne out by the Bank's July expectations survey, which found 84.0% of respondents planning to reduce their workforces or leave them unchanged in the

FIGURE 49
JOB CREATION IN 13 MAJOR CITIES
ANNUAL CHANGE IN NO. OF JOBS



Source: DANE's Continuing Household Surveys.

¹¹ Annual producer-price inflation for manufacturers was 8.5% in September 2001.



short term (three to six months), and 85% planning to do so in the long term (six to 12 months) (Figure 50). These percentages are similar to the findings of previous expectations surveys.

3. Pay settlements

Table 8 presents figures from the Ministry of Labor and Social Security on one- and two-year pay-rise settlements.

The upper part of Table 8 shows the percentages of workers receiving one-year pay rises negotiated between January and September 2001. For 8.2% of these workers the one-year rise was under 8.75%, for

another 25.5% it was equal to 8.75%, but for most of them (60.9%) it was in the range of 8.8% to 11.0%, and only 5.4% saw their wages rising by more than 11.0%. Thus, under agreements made this year up to September, 33.7% of the beneficiaries got a one-year pay increase of less than 8.8%, a smaller proportion than at the end of either the second quarter (38.4%) or the first (45.6%). This is surprising, given that inflation has fallen steadily throughout the year and unemployment has remained high.

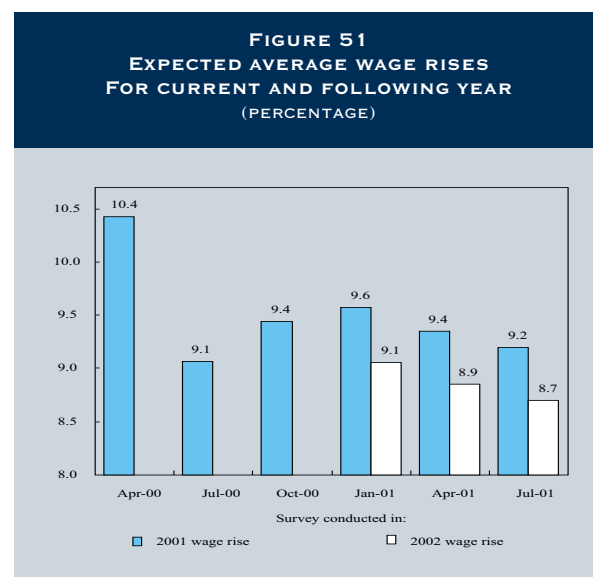
The bottom part of Table 8 shows the percentages of workers receiving two-year pay rises negotiated between January and September this year. The bulk of these workers (78.6%) obtained two-year wage increases ranging between CPI and CPI+2.5, much the same proportion as in June but lower than in March (88.1%). Another 15% of the workers got a two-year pay rise of under 10.0%, a significantly higher proportion than at the beginning of the year, which may suggest a trend in single-digit inflation expectations.

The Bank's expectations surveys, too, show that the labor market has lowered its expectations of inflation for both this year and next. In July, respondents expected a pay increase of 9.2% for 2001 and 8.7% for 2002, down from 9.6% and 9.1%, respectively, predicted in the January survey (Figure 51).

TABLE 8
PAY SETTLEMENTS: JANUARY-SEPTEMBER 2001
% OF BENEFICIARIES BY PAY-RISE LEVEL

One-year rises					
<8.75	8.75	[8.8-11.0]	>11.0		
8.2	25.5	60.9	5.4		
Two-year rises					
<10.0	[10.0-15.0]	CPI	[CPI+0.2-CPI+2.5]	MLW	Other
15.0	2.7	33.7	44.9	1.7	2.0

MLW: Minimum legal wage.
Source: Ministry of Labor and Social Security.

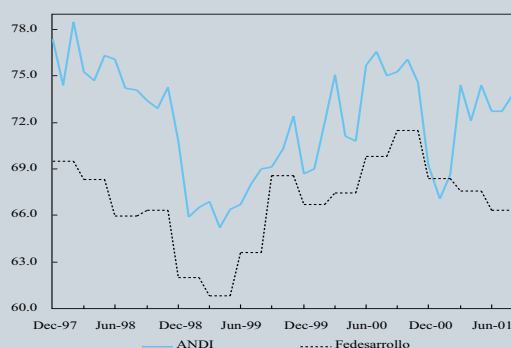


D. CAPACITY UTILIZATION

Capacity utilization decreased over the three months ending in August, relative to the same period last year, according to both of the indicators used for these Reports. Specifically, ANDI's indicator shows an average capacity utilization of 73.3% for July and August this year, 3.3% lower than the average for the same months last year, while Fedesarrollo's figure for July and August this year is 66.3%, representing a contraction of 4.9% relative to the same months last year (Figure 52).

The two indicators had not coincided in showing a clear annual reduction in capacity utilization since the middle of 1999, when the economy was in the depths of recession. ANDI's indicator did exhibit a decline between the end of 2000 and the start of 2001, but that essentially reflected a collapse of capacity utilization in the beverage industry, caused by a strike at the industry's major producer. In contrast, figures available to August show a widespread fall in capacity utilization across all sectors. This bodes ill for growth in the coming months, and especially for investment in the industrial sector, since everything seems to point to under-utilization of the investments made last year and so far this year.

FIGURE 52
CAPACITY UTILIZATION
TO AUGUST 2001



Sources: ANDI and Fedesarrollo.

Pricewise, however, the above developments mean that no strong inflationary pressures should come from demand over the next few months, as far as industrial prices are concerned. Thus, the chances of meeting this year's and next year's inflation targets are increased.

E. FISCAL SITUATION

1. Results for the first half of 2001

The consolidated public-sector deficit amounted to 2,446 billion pesos at the end of the first half of the year, representing 1.3% of annual GDP. As in the first quarter, this result was in line with the terms of the agreement made with the International Monetary Fund, which has set a half-yearly deficit target of 2,600 billion pesos. The fiscal situation deteriorated relative to the first half of 2000, largely because of a higher central-government deficit and a lower fiscal surplus for the rest of the nonfinancial public sector (Table 9).

Table 10 shows that, at annual rates, the central government's total revenues grew by 22.5% over the first half of the year, and its tax revenues by 27.3%. The fastest growing tax items were the gasoline tax (42.8%), the financial-transactions levy (40.2%), and external VAT (34.2%). The surge in gasoline-tax receipts came from decentralization and hydrocarbons contributions, which began to be counted under this income item from this year. Buoyancy in the transactions levy and external VAT resulted from higher rates introduced by the tax reform approved at the end of last year. Overall tax revenues fell short of the half-year forecast made by the Fiscal Policy Council, by a little over 400 billion pesos. The shortfall was concentrated in income-tax and internal-VAT receipts, which felt the effects of the slowdown in economic activity over the first half of the year.

On the side of expenditures, interest payments on debt grew by 29.4%, operating costs by 17.0%, and investment by 24.3%, at annual rates. Under operating

TABLE 9
CONSOLIDATED PUBLIC-SECTOR FISCAL BALANCE,
FIRST HALF OF THE YEAR

Item	Billions of pesos		Percentage of GDP	
	2000	2001	2000	2001
Electricity sector	317.0	408.0	0.2	0.2
Carbocol (coal)	142.0	0.0	0.1	0.0
F.A.E.P.(oil stabilization fund)	722.0	320.0	0.4	0.2
Ecopetrol	1,165.0	894.0	0.7	0.5
Telecom	(124.0)	(61.0)	(0.1)	0.0
Other entities 2/	138.0	81.0	0.1	0.0
Social security	510.0	571.0	0.3	0.3
Local & regional	771.0	(11.0)	0.5	0.0
National Coffee Fund	(148.0)	27.0	(0.1)	0.0
1. Subtotal rest of public sector	3,493.0	2,229.0	2.1	1.2
2. Central government	(2,920.0)	(4,557.0)	(1.7)	(2.4)
A. Total sector público no financiero (SPNF) (1 + 2)	573.0	(2,328.0)	0.3	(1.2)
B. Banco de la República cash profit/loss	461.0	709.0	0.3	0.4
C. Fogafin cash profit/loss	(189.0)	56.0	(0.1)	0.0
D. Financial restructuring costs	(272.0)	(813.0)	(0.2)	(0.4)
E. Adjustments	(935.0)	(70.0)	(0.6)	0.0
F. Total public-sector consolidated deficit (A+B+C+D+E)	(362.0)	(2,446.0)	(0.2)	(1.3)

1/ Includes EPM and EMCALI (Medellín and Cali municipal utilities companies).

Source: Fiscal Policy Council

costs, personal services climbed by 16.5%, general expenditures by 71.4%, and transfers by 13.1%. The surge in general expenditures was connected with the purchase of military equipment worth 316 billion pesos in the first half of the year. Net loans totaled 571 billion pesos, including notably credit operations amounting to 358 billion through the Special Foreign-Debt Account (CEDE), and debt guarantees worth 213 billion.

