Inflation Report
June 2002

Banco de la República

(The Central Bank)

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Presentation, Summary and Conclusions

Evaluation of the inflationary situation at june, 2002

✠ Inflation, at the close of the second quarter of 2002 was 6.2%, a higher level by 0.3 percentage points than the one recorded in March, 2002, and lower by 1.7 percentage points than June of last year. Inflation dropped in the first four months of the year, turning upward again in May and June.

✠ This higher annual inflation registered in the last two months is associated with greater growth in food prices, which went from a growth rate of 7.2% in March to 9.2% in June. This upswing in inflation for foodstuffs is a reflection of higher prices for potato, the supply of which was affected this year by less planting in the last semester of last year. For the remainder of the year, it is expected that supply of this product will continue to be limited and this could cause additional increases in its price.

✠ In addition to the foregoing, it is probable that in the second semester, the food group will register growing inflation, and the Niño phenomenon will make its appearance, possibly continuing until the beginning of next year. Last, the phase of cattle retention, although less intense than the situation experienced last year, will exert additional pressure through the price of beef and its substitutes.

✠ Furthermore, the acceleration of annual inflation is associated with the acceleration of devaluation in the exchange rate observed since last April. Devaluation was almost immediately transmitted to the IPP for imports, the annual increases for which began to rise in May. Nevertheless, the transmission from devaluation to inflation for the consumer has been less obvious, although it did generate greater annual inflation in the IPC for clearly tradable groups, like medicines and miscellaneous expenses in recent months.

✠ All the basic inflation indicators were at lower levels than the observed inflation and target inflation at the end of the first semester of 2002. With respect to the first quarter of the year, the average of basic inflation indicators descended 0.3 percentage points, dropping from 5.6% in March to 5.3% in June. This average stabilized at 5.3% in May and June. The basic inflation indicator that registered the greatest fall over the last three months was the IPC without food and the IPC without primary food, public utilities and fuel, which descended about 0.3 percentage points. On the other hand, the inflationary nucleus dropped 0.1 percentage points with respect to the level shown the previous March.

✠ Inflation for tradable goods rose from a growth rate of 5.8% in March to 6.0% in June. Likewise, some prices of non-tradable goods exhibited accelerated growth, rising from 6.0% in March to 6.4% in June. This upswing in the non-tradables is due entirely to the higher adjustment in annual IPC in June in the subgroup of flexibles (14.8%) as compared to last March (-1.8%) Potato is the category that substantially explains the upswing in prices for flexible goods.

✠ Producer inflation closed the second quarter at 2.9%, a level that is 0.7 percentage points lower than that observed in March (3.6%). This fall is the consequence of less growth in the prices of produced and consumed goods, which went from 4.4% in March to 3.4% in June, according to classification by origin, and the smaller increase in agricultural and industrial prices, according to the CIIU classification. In May inflation of producers reached a historically low level (2.3%), although in June it increased 2.9% when the increase in the dollar price over the previous two months began to be transferred. It is for this same reason that the IPP for imports grew 1.6%, that is, 0.8 percentage points above the level reached in March (0.8%).

✠ Central Bank inflation forecasts, made with price information for June, suggest that the current inflation tendency will continue to be compatible with the 6% target for this year and with an additional reduction in inflation for 2003, in accordance with the 5% operative target set for that year. The central path of the short term forecast for the average of the fourth quarter predicts total inflation at 5.8% and a total inflation figure of 4.7% without food. On the other hand, the combination of forecasts obtained from the various uniequational models used by the Bank estimates total inflation for December, 2002 at 5.0%.

✠ The growth figure for the first quarter reported by the DANE was below government expectations, even after controlling for the Easter Week effect. Deceleration in growth at the beginning of the year is the reflection of weakness seen in the majority of the investment components, with the notable exception of investment in buildings, which shows significant growth, thanks to recovery of the housing sector. On the foreign scene, a contraction in oil exports and non-traditional exports toward the U.S. was observed, along with a loss of dynamism in exports to Venezuela. Finally, household consumption was the most dynamic element of demand, just as had been anticipated in the previous report.

✠ For the second quarter, some acceleration in growth is expected, in part due to the Easter Week effect, which should act contrary to that of the first quarter. Recent performance by several indicators for the real sector confirm this tendency. Industrial production in April registered an important comeback, partially compensating for contraction observed in March. Other indicators, such as power consumption, automobile sales and housing construction indicators continued to show acceptable performance.

✠ In spite of the foregoing, the economy is expected to continue to confront obstacles in the foreign sector. The Venezuelan recession should be highlighted, as well as augmented nervousness about capital markets in Latin America, as a result of confidence problems that have arisen in several of the region’s economies. These circumstances will probably affect foreign demand to a greater degree than that foreseen early in the year, putting a brake on possibilities for expansion in several exporting sectors, mainly the industrial sector, and reducing the availability of foreign resources to finance expenditure. For the remainder of the year, it is estimated that the main source of growth will continue to be private domestic demand, and particularly household consumption. Recent improvement in the confidence indicator for consumers is an indication in this direction.

- Presently, the economy continues to operate below its potential capacity, as shown by the still high rate of unemployment and low level recorded for utilization of installed capacity in industry. Estimates on the product gap (difference between observed GDP and potential GDP) made by the Office of the Deputy Manager of Economic Studies (SGEE) suggest that for the first quarter of the year this gap was about -3.0% of potential GDP and that during the year it will remain on the negative side. In view of this, there are no expectations for inflationary pressure originating in demand for the rest of the year that could put fulfillment of the inflation goal in danger.

- Stabilization of inflation around 6% during the second quarter, as well as an acceptable probability of fulfilling the 6% target for this year and to continue reducing inflation for the year 2003 enabled the Board of Directors to relax its monetary policy position. Thus, in April, May and June, the Board reduced intervention rates by 200 basic points (pb). In this way, during the first six months of the year, reductions in intervention rates accumulated a total of 300 pb for the Lombard contraction rate and 325 pb for the other rates.

- Moreover, in the last three months, the Board granted permanent liquidity through a final purchase of TES in the amount of $240 billion and use of options for accumulation of reserves for US$100 million ($226b).

- This broad margin of liquidity granted by the Bank and reduction in intervention rates allowed for additional decreases in the various market interest rates. Thus, the interbank rate, on the average, was 5.4% in June, 220 pb lower than in March. Likewise, the DTF dropped during the second quarter by 220 pb, settling in June at 8.4%. Finally, active rates also showed decreases, the most pronounced of these being credit cards and consumption cards (by 386 and 309 pb respectively).

- During the second quarter of this year, the monetary base tended to situate itself above the reference line followed by the Board of Directors. This distance was greater in the month of June, when the base was at 2.3% and 1.3% above the mobile average by 20 and the reference line by 40 respectively, pulled up by greater cash and reserve demand, with respect to predictions. As for the broader liquidity aggregate (M3), its annual growth in June was 9.1%, accelerating with respect to that observed three months ago (7.3%). In general terms, during the last three months, the tendencies observed since the beginning of the year toward a recomposition of the public portfolio in favor of liquid assets, such as cash, current accounts and savings accounts have been maintained, to the detriment of Time Certificates.

✠ The total portfolio for the financial system (in domestic currency), which showed a slight recovery toward the end of last year and beginning of this year, decelerated again as of March and by the end of the second quarter, it was virtually at a standstill. Deceleration of this indicator can be explained, among other reasons, by the accounting effect of transfer of title of a part of the mortgage portfolio in early May and portfolio write-offs. Nevertheless, it is also due to continued scarce demand for credit by investors and consumers.

✠ After three quarters of relative stability in the exchange rate, the peso regained its devaluation tendency as of April, becoming more accentuated toward the end of the quarter, coinciding with news about anxiety in international markets with respect to the stability of various economies in the region. By the end of June, annual devaluation had risen to 4.3%, while devaluation to date was at 4.7%. In addition to deterioration in foreign conditions, including a lower growth rate than expected for the American economy, acceleration in devaluation was also propitiated by the exchange of internal debt for foreign debt carried out by the government in May.

✠ In general terms, inflation for the consumer has remained within the parameters foreseen by the Central Bank in its previous reports. In particular, basic inflation, an indicator that includes the effects of monetary policy, has continued to decrease slowly, and in June it was at a point below the inflation target. Likewise, the main projection of the transmission mechanisms model (MMT) and other models, does not contemplate important changes in this tendency in the coming months. This would allow for a certain security margin in order to fulfill the inflation target for 2003, a lower target than the one for this year.

✠ So far this year, inflationary pressures have mainly originated in food inflation, and to a lesser degree in the prices of some tradable goods, such as medicine. For the rest of the year, it is expected that food prices will continue to exert rising pressure that could last until early next year, especially due to the presence of a moderate Niño phenomenon, the appearance of which in the second semester is practically confirmed. In any case, the upward shift in food prices will be temporary, and a drop, during the second semester of next year at the latest, could contribute significantly in order to reduce total inflation.

✠ Although the main inflation prediction has not been substantially modified, the risks balance has changed over the last few months, especially as a result of worsening external conditions. The Argentine crisis and the substantial increase in the perception of risk in Brazil, increase the possibilities of a confidence crisis in the region's economies through a contagion effect (in spite of the fact that no significant spread has been recorded in foreign debt). The Colombian economy could be vulnerable to this situation, given the accumulated magnitude of foreign public debt, concentration of amortization and interest during the next two years and the still substantial fiscal deficit.

- An eventual increase in the perception of risk in Colombia would substantially increase devaluation expectations for the remainder of 2002 and for 2003. Even though in the short run, the effect on prices of greater devaluation will be less since it would encounter a situation of weak demand, in the long run this would not necessarily be the case. According to forecasts presented in this report, if there were substantial devaluation in 2002 and 2003, it would be more difficult for inflation to remain within the announced range of 4% to 6% for the 2003 goal.

- Aside from increased devaluation, other risk factors have recently arisen that could complicate the reduction in inflation toward next year. One of these is related to recent announcements of increases in several of the public utilities rates for 2003. Without yet having precise figures on the magnitude of these increases, the difficult financial situation that several of the sector's companies are experiencing makes it possible that rates much higher than the inflation target could be authorized. Another risk factor is related to a probable expansion of the taxable base for IVA (added-value tax) starting next year, in order to strengthen the national treasury. As seen on prior occasions, this measure will have repercussions on the prices of articles taxed, initially producing a temporary increase in inflation that could have a permanent effect in the future if it brings about a change in expectations.