The government's deficit was largely financed from foreign and domestic loans, and the transfer of profits amounting to 1,452 billion pesos produced by the Banco de la República's operations. Net foreign financing came to 5,032 billion pesos, resulting from

disbursements totaling 7,596 billion, less 2,564 billion in amortizations. Net domestic financing amounted to 1,961 billion pesos, resulting from 6,519 billion in disbursements, less amortizations totaling 4,558 billion. Sales of Treasury paper over the first half of the year produced 6,265 billion pesos, with 3,963 billion of this amount in the form of agreed or compulsory investments, and 2,303 billion through auctions.

2. Central government's fiscal results up to July

At the end of July, the central government showed an accumulated deficit of 5,196 billion pesos, representing 2.7% of annual GDP. Relative to budget projections for the year 2001 made at the end of last

TABLE 10
CENTRAL GOVERNMENT RESULTS: JANUARY-JUNE, 2001
(BILLIONS OF PESOS)

	January-June		Annual
	2000	2001	% Change
I Total revenues (A+B+C+D)	11,459.0	14,041.0	22.5
A. Tax revenues	10,276.0	13,082.0	27.3
Income tax	4,727.0	5,834.0	23.4
Internal VAT	2,667.0	3,361.0	26.0
External VAT	1,123.0	1,507.0	34.2
Customs	833.0	1,044.0	25.3
Gasoline	404.0	577.0	42.8
Financial-transactions levy	508.0	712.0	40.2
Other	14.0	47.0	235.7
B. Non-tax revenues	336.0	287.0	(14.6)
C. Special funds	186.0	98.0	(47.3)
D. Capital income	661.0	574.0	(13.2)
Financial returns	497.0	334.0	(32.8)
Financial surpluses	80.0	99.0	23.8
Other	84.0	141.0	67.9
II Total expenditures (A+B+C+D)	15,696.0	18,922.0	20.6
A. Interest payments	3,692.0	4,777.0	29.4
External	1,086.0	1,610.0	48.3
Internal	2,606.0	3,167.0	21.5
B. Operating costs	10,601.0	12,398.0	17.0
Personal services	1,916.0	2,232.0	16.5
General expenditures	583.0	999.0	71.4
Transfers	8,102.0	9,167.0	13.1
C. Investment outlays	946.0	1,176.0	24.3
D. Net loans	457.0	571.0	24.9
III Accrued adjustments	1,317.0	324.0	(75.4)
IV Cash deficit or surplus (I-II+III) 1/	(2,920.0)	(4,557.0)	56.1
V Financing (A+B+C+D)	2,920.0	4,557.0	56.1
A. Net external credit	1,974.0	5,032.0	154.9
Disbursements	2,569.0	7,596.0	195.7
Amortizations	595.0	2,564.0	330.9
B. Net domestic credit	2,677.0	1,961.0	(26.7)
Disbursements	5,834.0	6,519.0	11.7
Amortizations	3,157.0	4,558.0	44.4
C. Banco de la República profits	516.0	1,452.0	181.4
D. Other	(2,247.0)	(3,888.0)	73.0
VI Deficit as percentage of GDP	(1.7)	(2.4)	40.1

1/ Does not include financial restructuring costs.

Source: Fiscal Policy Council

TABLE 11
CENTRAL GOVERNMENT RESULTS: JANUARY-JULY, 2001
(BILLIONS OF PESOS)

	January-July	2001 budget figures	Porcentaje executed
I Total revenues (A+B+C+D)	16,558.0	28,644.0	57.8
A. Tax revenues	15,263.0	25,532.0	59.8
Income tax	6,406.0	10,488.0	61.1
Internal VAT	4,284.0	6,926.0	61.9
External VAT	1,770.0	3,121.0	56.7
Customs	1,229.0	2,287.0	53.7
Gasoline	679.0	1,044.0	65.0
Financial-transactions levy	839.0	1,568.0	53.5
Other	56.0	98.0	57.1
B. Non-tax revenues	294.0	337.0	87.2
C. Special funds	121.0	589.0	20.5
D. Capital income	880.0	2,186.0	40.3
Financial returns	371.0	815.0	45.5
Financial surpluses	358.0	1,250.0	28.6
Other	151.0	121.0	124.8
II Total expenditures (A+B+C+D)	22,076.0	37,741.0	58.5
A. Interest payments	5,379.0	7,523.0	71.5
External	1,733.0	3,241.0	53.5
Internal	3,646.0	4,282.0	85.1
B. Operating costs	14,669.0	26,234.0	55.9
Personal services	2,788.0	5,384.0	51.8
General expenditures	1,075.0	1,631.0	65.9
Transfers	10,806.0	19,219.0	56.2
C. Investment outlays	1,462.0	3,232.0	45.2
D. Net loans	566.0	752.0	75.3
III Accrued adjustments	322.0	996.0	32.3
IV Cash deficit or surplus (I-II+III) 1/	(5,196.0)	(8,101.0)	64.1
V Financing (A+B+C+D)	5,196.0	8,101.0	64.1
A. Net external credit	5,170.0	4,113.0	125.7
Disbursements	7,858.0	7,812.0	100.6
Amortizations	2,688.0	3,699.0	72.7
B. Net domestic credit	2,235.0	4,474.0	50.0
Disbursements	7,981.0	12,846.0	62.1
TES	7,673.0	11,900.0	64.5
Amortizations	5,746.0	8,372.0	68.6
C. Banco de la República profits	1,452.0	802.0	181.0
D. Other	(3,661.0)	(1,288.0)	284.2
VI Deficit as percentage of GDP	(2.7)	(4.3)	

1/ Does not include financial restructuring costs.

Source: Fiscal Policy Council

year, execution levels were 57.8% for revenues, and 58.5% for expenditures. Among tax items, execution levels were 61.1% for income tax, 61.9% for internal IVA, 65.0% for gasoline, 56.7% for external IVA, and 53.7% for customs receipts. With respect to the government's monthly income schedule, execution of customs and income-tax receipts fell short by about four and five percentage points respectively. Shortfalls in the execution of internal and external IVA were smaller and partly offset by higher execution of the gasoline tax. On the side of expenditures, the data reveal execution levels of 71.5% for interest payments, 55.9% for operating costs, 45.2% for investment, and 75.3% for net loans. By the end of July, foreign-loan disbursements had reached the target originally set for 2001, and sales of Treasury paper came to 64.5% of the amount budgeted for the year (Table 11).

Income execution achieved so far this year suggests that the tax-revenue target set by the government in its financial plan might not be met, especially in the case

of income tax. Execution of expenditures does not appear to pose any major problems, except as regards investment. But, since investment outlays are not distributed evenly over the year, the lag in their execution is very likely to be corrected during the second half of the year.

Lastly, it is important to point out that the Fiscal Policy Council intends to modify the government's annual fiscal budget by raising spending targets and adjusting budgeted revenues on the basis of tax receipts over the year. These changes will widen the government's annual deficit to a range of 4.3% to 5.0% of GDP and call for a review of funding sources.¹² The target agreed on with the IMF for the consolidated public-sector deficit in 2001 will therefore need to be raised from 2.8% to 3.3% of GDP.

¹² These projections do not include the consequences of a recent ruling by the Constitutional Court regarding this year's pay increases for civil servants. Including them could bring operating costs down by some 300 billion pesos, reducing the government's deficit by 0.15% of PIB if the entire sum is actually saved.

III

INTERNATIONAL CONTEXT

A. GENERAL ASPECTS

The outlook for world economic growth deteriorated over the third quarter, with both industrialized and emerging economies showing clear signs of downturns. After the terrorist attacks in the United States, the signs became even stronger. It is clear today that doubts about US defense capacity in the face of such attacks and uncertainty about the US-led war against terrorism have eroded investors' and consumers' confidence, seriously reducing the prospects of world growth next year. As a result, the latest growth forecasts for 2001 and 2002 are much more pessimistic than the predictions made in the second quarter (Table 12).

Even before September 11, the main economic indicators suggested that the US economy had gone into recession. In the euro area, too, economic activity had slowed, though not to the point of recession. In Japan, the worst predictions for growth have proved accurate in the past three months, and the Japanese economy is now shrinking.

The world economic crisis resulting from September's events has intensified problems in the emerging economies, particularly in Latin America, where major risks existing three months ago—as described in the June Report—have now taken on larger proportions. The financial crisis in Argentina and strong downturns in Mexico and Brazil are the chief sources of concern. Another cause for concern is, of course, the US economy's slowdown, which could affect these countries' balances of payments

not only through lower export volumes but also through lower prices for oil and the main commodity exports.

Although the downturn in the United States has been accompanied by the Federal Reserve Board's interest-rate cuts, which benefit indebted economies such as those of Latin America, local and international analysts agree that the benefit will not be large enough to make up for lower exports and their impact on economic growth.

On the basis of economic-growth projections for Colombia's main trading partners, discussed in detail below, the country's foreign trade is now expected to show a 1.7% weighted overall expansion, by volume, by the end of 2001; that is 0.7 percentage points lower than the rate predicted in the second quarter (2.4%). But, since this forecast takes only very limited account of the effects of September's events, it may be revised downward in the next few months.

1. United States

The slowdown in the United States grew worse over the second quarter, with real GDP expanding by an annual rate of 1.2%, significantly lower than the first-quarter expansion of 2.5% (Figure 53). In general, all components of aggregate demand slowed down sharply, the fall being particularly severe in non-residential private investment and in exports. Nevertheless, both private and public consumption continued to show some expansion.