- 2002. Likewise, they suggest that inflation for 2003 could remain in the range between 4% and 6%, compatible with announcements made by the Board regarding the target for 2003. The slight rise in inflation over the last two months is related to higher food prices and not to an increase in basic inflation, which continues to be below the 6% target, according to the various indicators used by the Bank. At the same time, several indicators of real activity suggest an acceleration in economic growth compared to the first quarter, in part, as a result of improved performance by internal demand. However, this favorable tendency is being counteracted by a fall in foreign demand, due to the recession in Venezuela and difficulties some exports to the U.S. market are facing. For this reason, the economy will continue to function below potential for the rest of this year. Based on the foregoing considerations, the Board of Directors of the Central Bank decided to keep its actual level of intervention rates. Therefore, intervention interest rates in force are: Lombard expansion 9.0%, auction expansion 5.25%, auction contraction 4.25% and Lombard contraction 3.25%.

Board of Directors of the Central Bank

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June 2002

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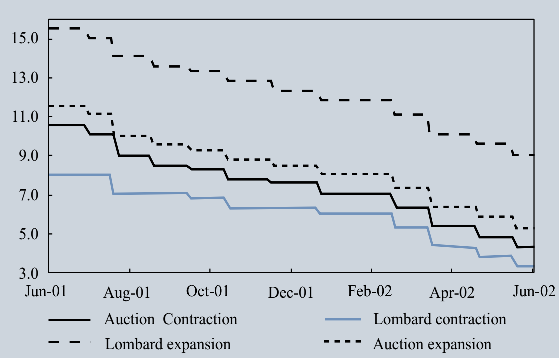
Determinants of Inflation

A. Monetary and credit aggregates

1. Monetary Policy Guidelines

Both the observed and expected behavior of inflation, economic activity and the international setting allowed the Board of Directors of the Central Bank to maintain a loose monetary policy during the second quarter of the year. The Board believes that this position does not compromise fulfillment of the 6% inflation goal set for this year, but will on the other hand, facilitate possible greater economic growth. In the months of April, May and June the BDBR reduced the Bank's intervention interest rates by 100, 50 and 50 basic points (pb) respectively, for an accumulation over the course of the year of a 325 pb reduction (Figure 1). In June, the intervention interest rates in force were: 9.0% expansion Lombard, 5.25% auction expansion, 4.25% auction contraction and 3.25% Lombard contraction.

Figure 1
Central bank
Intervention rates
(Percentage)



Source: Central Bank

In addition to the reduction in intervention rates, the Central Bank granted permanent liquidity in an amount of approximately $466.0 trillion through the purchase of international reserves and final purchase of TES. With respect to the first mechanism, during the second quarter, the BDBR set a limit for auction of options for the accumulation of international reserves of US$100 million (m) monthly. This limit was totally used in the month of April, with which the economy was given permanent liquidity in the amount of $226.6 trillion (mm) (Table 1). In May and June, however, no exchange sale options were carried out, reflecting the recent increase in the rhythm of nominal devaluation. With respect to the second mechanism, on April 26, the BDBR decided to step up the final purchase of some of the TES securities in the secondary market, carrying out purchases for a total of $240 mm between April 29th and June 28th (Table 2).

Taking into account the implicit demand for monetary base at the reference line and the permanent evaluation of monetary base supply conditions, the amounts of expansion and contraction Repos were set one day before the second quarter. In general, in this period the average amount of expansion Repos ($765.7mm) was underutilized, with demand for only 56.5%. The same situation occurred with the contraction Repos, of which 59.8% were used (Table 3).

Table 1
Use of Put options
net purchase of international reserves

Date	Number auctioned	Amount used	TRM	Amount used
	Millions of dollars			in $mm
Jan-02		27.5	2.291.2	63.0
Jan-15		22.5	2.297.3	51.7
Total january	50.0	50.0		114.7
Feb-05		1.5	2.266.6	3.4
Total february	50.0	1.5		3.4
Mar-08		50.0	2.289.8	114.5
Total march	50.0	50.0		114.5
Total 1st quarter	150.0	101.5		232.6
Apr-02		68.0	2.264.6	154.0
Apr-05		32.0	2.269.4	72.6
Total april	100.0	100.0		226.6
Total may	100.0	0.0		0.0
Total june	100.0	0.0		0.0
Total 2nd quarter	300.0	100.0		226.6

Source: Central Bank.

Table 2
Permanent purchase of TES
(Billions of pesos)

Weeks	Amount
April 29-May 3	26.6
May 6-May 10	40.5
May 14-May 17	40.1
May 20-May 24	20.4
May 27-May 31	16.0
June 4-June 7	18.8
June 11-June 14	16.3
June 17-June 21	20.9
June 24-June 28	40.3
Total	**240.0**

Source: Banco de la República.

2. Monetary and Credit Aggregates

a. Monetary Base

In the months of April and May the monetary base grew by rates very similar to the ones implicit in the reference line.[1] In June, however, the monetary base began to grow at a greater rhythm, with which at the end of the month, both the mobile average of the 20 level and of the 45 level of the monetary base were set above the implicit values of the reference line (2.3% and 1.3% respectively) (Figure 2). This deviation of the base with respect to the line of reference was the result of growth in the annual[2] demand for cash and reserves (20.7% and 10.8%, respectively) (Figure 3) above that implicitly projected

[1] Reference line presented to the BDBR on 1 March 2002.

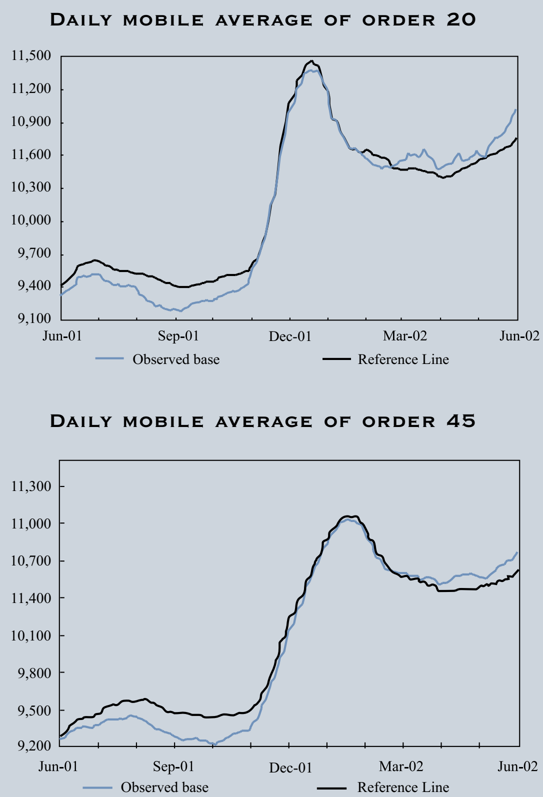
[2] Annual growth of the monetary aggregates referred to correspond to the annual variation in the average monthly balance.

Table 3
Expansion and contraction repos for one day (*)
Daily average
(billions of pesos)

	Expansion			Contraction		
	Limit	Use	Use %	Limit	Use	Use %
January	565.9	293.7	51.9	1,300.0	271.1	20.9
February	920.0	432.8	47.0	1,050.0	243.0	23.1
March	1,018.8	647.7	63.6	529.4	140.5	26.5
Average 1st quarter	834.9	458.1	54.9	959.8	218.2	22.7
April	727.5	325.3	44.7	1,210.0	781.1	64.6
May	769.6	396.3	51.5	804.3	550.2	68.4
June	800.0	575.8	72.0	725.0	307.2	42.4
Average 2st quarter	765.7	432.5	56.5	913.1	546.2	59.8

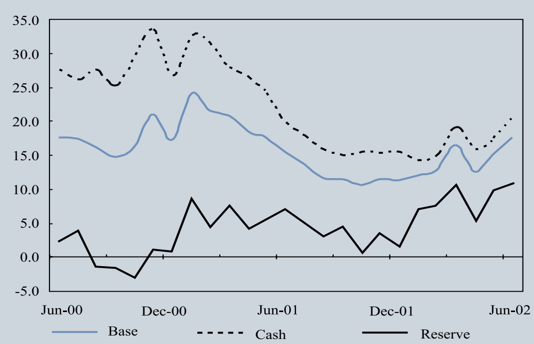
(*) Auction operations. Updated june 28, average of monetary month.
Source: central bank

Figure 2
Monetary base and reference line
(Billions of pesos)



Source: Central Bank, SGEE.

Figure 3
Monetary base and its uses
(Annual percentage variation of monthly average)



Source: Central Bank, SGEE

by the monetary base reference line (18.9% and 5.9%, respectively).

b. M3

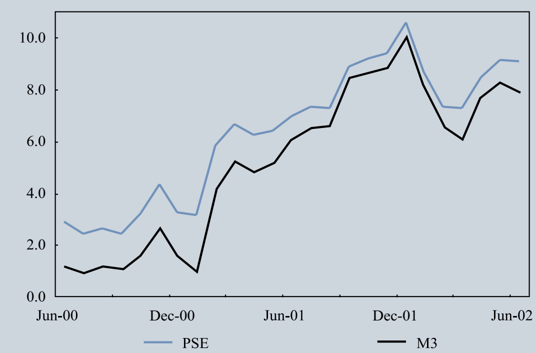
At 30 June, the broadest liquidity aggregate (M3) grew at an annual rate of 9.1%, greater than that registered three months before (7.3%) (Figure 4). The acceleration in the rhythm of M3 growth during the second quarter has been accompanied by a redistribution of the public portfolio toward more liquid assets. In fact, along with acceleration in growth of cash mentioned earlier, an important acceleration was observed in this period in the annual growth of current accounts as well as savings accounts. The counterpart to this greater demand for liquid assets has been a reduction in the demand for TDC. In the last three months, demand for TDC continued to contract and as of June, its level was 7.7% lower than the rate for the same month of the previous year (Figure 5).

This marked preference for liquidity had already been observed since the end of 2001 and during the entire first quarter of 2002, but it has become accelerated in the last three months, probably stimulated by a drop in the passive interest rate. The reduction in interest rates to levels lower than historical averages has reduced the opportunity cost of keeping liquid assets. To the foregoing we may add the existence of the tax on financial transactions (three per thousand) which in practice reduces the margin of remuneration obtained by keeping TDC and other less liquid assets, thereby providing negative stimulus for their demand and favoring the demand for savings accounts, some of which are exempt from the payment of this tax.