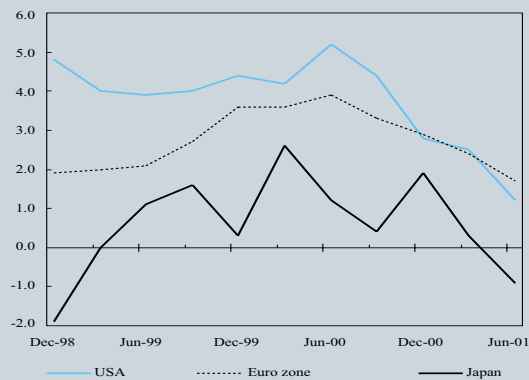
Regarding growth over the third quarter, the economy most probably contracted, as it had been expected to

TABLE 12
ACTUAL AND FORECAST GROWTH (*)
FOR COLOMBIA'S MAIN TRADING PARTNERS

	2000	2001	2002
World	3.8	1.1	3.2
United States	5.0	0.9	0.7
Euro zone	3.5	1.5	1.4
Japan	1.5	(0.7)	(1.4)
Latin America			
Argentina	(0.5)	(1.5)	0.4
Brazil	4.5	1.3	1.0
Chile	5.5	3.3	3.3
Ecuador	1.9	6.0	3.0
Mexico	6.9	0.0	3.1
Peru	3.1	(0.3)	3.0
Venezuela	3.2	2.9	1.6
Colombia	2.8	2.3	3.4

(*) Forecasts made by J.P. Morgan on September 28, 2001.

FIGURE 53
ANNUAL GDP GROWTH:
USA, EURO ZONE, JAPAN



Source: Bloomberg.

do even before September 11. Today, everything seems to indicate that the US economy is in recession. In its report dated September 19, the Fed¹³ stated that in August and early September the 12 economic districts into which it divides the country had reported

¹³ Information taken from the Fed's Beige Book. This Report's data were gathered before September 10, 2001.

declines in manufacturing and weak growth in orders. The index of the National Association of Purchasing Managers,¹⁴ which by the end of September completed 14 consecutive months under 50 points, also suggests that manufacturing continued to decline. Moreover, the Fed drew attention to lower consumption in most parts of the country and an easing of the labor market in all the twelve districts. Lastly, the unemployment rate in the United States continues to rise fast: it was 4.9% at the end of August, 0.4 percentage points higher than in July.

The Fed considers that, though the country's long-term economic outlook did not deteriorate significantly after September 11, uncertainty about the short and medium term did rise sharply and could produce a negative impact on consumer spending. According to the Fed and various international analysts the main risk the US currently faces is a sharp fall in consumption over the short term, which would reduce economic activity in general.

¹⁴ When the NAPM index drops under 50 points, it signifies a contraction in the entire economy.

The Fed's fears of falling consumption have been confirmed by the University of Michigan's consumer-confidence index. As shown by Figure 54, the index went up by 4.7 points in the first week after the terrorist attack, but then plunged by 16.1 points over the fourth week of September. The average for the whole month was 81.8 points, the index's lowest level since November 1993.

As American consumers' savings are largely held in shares, the impact of the terrorist attacks on consumer spending can also be gauged by stockmarket movements in the US. The main stockmarket indices fell steeply for five days running after the reopening on September 17. Though this trend underwent some correction in the following weeks, partly in response to government measures for reviving the economy, the correction was not enough to make up for the initial losses. Today, bad news about economic growth, and expectations about the success of the military campaign in the Middle East continue to curb recovery

of stock-exchange indices. As long as financial markets remain volatile, corporate balance sheets may show further losses, which would affect capital investment and private consumption.

The climate of pessimism notwithstanding, various international analysts expect the current downturn in the US economy to be a short one, and generally foresee signs of recovery appearing by the second half of 2002 or even earlier.

These optimistic expectations are based on the possible implementation of macroeconomic policies for stimulating consumption and private investment. The new policies would include increasing government spending and making tax cuts. And, according to international analysts' preliminary estimates, they could easily cost over \$100 billion. The direct effect of such an injection of capital into the economy could [would be to?] raise real GDP by one percentage point, to say nothing of further increases resulting from multiplier effects.

Fiscal stimuli would probably be coupled with easing of monetary policy, which should become a further source of support to financial markets and economic activity. Satisfactory inflation behavior has given the Fed more room for maneuver. Annual consumer inflation was 2.7% in July, considerably lower than earlier in the year (Figure 55). Falling inflation and lower inflation expectations allowed the Fed to reduce its intervention rate by 25 basis points on August 21.

Before September 11, the financial market and various international analysts expected this interest-rate cut to be the last this year. But on September 17, in the wake of the terrorist attacks in New York and Washington, the central bank cut its intervention rate by 50 basis points, to 3.0%, in an effort to restore investor confidence.

Because the US economy is going through a recession, and inflation presents no danger in the short term to the country's macroeconomic management, several

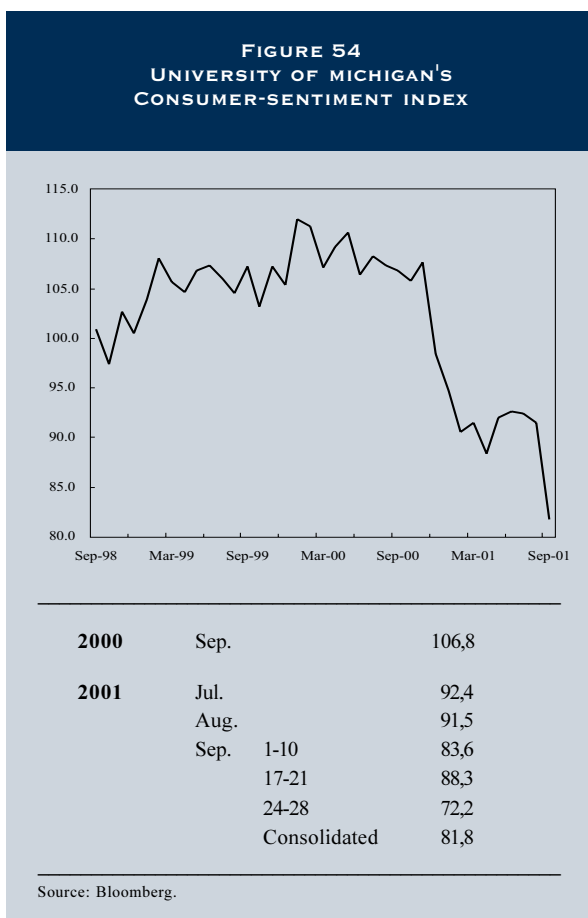
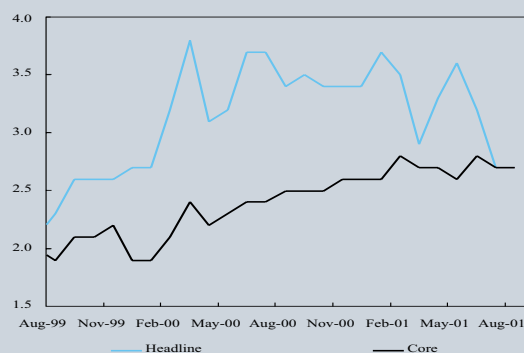


FIGURE 55
UNITED STATES
HEADLINE AND CORE INFLATION RATES



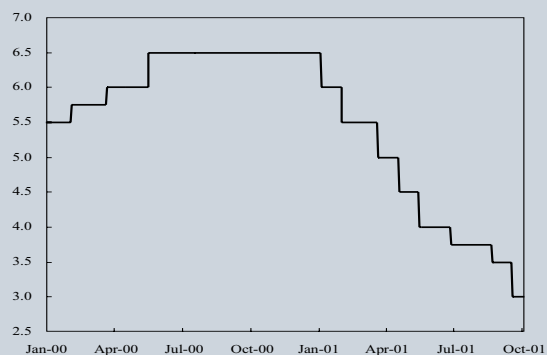
Source: Bloomberg.

international analysts expect the Fed to cut its intervention rate again by 50 basis points in early October (Figure 56),¹⁵ down to 2.5%, the lowest since 1962. Further cuts during the rest for of the year are not ruled out either, should the economic outlook grow worse.

The US economy is therefore expected to contract during the rest of this year and the beginning of next, but to recover in the second half of 2002. It is forecast to grow by an annual rate of 0.9% in the fourth quarter of this year (Table 12).

¹⁵ The Fed did actually reduce the rate by 50 basis points on October 2, 2001.

FIGURE 56
US FEDERAL-FUNDS INTEREST RATE



Source: Bloomberg.

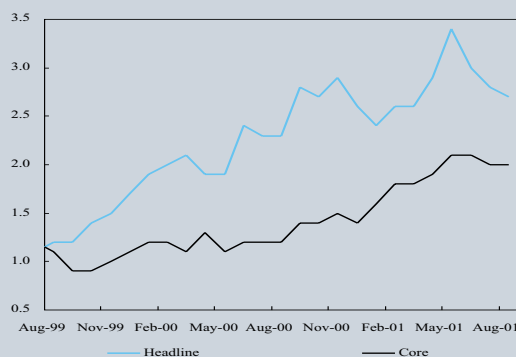
2. Euro area

In the second quarter of 2001, GDP growth for the 12 countries of the euro zone was 1.7%, at annual rate, significantly lower than the 2.4% expansion in the first quarter (Figure 53). Growth was again driven by private consumer spending, which revived strongly in the first half of the year, thanks to tax cuts and lower inflation. Exports slowed sharply in June because of worsening global economic conditions, while imports contracted because of stock reductions and falling investment in the euro zone.