The behavior of the M3 monetary multiplier during the second quarter of the year reflects the change in market preferences mentioned earlier. In fact, the greater demand for cash, current accounts and savings accounts reduced the monetary multiplier in May and June. Thus, the multiplier dropped from 6,517 in April to 6,238 in June, the consequence of the greater cash and reserve coefficients which shifted from 0.121 and 0.052 to 0.126 and 0.055 respectively (Figure 6).

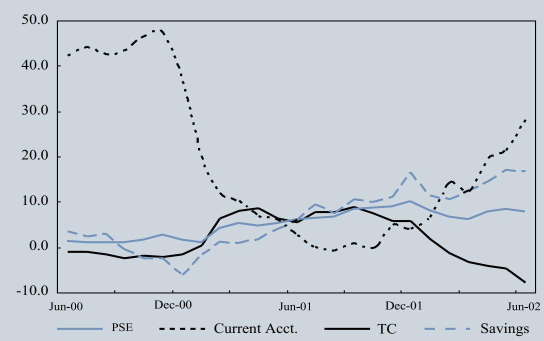
The ample availability of liquidity in the economy is confirmed by an expectations survey conducted by the Central Bank. In this survey carried out in April, 63.0% of the population surveyed perceived liquidity to be high, the highest percentage among all such surveys done since April, 2000. For the following months, the majority of the population surveyed did not expect substantial changes in liquidity conditions (Figure 7).

FIGURE 4
M3 AND LIABILITIES SUBJECT TO RESERVE (PSE)
(ANNUAL PERCENTAGE VARIATION OF MONTHLY AVERAGE)



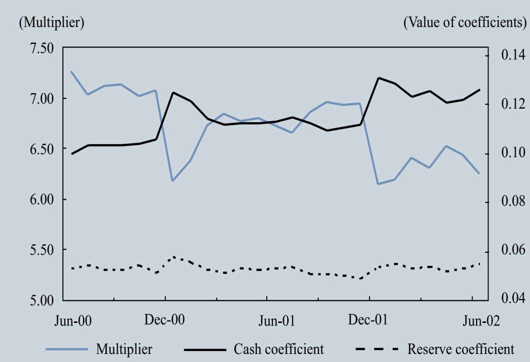
Source: Central Bank, SGEE.

FIGURE 5
PSE AND ITS PRINCIPAL COMPONENTS
(ANNUAL PERCENTAGE VARIATION OF MONTHLY AVERAGE)



Source: Central Bank, SGEE.

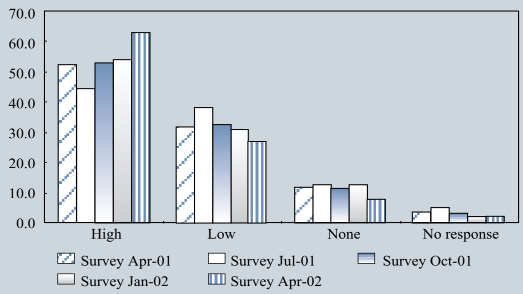
FIGURE 6
M3 MULTIPLIER AND ITS COEFFICIENTS



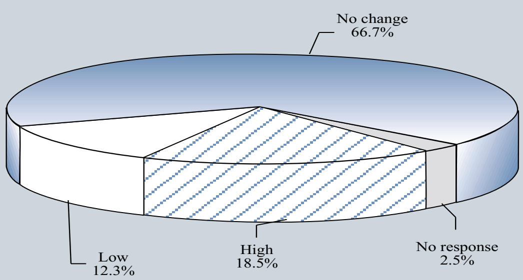
Source: Central Bank, SGEE.

Figure 7
Liquidity in the economy, April survey
(Percentage)

(A)
Perception of liquidity
(At the time of the survey)

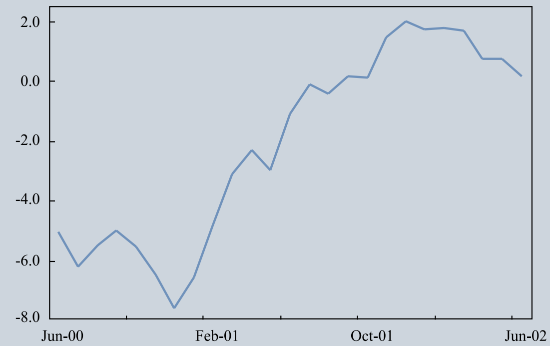


(B)
Evolution of liquidity in the next six months
(As of April, 2002)



Source: Central Bank, expectations survey April, 2002.

Figure 8
Nominal gross portfolio in national currency of the financial system without FEN
(Annual percentage variation of monthly average)



Source: DANE, calculations by the Central Bank.

c. Portfolio and Credit

The slight recovery shown by credit toward the end of last year and beginnings of this year did not hold during the second quarter. To the contrary, in this period, nominal portfolio in domestic currency throughout the financial system decelerated and by June the annual growth rate was null (0.2%) (Figure 8).

Portfolio performance during the second quarter of the year was determined, in large part, by the accounting effect caused by title transfer of a large part of the mortgage portfolio in early May. At this time, the recently created Titularizadora Colombiana bought mortgage portfolio for a value of $478 billion generating a reduction in portfolio in the balances of financial intermediaries.

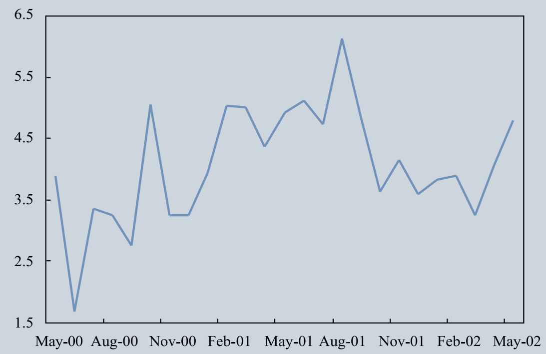
Despite the foregoing, portfolio in domestic currency of the financial system had been decelerating since March, so that lesser performance in the second quarter cannot be wholly attributed to the accounting effects derived from title transfer. Apparently, during this period important write-offs in portfolio continued to be observed, which together with a loss of dynamism in the demand for certain types of credit explains the stagnation of total portfolio in June. Nominal gross portfolio corrected for withdrawals from portfolio of financial intermediary[3] balances grew at an annual rate of 4.8% in the month of May (Figure 9).

Portfolio performance, by type of credit was also affected by the new regulations issued by the Banking Superintendency. Beginning in January, the Superintendency modified criteria for risk structure and classification of credit destination, adding the category of micro-credit. The inclusion of this new category implied modification of the concept of consumer credit and explains the lesser growth of the latter and increase in commercial portfolio (Figure 10).

Lastly, results of the expectations survey carried out by the Central Bank in April indicate that

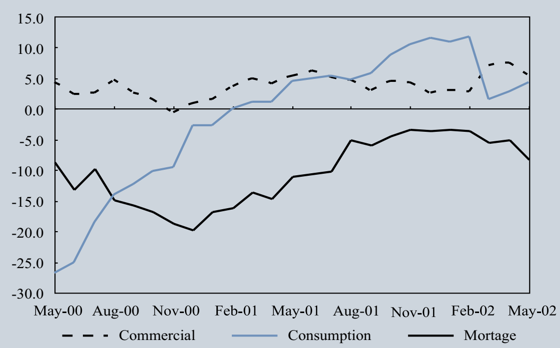
[3] These withdrawals have been motivated by the liquidation of some financial firms, the castigo of unproductive assets, reductions due to goods received in payment, titling and sale of portfolio to organizations outside the system and reliquidation of mortgage portfolio.

Figure 9
Nominal gross portfolio adjusted in national currency of the financial system without FEN
(Annual percentage variation)



Source: Central Bank and Superintendency of Banking.

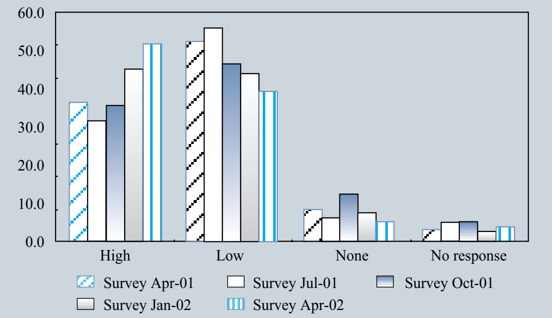
Figure 10
Nominal gross portfolio by type of credit in national currency of the financial system without FEN
(Annual percentage variation)



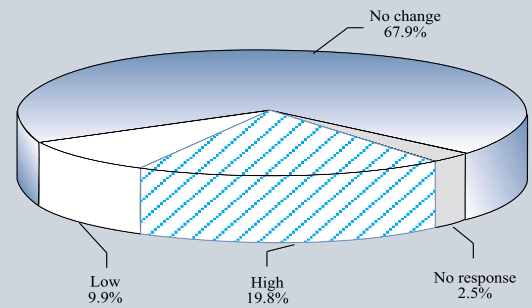
Source: Central Bank and Superintendency of Banking.

Figure 11

(A)
Perception of credit availability April, 2002 survey
(At the time of the survey)



(B)
Evolution of credit availability in the next six months beginning April, 2002



Source: Central Bank, expectations survey, April, 2002.

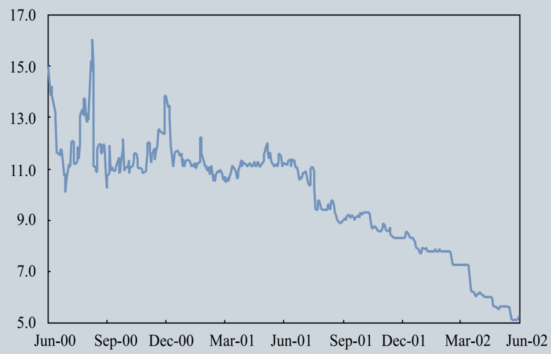
the perception of credit availability has increased. For the first time since this survey has been done, more than 50.0% of the population surveyed (51.8%) perceived availability as high. For the following months, 67.9% considered that credit conditions would be maintained (Figure 11).

3. Interest rates

During the second quarter of the year, the nominal interbank rate continued to decrease due to the loose monetary policy followed by the Central Bank. In June, the average interbank rate reached a minimum historical level at 5.4%, 219 pb below the figure for the end of March (Figure 12). The equivalent real interest rate in June was -0.8%, the lowest since January, 2000 (Figure 13).