Most indicators point to slow economic growth over the second half of the year in the euro zone. Industrial production contracted by an annual rate of 1.1% in July, its fifth contraction in the first seven months of 2001, which left it roughly 6.0% below its annual variation rate in December. Consumer and investor confidence declined further in August, reflecting negative perceptions of economic conditions, even before the terrorist attacks in the United States. The collapse of European stockmarkets toward the end of September could depress company profits during the rest of the year, producing negative effects on household earnings and investment spending.

Inflation in the euro area has dropped sharply in recent months, after its steep climb over the first five months of the year. Annual consumer inflation was running at 2.8% in July and 2.7% in August (Figure 57). Lower

FIGURE 57
EURO ZONE
HEADLINE AND CORE INFLATION RATES



Source: Bloomberg.

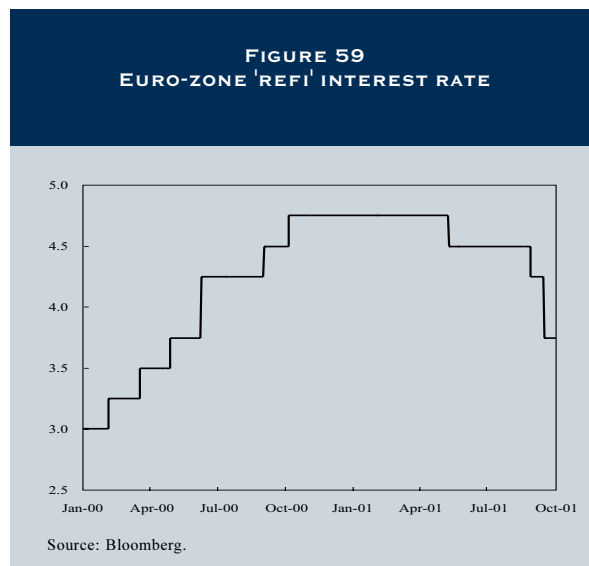
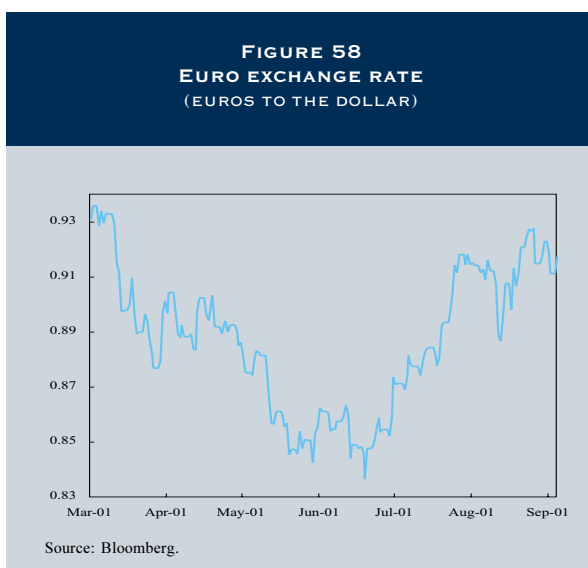
energy prices and less inflationary pressure from demand have been largely responsible for pushing inflation down.

Another factor that may have helped to moderate inflationary pressures is the euro's recent appreciation. Up to the middle of September, the euro had been falling continually against the dollar. But after the events of September 11, investors began to seek refuge in the euro, increasing demand for it and causing it to rise slightly against the dollar (Figure 58).

The euro zone's chances of seeing inflation drop below 2.0% in the medium term are further increased by a trend in wage moderation in recent years, and by lower inflation expectations.

The inflation, exchange-rate and growth results achieved in the euro area led the European Central Bank to reduce its intervention rate by 25 basis points on August 30. A little later, but before September 11, the BCE made several "fine-tuned liquidity-supplying adjustments" in an attempt to stabilize financial markets. On September 17, to revive investor confidence, it reduced its interest rate by 50 basis points, to 3.75% (Figure 59).

Several international analysts see the European monetary authority making further rate cuts in the short term, since inflation trends are not expected to change



and external conditions are likely to grow worse. Besides, it is clear that the tight monetary policy run by the BCE since November 1999 has restrained economic growth in the region. It is therefore possible that the BCE will make new cuts in its intervention rate, and that by the beginning of 2002 this rate will be about 3.0%.

Lastly, although monetary policy has been loosened recently and is expected to be eased further, the euro area's growth in 2001 is now forecast to be slower than predicted three months ago. The new forecast is 1.5%, one percentage point lower than in June.

3. Japan

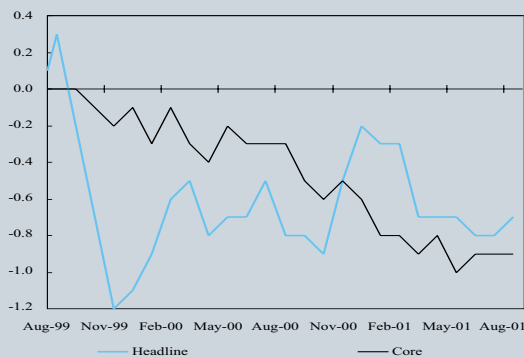
Japan's economic situation has deteriorated to such an extent this year that several international commentators believe it is now in its fourth recession in ten years. GDP shrank by an annual rate of 0.9% in the second quarter, having grown by barely 0.3 in the first (Figure 53). Though household consumption continued to expand in the second quarter, it still did so slowly, reflecting deteriorating earnings, and uncertainty caused by rising unemployment (5% in August, the highest rate since 1960). At the same time, fixed private investment continued to fall, because of worsening economic conditions in the region and the rest of the world. Net real exports shrank, as the world economy cooled and external demand for technology goods declined.

Information available to date mostly shows a worsening of growth trends, suggesting that Japan's economy has not yet touched bottom. Leading indicators such as investor confidence and private credit continued to fall. So did machinery orders and residential construction in July. Industrial output contracted by 11.7% in August, at annual rate. Lastly, most private-consumption indicators showed continued to deteriorate.

Poor growth results led the new government to announce in September future implementation of structural reforms required by different sectors of the economy. This reform package includes, among other things, the writing-off of non-performing loans by the financial system, monitoring the financial system in this process, and introducing plans to motivate job mobility. In the short term, however, these measures could impair economic growth and weaken employment, setting off a strong deflationary spiral. For this reason they are not considered feasible by several analysts.

Both the headline and core rates of consumer inflation continued to be negative and are expected to remain so, at least in the short term (Figure 60). This situation has allowed the Bank of Japan to ease monetary policy and increase liquidity by various measures, including raising its monetary target to over 6 trillion yen and lowering its interest rate from 0.25% to 0.10%.

FIGURE 60
JAPAN
HEADLINE AND CORE INFLATION RATES



Source: Bloomberg.

International analysts do not believe these measures will have any significant impact on the economy, and the government is therefore expected to continue to press the central bank to loosen monetary policy even further.

In view of the above, the outlook for Japan's economic growth is negative into the medium term. The economy is currently expected to contract by about 0.7% in 2001, instead of expanding by 0.9%, the forecast reported in the June Report.

4. Latin America

Prospects for economic growth in Latin American countries deteriorated significantly over the third quarter of 2001. Externally, a faster cooling of the world economy than was expected in the June Report is certain to reduce external demand, harming the region's exports and bringing down the prices of export commodities. Cuts in external interest rates, made recently or forecast to be made, will not make up for the decline in growth, partly because they are unlikely to extend to domestic interest rates. Internally, Brazil's strong downturn and Argentina's financial problems constitute major risks for the region, because of their potential contagion effect.

Over the rest of the year, this set of negative factors could reduce capital inflows, with a consequent weakening of these countries' balances of payments and greater devaluation of their currencies. Interest rates could thus come under greater pressure, making it necessary to tighten fiscal policy, which would in turn curb the pace of growth.

The greatest risk to the region's stability still comes from Argentina's financial situation, as it did three months ago. On September 7 the IMF confirmed a new loan package for Argentina, and Congress has passed a "zero-deficit law" whereby the government undertakes not to spend more than it collects in revenues, but international analysts doubt whether these measures will prove effective. This negative perception is amply reflected by Argentina's foreign-borrowing costs, which soared to unprecedented heights during the third quarter.

Average spread on the country's 10-year sovereign debt was 730 basis points higher in the third quarter than in the second, having reached a record high of 2,124.7 points over US Treasury bonds on August 1 (Figure 61).

The slowdown in economic activity has considerably weakened tax revenues, making it perhaps necessary to cut Argentina's already diminished public spending more drastically if the "zero-deficit" commitment is to be met. This, of course, further reduces growth prospects for the coming months, putting in doubt the stabilization program's consistency. Argentina's economy is currently forecast to contract by an annual rate of 1.5% in 2001, a smaller (larger?) contraction than predicted three months ago.

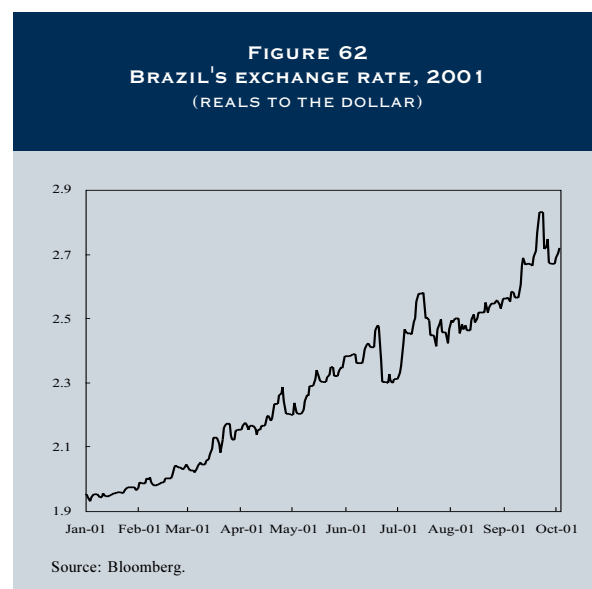
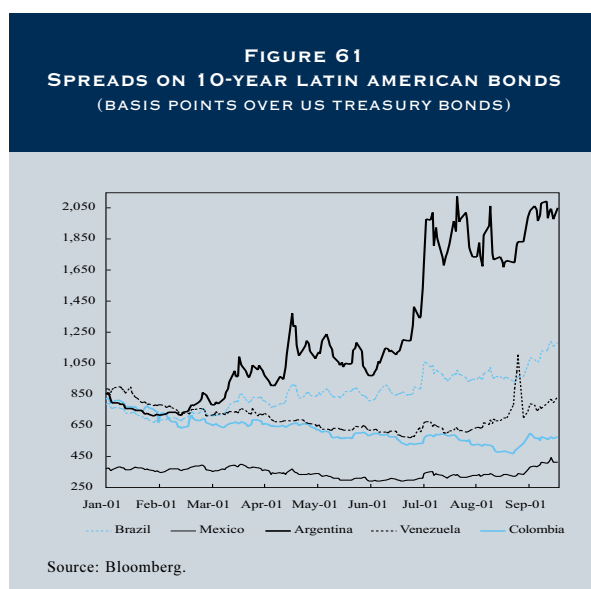
Instability in Argentina has had and will continue to have deep repercussions on Brazil's economy, given the size of their bilateral trade. The most striking effect has been on Brazil's exchange rate and its foreign-borrowing costs (Figure 61). Added to the external situation is the political and energy crisis the country is going through, which has impaired its balance of payments and prospects for economic growth.

The combination of all these shocks has weakened the real to such an extent that by the end of September devaluation was running at an annual rate of 44.7%,

putting strong pressure on interest rates and inflation (Figure 62). Brazil's central bank has, consequently, expressed doubts about being able to meet the inflation target for 2002. A further tightening of monetary and fiscal policy is expected over the short term, and it is bound to have a negative effect on economic growth. Brazil is forecast to show a real annual growth of 1.3% by the end of 2001, a downward revision of the previous quarter's prediction.

Mexico's economy continues to decelerate, judging from higher unemployment, shrinking domestic demand, and a contraction in real credit for the private sector. The downturn in the United States and lower oil prices make this state of affairs more disturbing. Thanks to a tight monetary policy adopted by the Bank of Mexico, inflation is expected to drop low by the end of the year, helping interest rates to keep stable. The government has expressed a commitment to fiscal reform and lower inflation targets for 2002 and 2003, causing growth expectations for 2001 to be lowered. Mexico is expected to register zero growth for this year.

Growth rates have also been revised down for the Andean countries. Although lower interest rates in the United States and the euro area could significantly reduce these countries' external-borrowing costs, the global downturn has decreased their exports and the prices of



their export commodities, putting greater pressure on their exchange and interest rates and weakening their financial and economic conditions.

In Venezuela, the second quarter's real GDP rise of 2.9%, at annual rate, was followed in the third quarter by a sharp economic slowdown (according to the main indicators) and a considerable deterioration of growth prospects. Oil prices fell, and if they keep on falling the country's growth next year will be drastically weakened, for the oil sector accounts for 80% of Venezuela's exports and provides 50% of the government's overall income. Falling oil prices would also affect non-oil tax revenues, because lower incomes in the oil-exporting sector lead to lower domestic demand and hence to a general decline in economic activity.

In recent months, the Venezuelan government has announced restrictions on certain types of imports, new limits on the banks' foreign-currency holdings, a land-reform policy, and an additional tax on income. These measures have caused a surge in capital outflows, with a consequent rise in devaluation (Figure 63). The central bank of Venezuela has raised interest rates to curb capital outflows and devaluation, but has had little success in containing speculative attacks, so that international reserves continue to fall. Besides exchange-rate instability, another significant development has been the announcement of a tax

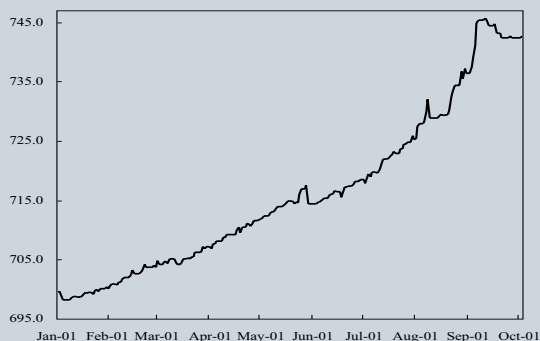
reform designed to bring the fiscal deficit-which threatens to become unmanageable-under control over the next few years.

Naturally, all these factors have further undermined investor and business confidence in the country, reducing its prospects for growth in the medium term. Bearing this in mind, international analysts now expect that Venezuela's real GDP growth will be 2.9% by the end of the year and barely 1.6% in 2002, far below the average growths predicted in the June Report.

Ecuador's economy is expected to continue to recover successfully. The latest figures show a 6.8% annual growth in real GDP over the second quarter, largely resulting from an upturn in domestic demand. The second half of the year may see this pace of growth slowing a little if the government, pressed by the IMF to carry out fiscal and financial reforms, is forced to make new cuts in public spending. And lower oil prices could affect exporters' incomes, leading to smaller expansion in domestic demand and fiscal revenues. In view of the approaching election, however, the government is expected to exercise caution at the time of cutting public spending or increasing taxes.

Ecuador's economy should continue to expand robustly in the short term, thanks to higher private investment, strong public investment-centered on construction of a new pipeline-, recovery in domestic demand, and the successful process of dollarization. Its growth rate is forecast to be around 6.0% by the end of this year but to fall below 3.0% next year, pulled down by deceleration of the global economy.

FIGURE 63
VENEZUELA'S EXCHANGE RATE, 2001
 (BOLIVARS TO THE DOLLAR)



Source: Bloomberg.

B. COMMODITY PRICES

1. 2001 trends and forecasts

The prices of major commodities continued to fall in the third quarter of 2001, extending the downward trend started last year. The Economist's overall commodity

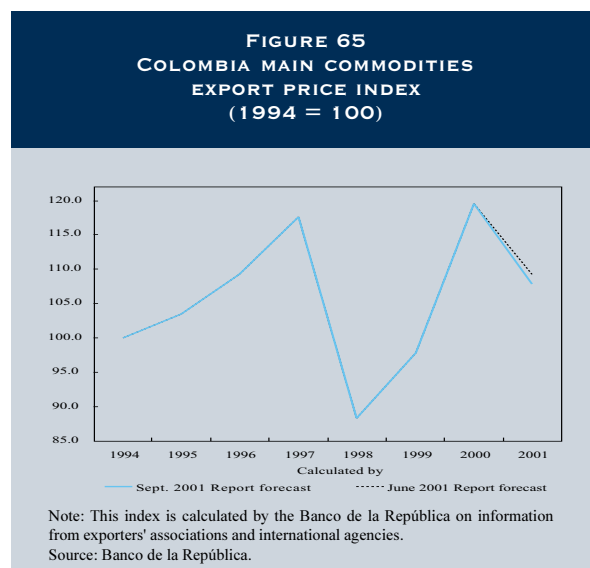
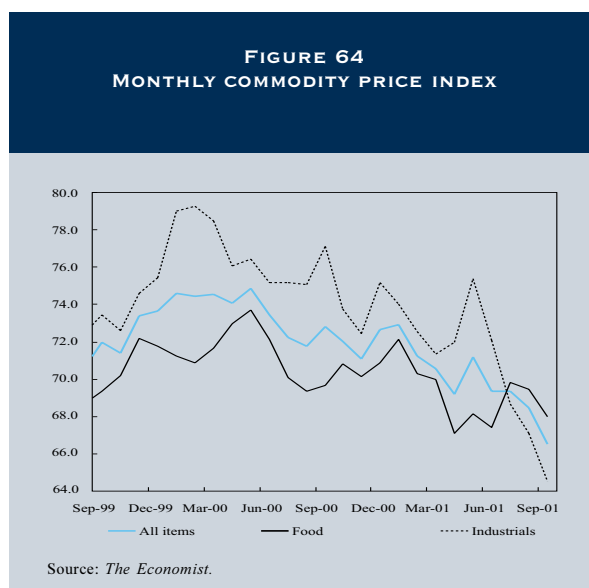
price index fell by 4.1% between June and September, ending the quarter 8.7% lower than in September 2000 (Figure 64).