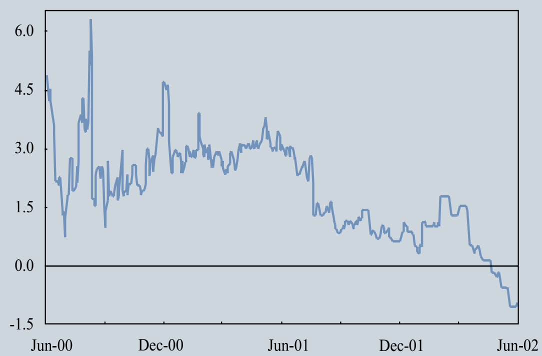
According to the path taken by the interbank rate, all the financial system interest rates dropped significantly. During the second quarter of the year, the capture rate measured by DTF registered 8.4%, with a quarterly fall of 2.2 percentage points, the greatest recorded since March, 2000 (Figure 14). On the other hand, the reduction shown by the five placement rates was particularly important, highlighting the drops in the treasury and consumption loan rates. By June, these were respectively at 9.6% and 27.9%, which represented a drop of 3.1 and 1.5 percentage points with respect to values observed in March (Figure 15).

Figure 12
Nominal interbank rate
(Daily series)



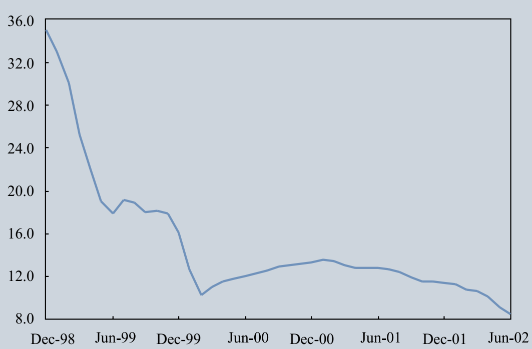
Source: Central Bank.

Figure 13
Real interbank rate
(Daily series) (percentage)



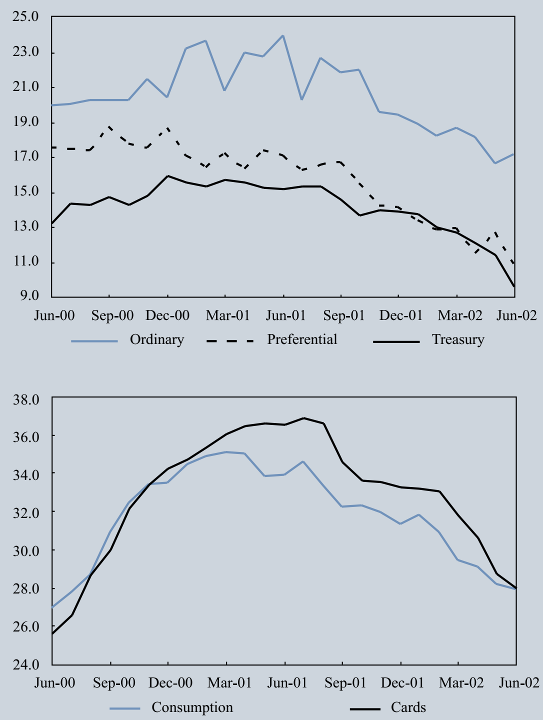
Source: Central Bank.

Figure 14
Nominal passive interest rate
DTF for 90 days
(Annual effective rate)



Source: Central Bank.

Figure 15
Nominal interest rates
by type of placement
(Percentage)

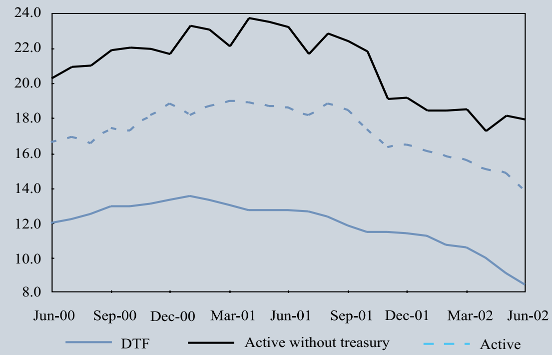


Source: Central Bank.

The rate of aggregate placement, measured by the active rate of the Central Bank closed in June at 13.8%, while the active rate excluding treasury loans recorded 17.9%, 1.8 and 0.6 percentage points below the respective level for March (Figure 16).

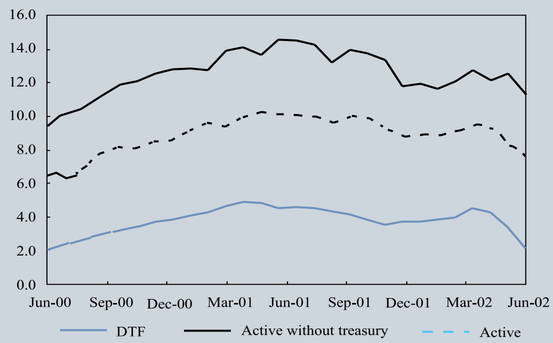
The reduction in nominal rates and the greater inflation reported in June, aided in the fall of real rates. As seen in Figures 17 and 18, the reduction has occurred in both assets and passive rates, and furthermore, has been seen for all types of credit. The real rate for capture dropped from 4.4% during March to 2.0% at closing in June. On the other hand, the real rate for placement, measured by the active rate of the Central Bank, registered at 7.1%, that is 2.1 percentage points below the level that had been reached in March, while the real asset rate, excluding treasury loans decreased by 0.9 percentage points in the same period, ending at 11.0% in June.

Figure 16
Nominal interest rates
(Percentage)



Source: Central Bank.

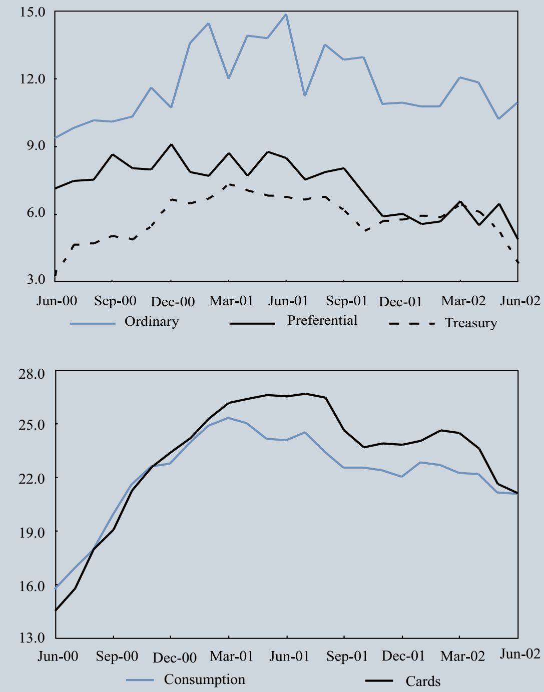
Figure 17
Real interest rates
(Percentage)



Source: Central Bank.

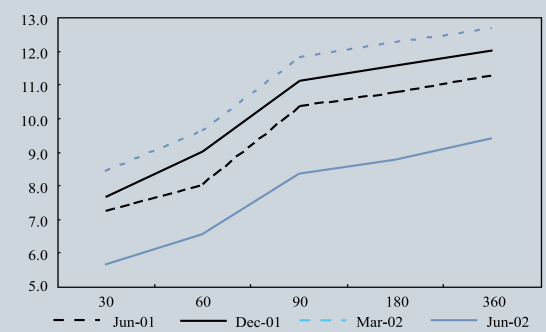
During the second quarter a reduction was also observed in the interest rate of the various time deposits (in addition to 90 day ones). Figure 19 shows the evolution of the basic rate yield curve from the Banking Superintendency to banks. On the average, during June the level of these rates continued to drop until it oscillated between 5.6% for short terms and 9.4% for longer terms. The foregoing levels show the greater reduction registered for all terms since March, 2000. At the same time, the absence of significant changes in the slope of the curve does not suggest that the market expects higher interest rates in the coming months. To the contrary, this performan-

Figure 18
Real interest rates by type of placement
(Percentage)



Source: Central Bank.

Figure 19
Term structure for TBS
(Percentage)



TBS: Banking Superintendency Basic Rate
Source: Banking Superintendency

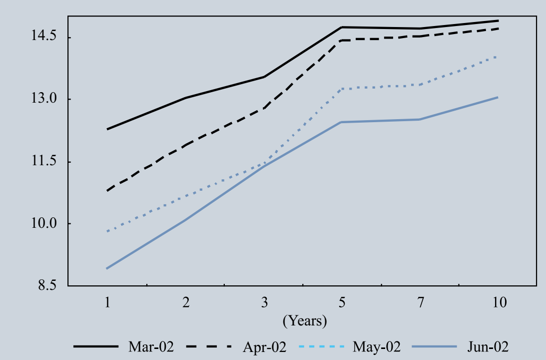
ce allows for continued confidence in a reduction in the capture interest rate for the various terms.

In addition, Figure 20 shows the development of the interest rate yield curve for TES titles in the secondary market. In can be seen how interest rates to date this year at all terms have been developing favorably: an uninterrupted tendency toward lower levels. At the same time, contrary to what was seen four quarters ago, and as had been forecast in the December, 2001 inflation report, the slope of the curve started to level off in June. Thus, while short terms showed a drop of an average of 1.7 percentage points with respect to that shown in March, the interest rates on titles for 5 year or longer terms showed respective drops of 2.0, 2.0 and 1.6 percentage points compared to March. Since the TES titles for short terms have already registered significant decreases in previous quarters, it is expected that the longer term documents will maintain higher prices for the rest of the year. Thus, at this point there is still expected to be a greater leveling off of the yield curve.

Furthermore, Figure 21 shows how the difference between the monthly average interbank rate and the DTF has increased almost without interruption over the last year. And just as in previous reports, it is important to point out that, although the rapid reduction in DTF has helped stabilize the difference at around 300 pb, taking into account that the historical average of this difference between January, 1994 and June, 2002 is 2.5%, additional reductions in the passive rate are expected during the coming months.

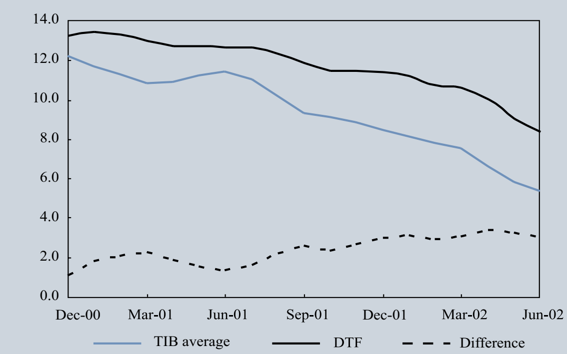
Finally, as a consequence of the immense liquidity in the market, the continual reduction observed in interest rates and the various indicators shown above, it is currently possible to expect a future descending path for long-term interest rates. However, the last expectations survey the Central Bank carried out (last April) reflects that the market is completely independent of these developments, and particularly, that it is expected that the DTF will end up around 10.6% by the end of December, 2002. The foregoing would imply a recovery of 215 pb (Figure 22). It is worth mentioning, however, that similar results have been culled from the previous four surveys, so that presently the expectations survey is not considered a good indicator of future movements in the rate.

Figure 20
Yield curve for TES secondary market (SEN)
(Percentage)



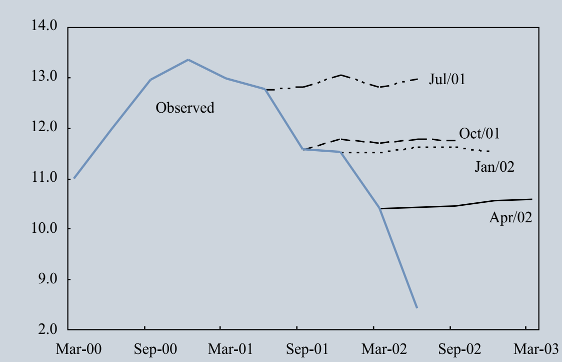
Source: Central Bank.

Figure 21
Difference between the DTF rate for 90 days and the TIB average
(Percentage)



Source: Central Bank.

Figure 22
Observed (DTF) interest rate and the evolution of expectations
(Annual effective rate)



Source: Central Bank, expectations survey, April, 2002.

4. Profitability differential

In this section we show the differential between external and internal profitability. External profitability is defined as that which local investors expect to obtain if they decide to invest in assets in dollars. This calculation is based on the external reference interest rate and expectations for devaluation. For this exercise, devaluation expectations are taken to be the implicit devaluations agreed to in forward contracts sold in dollars between 80 and 100 days within the financial system. The external reference rate is taken to be the rate on 90 day TDCs in the U.S. financial system. Lastly, the internal reference rate used is the DTF.

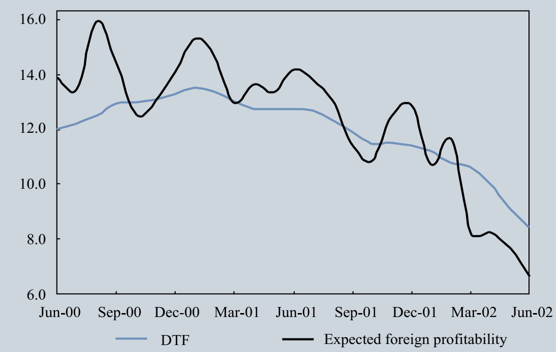
The level reached by the representative market rate (TRM), has caused devaluation expectations to diminish. This fact together with a decline in external interest rates, currently has favored domestic investment. This is reflected in Figure 23, which compares expected external profitability and internal investment profitability (measured with the DTF). Thus, by the end of June expected external profitability was around 6.6%, that is, 1.8 percentage points below the DTF, and furthermore, below that shown at the end of March by 1.6 percentage points.

Finally, implicit devaluation that should have been agreed to in forward contracts to close the rate differential in June, keeping external and internal monetary policy unaltered, should have been 3.5 percentage points greater than that actually agreed upon (4.7%).

5. Nominal exchange rate

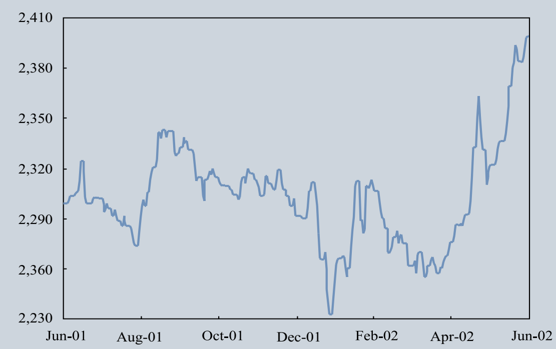
As of April, the level of the exchange rate has been characterized by its permanent upward tendency. The TRM closed in June at $2,398.8 per dollar as compared to $2,261.2 per dollar in March, thereby corresponding to an annual devaluation of 4.3% and thus far in the year 4.7% (Figures 24 and 25).

FIGURE 23
OBSERVED DOMESTIC AND EXPECTED FOREIGN PROFITABILITY
(PERCENTAGE)



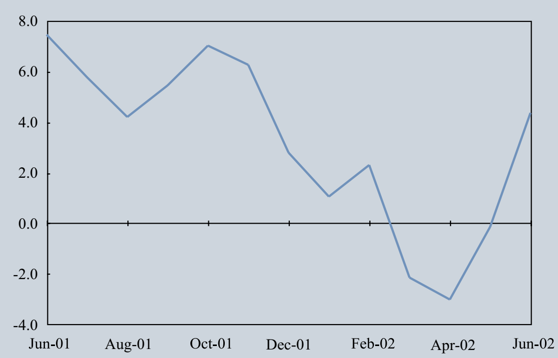
Source: Central Bank.

FIGURE 24
REPRESENTATIVE MARKET RATE
(PESOS PER DOLLAR)



Source: Central Bank.

FIGURE 25
NOMINAL ANNUAL DEVALUATION
(PERCENTAGE END OF MONTH)



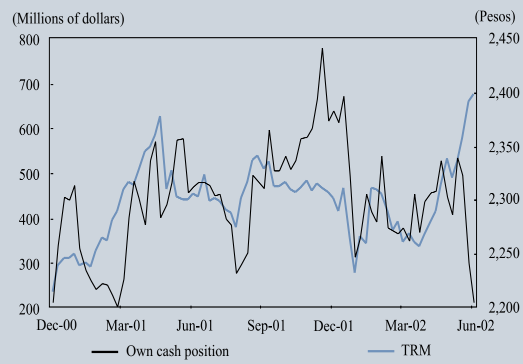
Source: Central Bank.

During the second quarter of the year, evolution of the TRM was affected by greater demand for exchange by the real sector, the exchange of foreign debt for domestic debt occurring in early May and the exchange of foreign debt that occurred in June. On the other hand, a worsening in financial and political conditions in Argentina, Brazil and Venezuela, as well as the possible moderation in U.S. economic reactivation are factors that feasibly added to propitiating a greater demand for dollars in the market.

Additionally, as observed in Figure 26, this greater demand for exchange, faced by the market over the last three months, could not be completely absorbed by the liquidation of the financial system's own cash position. Therefore, this situation brought about a rise in the TRM.

At the same time, the Board of the Central Bank continued to hold PUT auction options for the accumulation of international reserves. The results of the exercise of this instrument are summarized in Table 4. Based on these figures, it may be deduced how clearly, as of last April, the exchange rate showed a break in its trend.

Figure 26
Financial system's own cash position and representative market rate
(Percentage)



Source: Central Bank.

Table 4
Auction of sales options for accumulation of international reserves
(Millions of dollars)

Auction date		Amount Presented	Amount Approved	Limit	Premium Minimum (Pesos/thous. Dollars)	Premium Maximum (Pesos/thous. Dollars)	Premium Cutoff (Pesos/thous. Dollars)	Amount used
2001	Jun-29	133.5	30.0	30.0	1,500.0	11,560.0	10,200.0	30.0
	Jul-31	86.5	30.0	30.0	1,000.0	12,500.0	6,000.0	30.0
	Aug-31	427.0	80.0	80.0	100.0	10,570.0	7,180.0	0.0
	Sep-28	222.4	100.0	100.0	100.0	11,000.0	5,780.0	100.0
	Oct-31	530.0	140.0	140.0	100.0	8,210.0	5,210.0	140.0
	Nov-30	448.0	119.9	120.0	210.0	10,200.0	6,010.0	119.9
	Dec-28	188.5	50.0	50.0	3.5	10,510.0	8,000.0	50.0
2002	Jan-31	211.5	49.9	50.0	3,600.0	10,565.0	10,000.0	1.5
	Feb-28	107.5	50.0	50.0	3,000.0	9,010.0	8,560.0	50.0
	Mar-27	277.8	100.0	100.0	4,000.0	12,000.0	8,300.0	100.0
	Apr-30	275.0	100.0	100.0	1,500.0	8,220.0	3,566.0	0.0
	May-31	388.0	100.0	100.0	2,010.0	9,220.0	6,010.0	0.0
	Jun-28	243.0	100.0	100.0	2,010.0	6,800.0	3,510.0	

Source: Central Bank.

It may be pointed out how options failed to be used in April and May, as did the cutoff premium. The foregoing reflects not only the greater devaluation that took place, but also lower expectations for revaluation of the financial system.

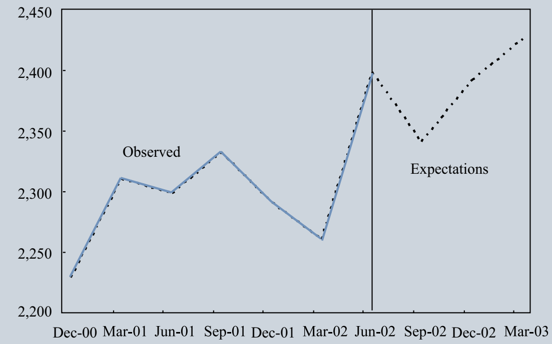
Finally, the last expectations survey done by the Central Bank in April, shows that on the average, agents expected the exchange rate to settle at about $2,301.5 per dollar by the end of June. Compared to the rate actually recorded, this expectation is 4.1% lower. Likewise, the survey reveals that for the following three quarters, the exchange rate could be situated at $2,341.1, $2,391.9 and $2,425.9 per dollar respectively. Consequently, the agents expect an annual devaluation of 0.4% in September, 4.4% in December and 7.3% in March, 2003 (Figure 27).

6. Real exchange rate

The real exchange rate measured by the ITCR1 (1994=100), which uses a producer price index for this country, together with its 20 commercial partners, was situated at 112.9 at the end of June. Thus this indicator showed an annual revaluation of 4.1%, while its revaluation for the course of the year was 2.1%. At the same time, if the ITCR3 (1994=100) is used based on the consumer price index, it yields a real annual revaluation in June of 6.5%, and 6.0% thus far for the year (Figures 28 and 29).