The third-quarter fall in world commodity prices occurred mostly in industrial goods, which dropped by 10.5%, ending up 16.3% lower than a year earlier. The industrials' drop was in turn caused by a strong decline in metals, attributable to the world economic downturn; metals fell by 10.8% over the quarter and by 23.3% relative to September 2000. And, though the food-price index crept up by 0.8% in the third quarter, in September it was still 2.4% lower than 12 months earlier.

Colombia's commodity export index is built from world prices for the country's main commodity exports: coffee, oil, ferronickel, sugar, coal and bananas.¹⁶ On the basis of actual third-quarter prices, the index's fall in 2001 as a whole is now expected to be steeper than predicted at the end of the second quarter: 9.85% instead of 8.7%, largely because oil, coffee and sugar prices are now expected to be lower (Figure 65).¹⁷

¹⁶ These commodities make up 51% of Colombia's total exports.

¹⁷ Forecasts are based on information furnished by the IMF and exporters' associations.



The reason for downward revision of expected coffee and sugar prices is that world supplies have increased. More sugar is now available on the world market owing to larger exports from Brazil, boosted by the real's devaluation against the dollar. And, with coffee stocks still high in consuming countries, world coffee prices are not expected to recover in the short term.

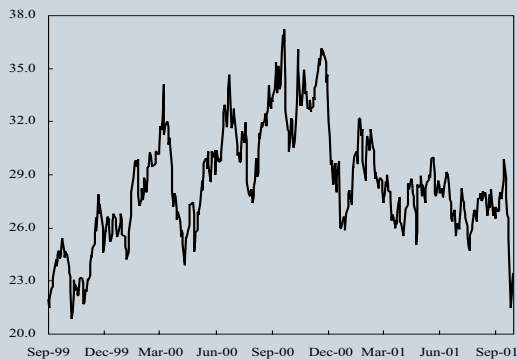
The June forecast for oil prices in 2001 has been lowered because the world economy has slowed more abruptly than was initially expected, and also because OPEC is confidently expected to fulfill its recent commitment to keep the market supplied in the event of conflict in the Middle East.

2. Oil

OPEC's measures for stabilizing crude prices continued to prove successful for much of the third quarter, as evidenced by the fact that prices remained within the range of the Organization's band mechanism.¹⁸ After the terrorist attacks in the United States, however, the price of crude first rose briefly in the week of September 11 then plummeted unexpectedly, so that a week later it had fallen by 27.9%, to \$21.5 a barrel on September 24 (Figure 66).

¹⁸ Under the band mechanism, prices for OPEC's basket of crude oils should remain between \$22 and \$28 a barrel, roughly equal to \$25 - \$30 in terms of the US West Texas Intermediate (WTI) indicator.

FIGURE 66
WTI OIL PRICES
NEW YORK STOCK EXCHANGE
(DOLLARS/BARREL)



Source: Bloomberg.

In the last week of September, the average price was \$22.3, the lowest since the end of 1999. Two factors were responsible for the plunge in crude prices. First, demand for crude oil decreased as the world economy and particularly the US economy lost pace in the wake of the September 11 attacks. The second factor was OPEC's pledge to the United States to keep the market supplied, should conflict reduce the world supply of oil. This pledge was ratified at OPEC's meeting on September 28, when the members states decided to hold daily production at 23.2 million barrels, the level fixed on September 1.¹⁹

Crude-price movements over the rest of the year will depend partly on OPEC's decisions about daily production quotas, and partly on how the United States' anti-terrorist actions in the Middle East turn out. OPEC may decide to reduce daily crude production before its next meeting scheduled for November 14, if the market fails to stabilize oil prices and they continue to fall. OPEC is now in a difficult position, for it has to decide between keeping its pledge to the United States and defending its band mechanism established in March 2000.

Analysts think crude prices are unlikely to rise in the fourth quarter to levels reached in January and

¹⁹ On August 25, OPEC decided to reduce crude production for the third time this year, this time by a million barrels a day, effective from September 1.

FIGURE 67
WTI OIL FORWARD SALES PRICES
NEW YORK STOCK EXCHANGE



Source: Bloomberg.

February (\$28). Their view is supported by price changes in forward sales contracts on the New York Stock Exchange, which have kept in line with the third quarter's oil-price movements, reflecting their fall in the last week of September (Figure 67). Thus, on September 24, the prices of one-, six- and twelve-month forward contracts were \$22.0, \$22.7 and \$21.9 respectively, far below the prices registered a week earlier, after the September 11 attacks: \$28.8, \$27.8 and \$25.6). The six- and twelve-month contracts also suggest that the market expects oil prices to be lower over the short term than they have been for much of this year.

Today, with uncertainty undoubtedly higher than usual, it is difficult to predict crude-price behavior with any degree of confidence, even for the rest of this year. If market conditions remain as they are, crude prices in the fourth quarter should be lower than in the third, averaging about \$22 to \$23 a barrel. The average for the year would then be \$26, slightly lower than predicted in the June Report.

3. Coffee

Despite the Coffee Retention Plan²⁰ put into operation in June last year by the Association of Coffee

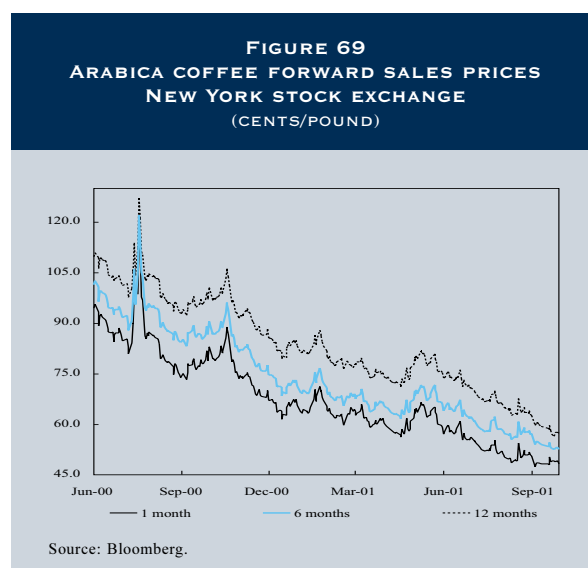
²⁰ Under the Retention Plan, coffee exports were to be reduced by 20% if the price dropped below 95 cents a pound.

Producing Countries,²¹ world coffee prices have failed to pick up and continued their downward trend over the third quarter. Between July and September, the price of Colombian coffee averaged 71,0 cents a pound, 9% lower than in the second quarter (Figure 68). This behavior was mirrored by forward sales prices, which fell steeply, from 56.1, 62.3 and 70.6 cents a pound respectively for one-, six- and 12-month contracts at the end of June, to

48.3, 52.6 and 57.0 cents a pound at the end of September (Figure 69).

International coffee prices have been falling since January 2000 largely because of oversupply in the world market. The Retention Plan was suspended from October 1 of this year for having failed to produce the desired effect on world supply. In view of this and given current market conditions, prices are unlikely to improve either this year or next. They are expected to average 71 cents a pound in the fourth quarter, giving an average of about 74 cents for 2001 as a whole.

²¹ The ratified members of the Association of Coffee Producing Countries are Brazil, Colombia, Costa Rica, El Salvador, India, Indonesia, Venezuela, Angola, Ivory Coast, Kenya, Tanzania, Togo, Uganda and the Democratic Republic of Congo.



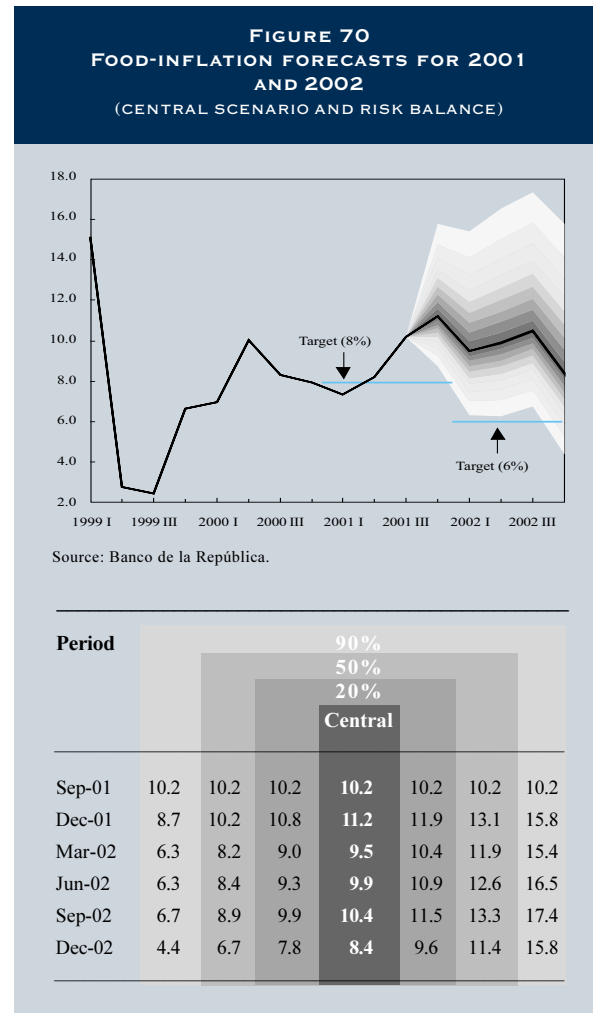
IV

INFLATION FORECASTS

On price figures to the end of the third quarter, inflation appears quite likely to run close to this year's 8% target by the end December. For next year, no inflationary pressures from demand are expected to impede meeting the target of 6%. But there is still great uncertainty from two main sources: (1) food supply; and (2) developments in the external sector, with their impact on costs and devaluation.