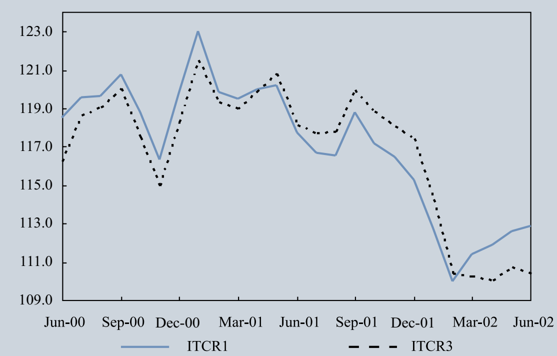
The real exchange rate index gives evidence of the development of the exchange market and of both internal and external inflation. In this way, variations in the ITCR show the difference between nominal devaluation of the Colombian peso with respect to its principal trade partners and the gap between domestic and external inflation. So far this year, the ITCR has suffered pressure toward revaluation as a consequence of the fact that external devaluation has been significantly higher than external inflation (see Chapter II, International Context). Additionally, given that Colombian inflation is currently greater

FIGURE 27
QUARTER EXPECTATIONS FOR TRM
(PESOS PER DOLLAR)



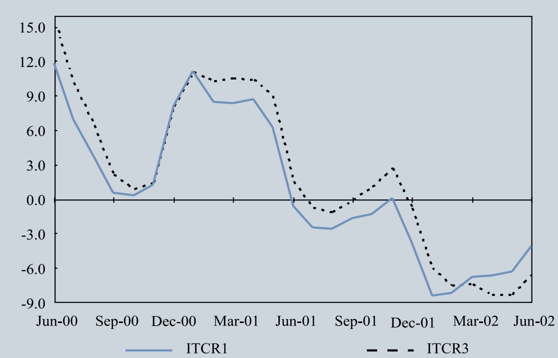
Source: Central Bank, Expectations Survey, April, 2002.

FIGURE 28
INDEX OF REAL EXCHANGE RATE
ITCR1 AND ITCR3, (1994= 100)



Source: Central Bank.

FIGURE 29
REAL ANNUAL DEVALUATION
ITCR1 AND ITCR3, (1994 = 100)



Source: Central Bank.

than the nominal devaluation of the peso, the revaluation tendency of the index has been reinforced. Therefore, in the last 12 months, the ITCR has risen.

7. Asset prices

Two variables presented below describe the performance of the prices of some assets in Colombia. The first of these is the general Colombian Securities Market (IGBC), which measures the evolution of the most representative share prices in the market as an aggregate by using a basket of selected shares, chosen on the basis of their rotation and frequency.

The IGBC closed in June at 1,238.4 points, as compared to 1,102.3 points at the end of March. The foregoing implied that the market for variable income, on the average, increased its value at an annualized quarter rate of 59.3%, a much higher yield than that offered by other financial assets. Furthermore, during this quarter, the IGBC reached its historical maximum since creation, hitting 1,289.3 on last June 18 (Figure 30). These positive results offered by the share market are a consequence of a pronounced increase in share prices, good financial sector balances, low interest rates offered by the fixed income market and some particular investment operations.

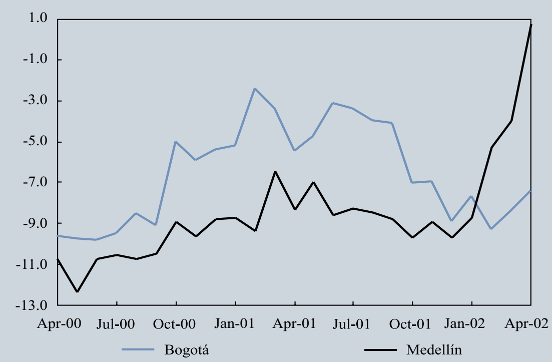
Finally, another variable that offers information about the prices of assets in Colombia is the housing price index. This indicator is calculated by the National Planning Department (DNP) for Bogota and Medellin since 1994 on a monthly basis.

Figure 31 gives the monthly variation in the real housing price index for Bogota and Medellin. For both cities, the monthly variation for this indicator remained in the negative zone. However, it may be pointed out that since February for Bogota and since December for Medellin, the falling tendency has been slowing and begins to show growth rates that are less and less negative. Thus, in April, the

FIGURE 30
GENERAL INDEX OF COLOMBIAN SECURITIES MARKET

Source: Colombia Securities Exchange.

FIGURE 31
ANNUAL VARIATION IN REAL PRICE INDEX FOR HOUSING IN BOGOTA AND MEDELLIN
(PERCENTAGE)



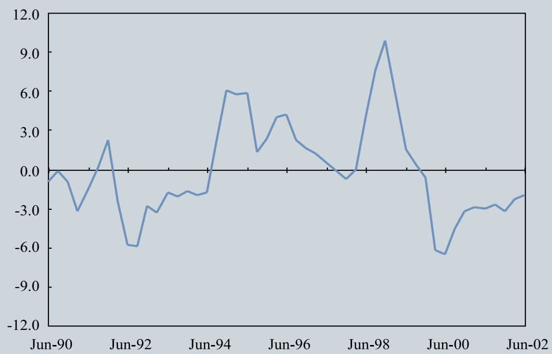
Source: National Planning Department (DNP).

annual growth of real housing prices in Bogota was -7.4%, 1.5 percentage points greater than the value reported for December, while Medellin showed a real housing price for the same month with annual negative growth of 0.8%, which is 8.9 percentage points above the corresponding figure for December.

8. Monetary conditions indicator

The indicator for monetary conditions (ICM) with respect to aggregate demand, for the second quarter of 2002, continues below the base period (1998:01) indicating an expansionist stance for monetary policy. This result is based on a

Figure 32
Indicator of monetary conditions (ICM) of aggregate demand
(Percentage)



Source: Central Bank, SGEE.

reduction in interest rates. Likewise, the revaluation of the real exchange rate contributes to a positive slope for the ICM path in the first two quarters of the year (Figure 32).

B. Supply and demand

1. General considerations

During the first quarter of the year, the economy decelerated as a consequence of:

- The contraction of investment in civil works, transportation equipment and the lesser variation in inventories.
- The lesser dynamism of consumption, as a consequence of the contraction of consumption by the Government and the deceleration of growth in household consumption.
- The negative shock that external demand underwent.

Growth observed during this period (0.5%), turned out to be less that that expected by the market and that which had been forecast in the last inflation report. A smaller external demand shock was expected and, in general, the effect of Easter Week celebration in the month of March had been underestimated (in the first quarter of this year there were three working days less than in the first quarter of 2001) as it coincided with a Monday holiday. On the positive side, it is worth pointing out a recovery by building with a favorable effect on investment and the generation of employment.

As a result of the overall poor performance of the economy during the first quarter of the year and according to the evolution of some economic activity indicators for the month of April, the government decided to modify its growth goal for this year to 1.5%. Nevertheless, the final result for growth will largely depend on the outcome of the problems that loom on the foreign front.

For the rest of the year, it is expected that the weakness of foreign demand will continue due to deterioration that has been observed in the economies of several of our principal trade partners, particularly Venezuela, and the uncertainty that still weighs on the consolidation of recovery of the U.S. economy. With regards to this topic, we currently ignore the impact that the accounting scandals, involving some of the most important firms active in the stock market, could have on the confidence and wealth of consumers, and therefore, on the performance of the economy as a whole. Finally, even though the ATPA was approved by the U.S. Congress, the conciliation process has not yet been concluded and Colombia is yet to be declared a favored nation to be able to enjoy the benefits of the treaty.

On the other hand, on the domestic front new sources of uncertainty have appeared. Thus, the announcement by the National government of a greater adjustment in expenditure, especially investment, in order to meet fiscal goals (an additional cutback of $2.2 trillion was announced to compensate for diminished income as a consequence of lesser economic activity) can lead to a temporary weakening of domestic demand. Nevertheless, this adjustment in expenditure will bring about greater growth in the future, to the degree that it sends a message to investors with respect to the government's commitment to make public finance sustainable, and this seeks to dissipate uncertainty caused by the situation abroad.

2. External demand and current accounts

In the first quarter of the year, the deficit in current accounts was reduced by 43.2% with respect to the same quarter of the previous year, by dropping from US$-677 million dollars to US$ -384 million. The reduction in deficit was a result of the strong contraction of imports equal to 14.9% and of an increase (13.0%) in net transfers, which compensated for the fall of 7.4% in total exports (Table 5).

As can be deduced from the foregoing figures, the commercial surplus was not caused by an increase in production aimed at export, but rather by a contraction in domestic demand (Figure 33).

According to the statistics given by the Administrative Department of National Statistics (DANE) the value of total exports decreased by 23.4% for the year up to May as compared to the first five months of the preceding year, as a consequence of the contraction of traditional exports (-6.9% in the same period) and of non-traditional exports (-0.5% January to May of 2002 as compared to January to May, 2001). The foregoing figures give evidence of a weakening external demand.

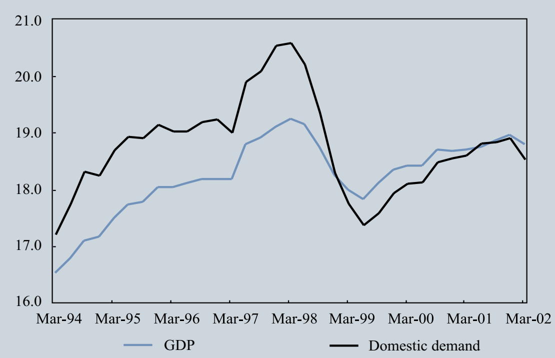
With respect to non-traditional industrial exports, there was a reported accumulated annual variation (over the last 12 months) of 4.8%, as a consequence of the stagnation shown in the levels for the last six months (Figure 34). This decreased activity for non-traditional industrial exports can be explained due to the deceleration registered in sales to Venezuela (7.7% annually for the last 12 months, Figure 35) and the drop in sales to the U.S. (-14% over the same period, Figure 36), which have overshadowed the dynamic growth in exports of this type to Ecuador (38.0% Figure 37)).

TABLE F5
COLOMBIA'S CURRENT ACCOUNT - SUMMARY
(MILLIONS OF DOLLARS)

	January-March		Variation
	2001 (p)	2002 (p)	(%)
Current Account (A + B + C)	(677)	(384)	(43.2)
Income	4,255	3,972	(6.6)
Expenditure	4,931	4,357	(11.6)
A. Non-factorial goods and services	(293)	(76)	(73.9)
Income	3,579	3,292	(8.0)
Expenditure	3,873	3,369	(13.0)
1. Goods	37	265	618.0
Income	3,091	2,863	(7.4)
Expenditure	3,054	2,598	(14.9)
2. Non-factorial goods	(330)	(341)	3.4
Income	489	429	(12.1)
Expenditure	819	771	(5.9)
B. Factor Income	(793)	(771)	(2.8)
Income	205	151	(26.5)
Expenditure	999	922	(7.7)
C. Transfers	410	463	13.0
Income	470	529	12.6
Expenditure	60	66	10.3

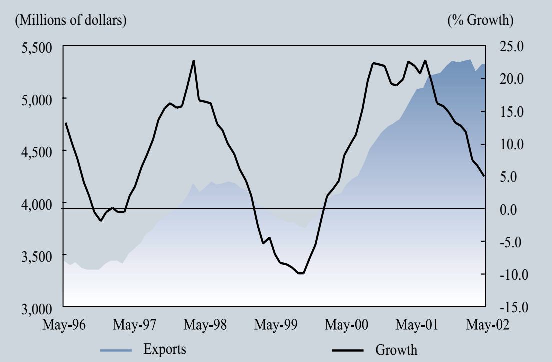
(p) Provisional.
Source: Central Bank.

Figure 33
GDP vs. Domestic demand
(Non-seasonal series - trillions of 1994 pesos)



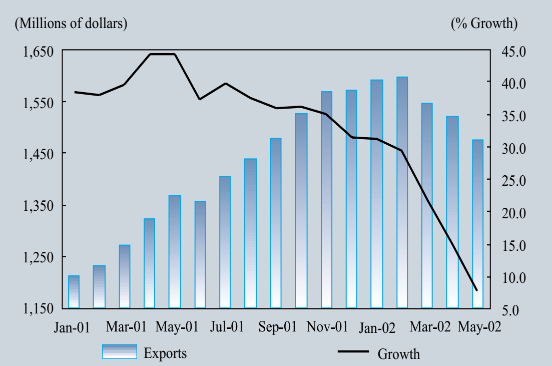
Source: DANE.

Figure 34
Non-traditional industrial exports
Last 12 months



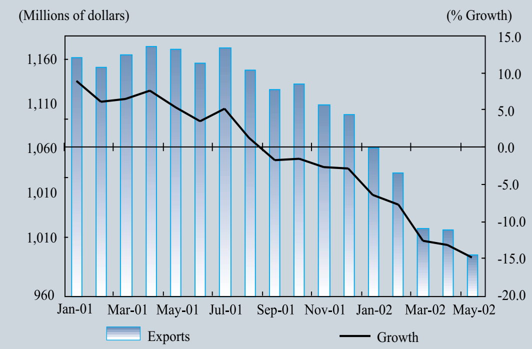
Source: DANE.

Figure 35
Non-traditional industrial exports to Venezuela
Last 12 months



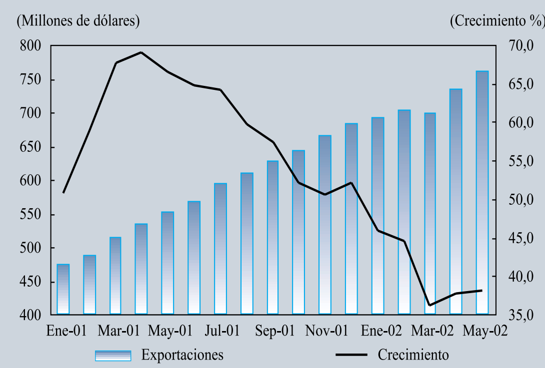
Source: DANE.

Figure 36
Non-traditional industrial exports to the USA
Last 12 months



Source: DANE.

Figure 37
Non-traditional industrial exports to Ecuador
Last 12 months



Source: DANE.

As regards the dynamics of total import values, according to DANE statistics as of April for the year to date, they had contracted by 9.6%. Upon excluding rolling transportation equipment from imports, you can observe that the fall in the value of imports is due to a decrease in the price of imported goods, since the volume remains steady (Figures 38 and 39).

For the rest of the year greater reductions in external demand are expected as a consequence of the economic crisis facing Venezuela. Furthermore, it is not clear when U.S. demand for exports will recover, given that it will depend on the capability of that country's economy to absorb the crisis in confidence unleashed by recent accounting scandals, in addition to the rapidity with which the process of ATPA conciliation takes place and the treaty is reestablished.

Evolution of current account during the rest of the year will depend on the outcome of the current situation that the Brazilian economy is undergoing and whether it creates a contagion effect in Colombia. The worst possible scenario, that of contagion, would create lesser capital flows towards the country, which would in turn affect the exchange rate and would imply an adjustment in the current account through domestic demand (since there would be few resources for the public and private sectors), which would also bring about a deceleration of economic activity.

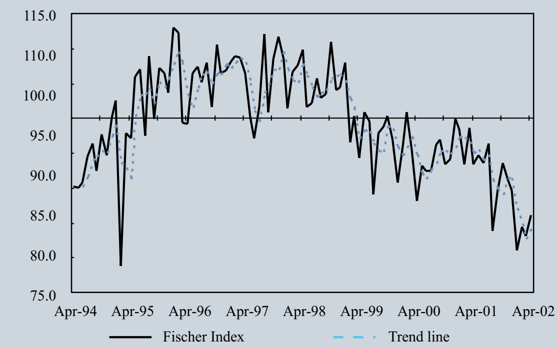
3. Consumption

During the first quarter of the year, total consumption decelerated (Table 6), reflecting a shrinkage in government consumption (-0.2%) and lesser growth in household consumption (1.0%).

a. Household consumption

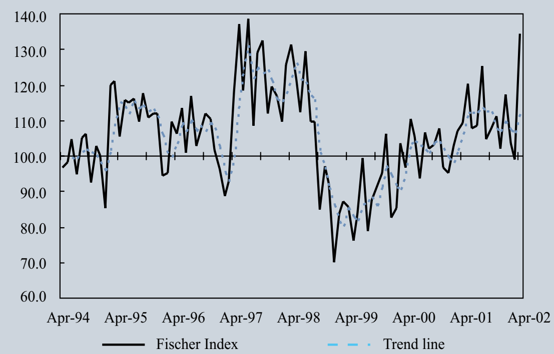
The deceleration in household consumption in the first quarter of the year was evident in all categories in general. This behavior seems to be explained mainly by the Easter Week phenomenon and deterioration in the confidence and expectations of consumers, as suggested by the consumer confidence index (ICC) developed by Fedesarrollo (Figure 40), since other consumption determinants indicated favorable performance, among others, in the level of interest rates, given that the Central Bank reduced its intervention rates by 125 pb in the first quarter of the year. Likewise, inflation dropped by 175 pb, which improved the household balance (according to estimates by the Director of Macroeconomic Policy of the Ministry of Finance and Public Credit, available income for households increased by 0.3% in the first quarter of the year). Finally, transfers carried out by citizens abroad (remittances) increased by 12.6% with respect to the first quarter of 2001 (Table 5).

Figure 38
Fischer price index for imports without rolling transportation equipment



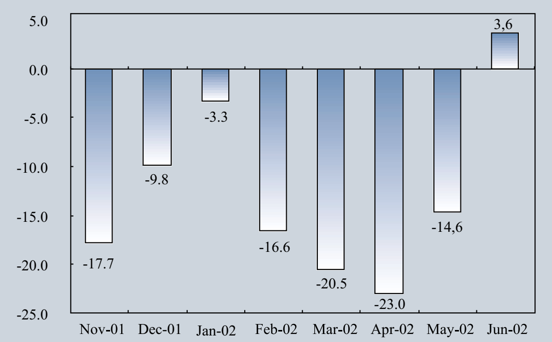
Source: SGEE.

Figure 39
Fischer index for volume of imports without rolling transportation equipment



Source: SGEE.

Figure 40
Consumer confidence index
(Balances)



Source: Fedesarrollo.

TABLE 6
ANNUAL GDP GROWTH FROM THE POINT OF VIEW OF DEMAND
(PERCENTAGE VARIATION)

	2000 (p)	2001 (p)					2002 (p)
	Annual	I	II	III	IV	Annual	I
Gross domestic product	2.74	1.59	1.71	0.89	1.42	1.40	0.50
Total imports	8.63	11.37	20.22	9.98	4.08	11.19	(4.26)
Total final supply	3.57	3.01	4.37	2.24	1.83	2.85	(0.25)
Final Consumption	2.49	1.29	0.96	0.91	1.90	1.26	0.66
Households **1/**	3.65	1.94	1.15	0.33	1.51	1.23	0.97
Final domestic household consumpt. **2/**	4.00	2.30	1.44	0.52	1.78	1.51	1.03
Non-durables **2/**	3.82	0.62	(0.48)	(2.17)	0.32	(0.44)	(0.42)
Semi-durables **2/**	15.28	8.99	4.47	1.84	0.60	3.83	(0.35)
Services **2/**	1.60	2.21	2.24	2.45	2.99	2.48	2.41
Durables **2/**	5.90	4.10	4.73	3.51	6.30	4.67	4.14
Government	(0.74)	(0.54)	0.43	2.60	3.06	1.37	(0.23)
Formation of gross capital	11.79	11.77	22.77	8.44	2.14	10.92	(6.12)
Variation in inventories **3/**	(540.29)	67.26	167.84	(22.23)	(71.98)	6.66	(62.24)
Gross formation of fixed capital	(0.84)	7.37	13.56	12.44	12.04	11.37	0.81
Agriculture. forestry. hunting. fishing	3.10	5.46	(0.77)	10.14	6.27	5.12	7.87
Machinery and equipment	4.22	18.26	35.34	18.57	9.80	19.96	1.61
Transportation equipment	8.65	31.82	34.46	45.95	37.81	37.46	(16.26)
Buildings	(11.10)	7.90	10.48	7.98	17.35	11.04	24.33
Civil works	0.22	(10.84)	(9.38)	1.03	4.83	(3.63)	(16.96)
Subtotal: final domestic demand	3.70	2.72	3.87	1.98	1.94	2.62	(0.35)
Total exports	2.92	4.57	7.01	3.63	1.30	4.09	0.23
Total final demand	3.57	3.01	4.37	2.24	1.83	2.85	(0.25)

(p) Provisional.
1/ Includes purchases of goods by residents made abroad and excludes those by non-residents made inside national territory.
2/ Corresponds to final consumption by resident households made inside national territory.
3/ Calculations made by Central Bank, SGEE.
Source: National Administrative Department of Statistics (DANE).