Forecasting for this Report assumes that the climatic condition known as El Niño is highly likely to occur in December and last through much of next year. Based on information from environmental agencies, the likelihood is considerably stronger now than in the June Report. El Niño's occurrence could reduce rainfall to below normal levels, thereby decreasing food supply and raising food prices above levels prevailing under normal weather conditions. Current uncertainty also extends to El Niño's possible intensity. A strong El Niño tends to reduce farm supply more steeply and raise food prices more sharply than a moderate one. For the purposes of this Report, El Niño was assumed to be as likely to occur strongly as moderately.

The impact of climatic conditions on inflation was captured through a satellite model of food prices. Figure 70 presents food-inflation forecasts for the rest of this year and for 2002. The central path shows food inflation averaging 11.2% in the fourth quarter of this year and 8.4% in the fourth quarter of 2002. Annual food inflation is forecast to rise over the first three quarters of next year, from the effects of El Niño. But it is expected to drop back in the fourth quarter, in response to a boost in supply that should result from



high prices at the end of this year and start of next, as has happened on previous occasions.

Besides the two factors indicated above, the cattle-retention stage is another factor that will be affecting food prices next year, as it has this year. As explained in detail in the June Report, the current cattle-retention phase, which began at the start of this year, is expected to extend over 2002, for it usually lasts

about two years. It will then cause further reductions in beef supply in 2002 and hence raise the prices of beef and meat substitutes, strongly affecting overall inflation, given the heavy weight these items have in the CPI basket of goods.

Exchange-rate assumptions for this Report's forecasting are similar to those for the June Report. That is to say, for the rest of this year and during next year the real exchange rate is assumed to remain close to its actual level at the time of forecasting. But this scenario could underestimate devaluation, given recent external developments, particularly a stronger world economic downturn than was expected a few months ago, and the growing possibility of financial crises in some emerging markets.

The global downturn may benefit exchange-rate stability, if it comes with a lowering of international interest rates that discourages capital outflows. But this benefit could be heavily outweighed by a slowdown in exports, a worsening of the terms of trade, and harder access to capital markets. This Report already expects a 9.8% average drop in Colombia's main commodity exports this year, a bigger drop than was predicted in the June Report (see Chapter III). Add to the foregoing the financial difficulties currently faced by some countries of the region, and the public sector's greater need of external funds for 2002. All these factors could cause a further increase in devaluation, whose impact on inflation is not taken into account in this Report's central forecast.

But, at the same time, a downturn in the world economy and particularly in the countries important to Colombian trade—the United States, Venezuela and Ecuador (Chapter III)—will tend to decrease aggregate demand in Colombia, thereby reducing inflationary pressures next year. Part of this effect has been captured in this Report's inflation forecasting by the assumption that the US economy's growth next year will be near zero, a lower rate than envisaged in previous forecastings.

Overall inflation is forecast to average 5.5% in the fourth quarter of 2002; this central forecast is compatible with the 6% target for 2002 but slightly higher than the 5.3% predicted in the June Report (Figure 71). This year's fourth-quarter forecast (8.0%) is also higher than the rate predicted in June (7.5%) but still compatible with the 8.0% target for 2001.

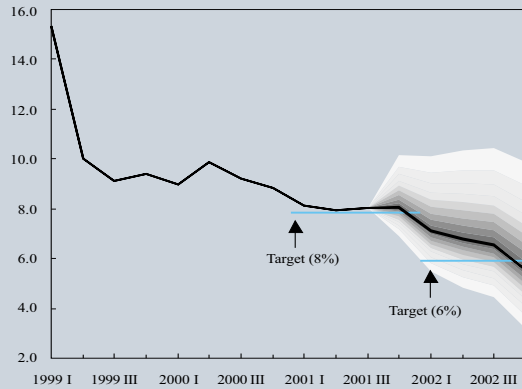
The slight increases in this year's and next year's inflation forecasts stem from a higher-than-expected rise in food prices up to September 2001 and from higher food-price projections for the rest of this year and for 2002. For example, the June forecast for annual average food inflation in the third quarter was 8.6%, whereas the actual rate turned out to be 10.2%.

As in the June Report, the central path of inflation forecasts in this Report comes with an upward-biased risk balance (Figure 71). This upward bias reflects current uncertainty about food-price movements and devaluation. The bias indicates a 50% probability for fourth-quarter inflation in 2002 to range between 4.6% and 7.3%.

Although this time the forecasts for overall inflation and food inflation are not lower than three months earlier, the predictions for core inflation, measured as non-food inflation, are once again lower than before. The central path projected for non-food inflation suggests that it may average 6.8% in this year's fourth quarter and 4.4% in next year's (Figure 72), down from 7.2% and 5.6% respectively predicted in the June Report. Lower core inflation this year and next is consistent with lower-than-expected economic growth over the first half of 2001, and with lower growth predicted for the next few quarters because of the global downturn. In these circumstances, inflationary pressures from demand are unlikely to be a problem next year.

Lastly, recent levels of inflation expectations hold out hopes of lower inflation next year. The Banco de la República's expectations survey conducted in July

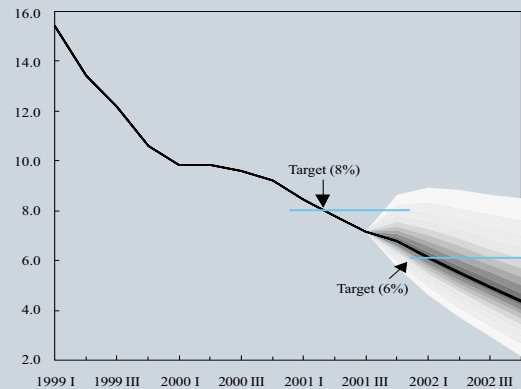
FIGURE 71
CONSUMER-INFLATION FORECASTS FOR 2001
AND 2002
 (CENTRAL SCENARIO AND RISK BALANCE)



Source: Banco de la República.

Period	Risk Balance						
	90%	50%	20%	Central	20%	50%	90%
Sep-01	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Dec-01	6.9	7.6	7.9	8.0	8.4	8.9	10.2
Mar-02	5.5	6.4	6.8	7.1	7.6	8.4	10.1
Jun-02	4.8	6.0	6.5	6.8	7.3	8.3	10.3
Sep-02	4.4	5.7	6.2	6.5	7.1	8.1	10.4
Dec-02	3.2	4.6	5.2	5.5	6.2	7.3	9.9

FIGURE 72
FORECASTS OF NON-FOOD INFLATION FOR 2001
AND 2002
 (CENTRAL SCENARIO AND RISK BALANCE)



Source: Banco de la República.

Period	Risk Balance						
	90%	50%	20%	Central	20%	50%	90%
Sep-01	7.1	7.1	7.1	7.1	7.1	7.1	7.1
Dec-01	5.7	6.3	6.6	6.8	7.1	7.5	8.6
Mar-02	4.6	5.5	5.9	6.1	6.6	7.3	8.9
Jun-02	3.7	4.8	5.2	5.5	6.0	6.9	8.8
Sep-02	2.9	4.1	4.6	4.9	5.5	6.5	8.6
Dec-02	2.2	3.5	4.0	4.4	5.0	6.1	8.5

shows respondents once more lowering their inflation expectations for all time horizons. They have, for example, revised down the expected rate of inflation for December, from 8.5% reported in the April survey to 8.4%, and the expected rate for next March from 8.2% to 7.7%. And they see inflation running at 7.9% by next June (Figure 73).

The July survey's findings of inflation expectations are encouraging in that they show the expected rate for next year dropping below 8.0% for the first time. Although inflation expectations for the first half of 2002 are high with respect to the 6% target, it should be noted that respondents always tend to overestimate future inflation, for all time horizons, as can be appreciated from Figures 74 and 75

FIGURE 73
ACTUAL INFLATION AND

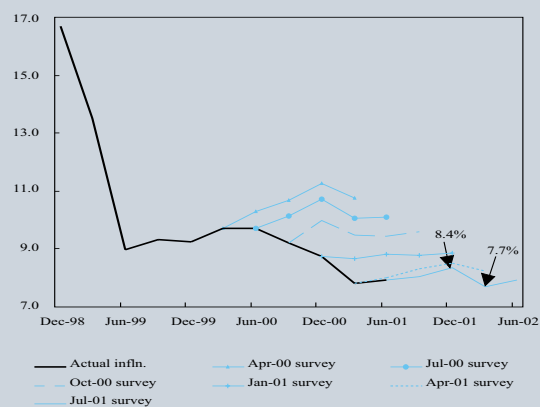


FIGURE 74
ACTUAL INFLATION AND
INFLATION EXPECTED IN 6 MONTHS' TIME

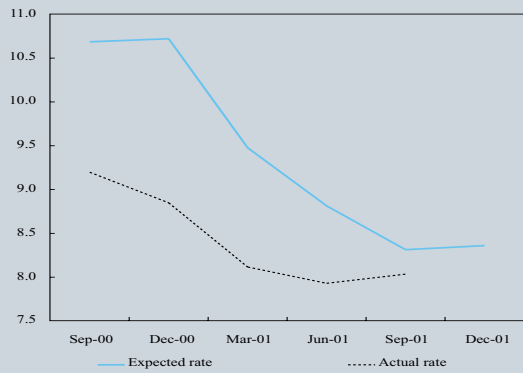
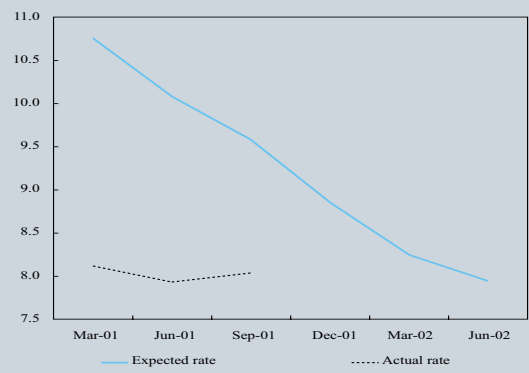


FIGURE 75
ACTUAL INFLATION AND
INFLATION EXPECTED IN 12 MONTHS' TIME



Lower inflation expectations are vital to securing a significant reduction in inflation next year; given the important part indexation mechanisms traditionally play in the Colombian economy. It is disturbing in this

respect that most pay rises for the next two years, negotiated through collective bargaining, continue to be automatically linked to past inflation, which is sometimes raised by several points (see Chapter II).

LOCAL AND FOREIGN ANALYSTS' FORECASTS FOR MAIN MACROECONOMIC VARIABLES

The latest forecasts by local and foreign analysts for Colombia's main macroeconomic variables in 2001 and 2002 are reviewed below. It is important to point out that when this Report was being prepared several of the analysts had not yet taken into account the effects of external events on variables such as growth.

Forecasts for 2001

Table 1 shows in detail the forecasts made for this year. The major change relative to forecasts made in June is, in general, the downward revision of expected growth for 2001 as a whole. Local analysts now expect a 1.8% growth rate, 0.7 percentage points lower than in June, while foreign analysts predict a 2.3% growth, 0.6 percentage points lower than in June. The foreign analysts' more optimistic rate may be explained by the fact that some of their forecasts were made before the terrorist attacks in the United States.

If the latest forecasts for growth are less optimistic than in June, those for inflation are in contrast more optimistic than before. Both local and foreign analysts have sharply reduced their inflation forecasts for this year, the former now expecting a rate of 8.2% (down from 9.2% predicted in June) and the latter a rate of 8.4% (down from 9.0%), both quite close to the Banco de la República's 8% target.

Forecasts for the nominal exchange rate have also been revised down. Today, local analysts expect the dollar to fetch 2,400 pesos by the end of the year (down from 2,432 pesos predicted three months ago), while foreign analysts forecast a rate of 2,415 pesos (down from 2,435 pesos). The corresponding devaluation rates for 2001 would be 7.7% and 8.3% respectively.

As regards interest rates, local analysts have substantially decreased their forecasts for deposit rate, in line with its actual fall over the third quarter. They now predict a DTF rate of 12.0% by the end of the year.

Lastly, forecast for the fiscal deficit in 2001 has been left unchanged at 3.1% to 3.2. This, it should be noted, is close to the deficit level to be agreed on eventually with the IMF.

Forecasts for 2002

Table 2 presents the main forecasts for 2002. Comparison with predictions for 2001 reveals that the analysts in general are more optimistic about growth and inflation in 2002. Both groups expect growth to accelerate by one percentage point, the foreigners once more predicting a faster rate. All analysts also foresee inflation running below 8% next year, but their forecasts are still far from the Banco de la República's 6% target. It is to be noted, however, that in the past two years most analysts' predictions have usually proved to be substantially higher than actual inflation.

TABLE 1
FORECASTS FOR MAIN MACROECONOMIC VARIABLES IN 2001

	Forecast date	Real GDP growth %	CPI Inflation %	Nominal exchange rate (yearend)	Nominal DTF deposit rate %	Deficit (% of GDP): Fiscal, Curr. acct.		Unemployment %	
Local analysts									
	Revista Dinero 1/	14-Sep-01	1.8	8.2	2,420	13.0 2/	2.8 3/	1.9	19.0 2/
	Javier Fernández Riva 4/	3-Oct-01	1.7	8.1	2,445	12.2	3.1	n.d.	17.0
	Suvalor-Corfinsura 5/	3-Oct-01	1.9	8.1	2,430	12.2	3.2	n.d.	n.d.
	ANIF 6/	2-Oct-01	1.6	8.2	2,385	12.2	n.d.	2.9	18.5
	Fedesarrollo 7/	Jul-01	1.8	8.2	2,322	14.2 2/	3.3	2.7	17.6
	Average		1.8	8.2	2,400		2.5		
Foreign analysts									
	Goldman Sachs 8/	27-Sep-01	1.8	8.0	2,379		3.3	2.7	n.d.
	IDEA global 8/	20-Ago-01	2.4	8.0	2,410		2.7	2.9	n.d.
	J. P. Morgan 8/	6-Sep-01	2.3	8.0	n.d.		3.1	0.8	n.d.
	ABN Amro Bank 8/	19-Sep-01	2.0	8.0	2,404		4.5	0.7	n.d.
	Salomón Smith Barney 8/	28-Sep-01	1.6	8.1	2,441		3.2	2.9	n.d.
	Deutsche Bank 8/	20-Sep-01	2.3	8.2	2,445		3.3	3.3	n.d.
	Morgan Stanley 8/	22-Jun-01	3.0	9.5	2,415		2.8	0.7	n.d.
	Merrill Lynch 8/	3-Sep-01	3.0	9.0	2,410		2.8	1.5	n.d.
	Average		2.3	8.4	2,415		3.2	1.9	n.d.

TABLE 2
FORECASTS FOR MAIN MACROECONOMIC VARIABLES IN 2002

	Forecast date	Real GDP growth %	CPI Inflation %	Nominal exchange rate (yearend)	Nominal DTF deposit rate %	Deficit (% of GDP): Fiscal, Curr. acct.		Unemployment %	
Local analysts									
	Revista Dinero 1/	14-Sep-01	2.3	7.0	2,700	15.0 2/	2.2 3/	3.0	20.0 2/
	Javier Fernández Riva 4/	3-Oct-01	3.0	8.0	2,730	13.0	2.5	n.d.	16.0
	Suvalor-Corfinsura 5/	3-Oct-01	2.9	7.6	2,640	12.2	2.2	3.2	n.d.
	ANIF 6/	2-Oct-01	2.7	7.0	2,576	12.0	n.d.	3.0	17.5
	Fedesarrollo 7/	Jul-01	3.0	8.1	2,538	15.3 2/	3.4	3.7	16.7
	Average		2.8	7.5	2,637		3.2		
Foreign analysts									
	Goldman Sachs 8/	27-Sep-01	2.5	7.0	2,495		3.1	3.2	n.d.
	IDEA global 8/	20-Ago-01	3.7	6.0	2,602		1.6	2.7	n.d.
	J. P. Morgan 8/	6-Sep-01	3.4	6.5	n.d.		2.2	1.3	n.d.
	ABN Amro Bank 8/	19-Sep-01	3.0	9.0	2,547		4.0	1.2	n.d.
	Salomón Smith Barney 8/	28-Sep-01	2.3	8.5	2,729		2.5	3.3	n.d.
	Deutsche Bank 8/	20-Sep-01	3.5	8.0	2,520		2.8	3.8	n.d.
	Morgan Stanley 8/	22-Jun-01	3.5	9.0	2,559		2.5	2.3	n.d.
	Merrill Lynch 8/	3-Sep-01	3.7	8.0	2,550		2.3	2.1	n.d.
	Average		3.2	7.8	2,572		2.6	2.5	n.d.

n.a. Not available.

1/ Dinero magazine, September 14, 2001, No. 141.

2/ Average for the year.

3/ IMF methodology.

4/ Javier Fernández Riva y Asociados, October 3, 2001.

5/ "Suvalor-Corfinsuar," October 3, 2001.

6/ ANIF, "Guía empresarial," October 2001.

7/ "Perspectivas económicas de corto y mediano plazo," July 2001.

8/ "Cómo nos ven afuera?" Report by the Banco de la República's Monetary and Reserve Division (SMR), September 28, 2001.

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