For the second quarter of the year, the analysis of available indicators suggests that consum-ption for households will not become worse. For the month of April, the DANE reported negative annual growth for retail business sales excluding fuel and vehicles (-2.2%). In this case, also the data for March and April were affected by the Easter Week phenomenon. Annual growth for the year to date (at April) for real sales was 2.7%, that is, observed growth has been maintained since the last quarter of 2001. As for industrial production of consumption goods, the SGEE of the Central Bank, based on figures for the new monthly sample of manufactures (NMMM) issued by the DANE estimates growth of 1.0% for the first four months of the year, sales with credit cards have accelerated the growth rate (13.1%), showing a small recovery. Likewise, for the month of May, Fenalco's business survey did not report any deterioration in business activity

(Figure 41). As for consumer goods imports, DANE figures as of April show growth of 11.1% to date for the year, maintaining the tendency seen since some months ago. Finally, vehicle sales within the national territory continued to accelerate with reported annual growth of 39.6% in the second quarter.

For the rest of the year household consumption is expected to show more dynamic performance, since recovery of the ICC in May and June suggests that consumers ended the second quarter very optimistically (Figure 40). At the same time, for the rest of the year we can forecast constant performance for factors such as low interest rates and inflation, the dynamics of remittance flows and greater creation of employment. These factors have positive effects on available income for households and consumption. Likewise, it is expected that there will a continued trend toward replacement of durable consumer goods, particularly, electrical appliances and vehicles.

b. Government consumption

During the first quarter of the year government consumption shrank by 0.2% (Figure 6). This had been foreseen in the previous inflation report and is consistent with the program for adjustment in public finance that the Central National Government (GNC) is carrying out.

According to the preliminary balance of the GNC for the first quarter of 2002,[4] operational payments dropped 14% compared to the first quarter of 2001, as a consequence of a contraction in transfers of 18%, negative growth in general expenditures of 30% and an increase of 6% in general services.

For the second quarter improved dynamism in government consumption is expected, the results of which depended in the first quarter to a large degree on the change of dates for transfer drafts

Figure 41
Evolution of business sales
(Balances)

Source: Fenalco.

to the regions (according to the new general shares system[5]), and that only in the month of April did the GNC decree a salary increase for public workers.

As regards the announced freeze on resources equal to $2.2 trillion (approximately 1% of GDP) in order to meet fiscal goals for the year, we still do not know which categories will be affected by the measure and whether their impact will be seen during the second half of this year or in 2003.

4. Investment

During the first quarter of 2002, total investment measured as gross capital formation, contracted by 6.1%, as compared to the first quarter of the previous year. Upon subtracting inventory accumulation, stagnation can be seen in investment measured as gross fixed capital formation (0.8%). Based on the figures reported by the DANE, it is estimated that variation in inventories during the first quarter of the year was -62.2%. It is not easy to interpret the process of de- accumulation of inventories that has been occurring over the last three quarters and that has coincided with a deceleration in industrial production and the stagnation of non-traditional industrial exports. Taking into account the present day international

[4] Central Nacional Government, first quarter 2002. Documento Asesores Confis, No. 5 June 21, 2002.

[5] Law 715 of 2001.

context, the most probable interpretation is that demand expectations by businessmen have deteriorated, leading to lower industrial production and investment.

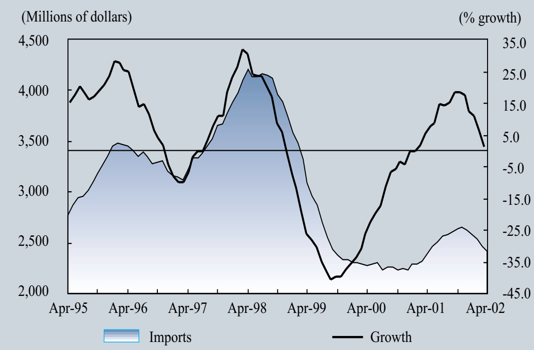
Stagnation in gross capital formation can be explained by the contraction in investment in civil works (-17.0%) and transportation equipment (-16.3%), and the absence of growth in machinery and equipment investment (1.6%), which outweighed the favorable performance of building investment (24.3%).

Data from DANE for the month of April show that imports of industrial capital goods have shrunk by 22.6% to date for the year and over the last 12 months have grown by only 1.1% (Figure 42). This fact can be associated with a phenomenon of over-investment by business. In the first three quarters of last year, investment in machinery and equipment was one of the most dynamic lines in gross capital formation (Figure 6). This phenomenon very possibly resulted from a process of replacement of equipment and investment in competitivity that businessmen made, motivated by the recovery of industry in the year 2000 (in this same year non-traditional industrial exports grew 2.19%). However, with the deceleration of industrial production that began to be observed as of the second quarter of 2001, businessmen's production expectations were not fulfilled, causing along with it a level of installed capacity utilization below that registered during the year 2000 (see Section D. of this chapter).

To the degree that total demand is expected to continue weak due to the poor performance of exports, it is not considered that incentives exist for businessmen to go ahead with ambitious programs for expansion. Thus, and as was pointed out in the previous report, it is expected that investment in machinery and equipment will continue in a slump for the rest of the year.

For the rest of the year, it is expected that investment in civil works will show a similar dynamics

FIGURE 42
IMPORTS OF CAPITAL GOODS - INDUSTRIAL
LAST 12 MONTHS



Source: DANE.

to that observed in the first quarter of this year, which is consistent with the adjustment program for public finance. Similar behavior is expected for investment in transportation equipment, if we take into account that for the rest of the year there will be no massive importation of buses for the mass transportation system of Bogota, and that the bulk of the aid in military equipment under Plan Colombia was carried out the previous year. As regards investment in buildings, this category continues to be one of the most dynamic, as suggested by some sectorial indicators such as annual growth during the first five months of the year of real loans issued to builders (156.8%) and to buyers (70.5%). On the other hand, as of the month of April, the licenses approved for housing construction underwent an increase of 51.0% to date for the year as compared with the same period of last year. Upon disaggregating, the licenses for construction of low cost housing have grown 76.5% and the rest of housing 35.3% in the same period of time.

5. Industrial production

The NMMM of the DANE recorded a significant contraction in industrial production of (-11.0%) during the first quarter of the year. This performance of the sector can be explained, principally by the celebration of Easter Week during the month of March, when in 2001 it took place in the month of April. In this way, the comparison does not take into account that in the first quarter of the year there were three working days less than during the same period for the previous year.

The NMMM data for April reported that industrial production has contracted by 1.0% when comparing the first four months of the year with the same lapse of time in the year 2001 (Figure 43). This comparison at the date named has already discounted the effect of Easter Week and allows us to make a more precise analysis.

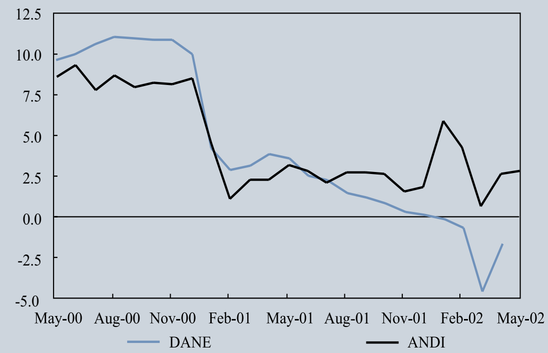
According to the DANE, industrial production has kept up the declining tendency that it has shown since the second quarter of 2001. This behavior is explained by the lesser dynamics of exports of non-traditional industrial goods and the slow recovery of domestic demand. Thus, as of the second quarter of 2001, Colombian companies began a process of inventory accumulation that has led to diminished productive activity (Figure 44).

The behavior of inventory variations, which is estimated based on figures put out by DANE (Figure 6), apparently is consistent with the evolution observed for production and industrial sales. Now, some indicators seem to suggest that companies have already been able to evacuate a large part of the inventory they had accumulated. The business opinion survey (EOE) by Fedesarrollo for the month of May, suggests that the non-exporting businesses have made a more rapid adjustment than the exporting ones (Figure 45).

For the second quarter of the year a recovery is expected in industrial production, but due to the statistical effects (Easter Week). The demand for electrical power during the second quarter was 4.0% higher than that observed in the same period of the previous year (Figure 46 supports this view). Likewise, it leads us to expect a comeback in urban economic activity for the months of April, May and June.

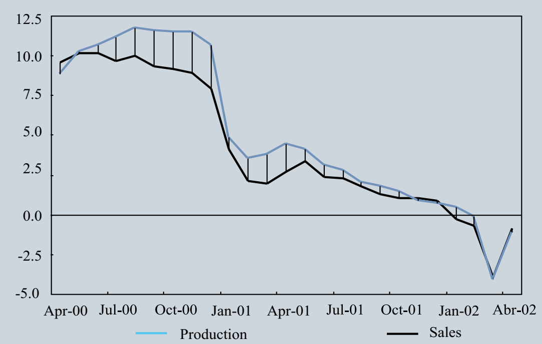
With respect to the evolution of the sector in the second semester of the year, it will depend on

Figure 43
Index of real industrial production annual growth for year to date
(Percentage)



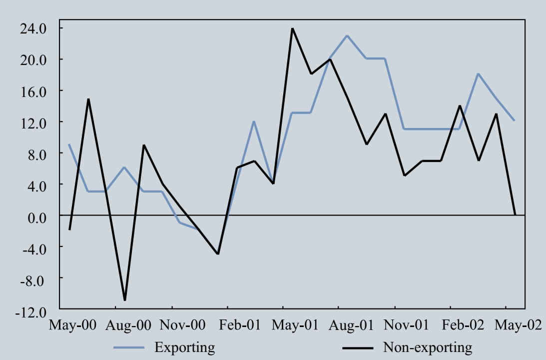
Source: DANE and ANDI.

Figure 44
Production vs. Industrial sales annual growth for year to date
(Percentage)



Source: DANE.

Figure 45
Current level of inventories
(Balances)



Source: Fedesarrollo, EOE.

the behavior of the domestic market. If the hypothesis that non-exporting companies have managed to adjust their inventory levels is accurate, any comeback in demand will have immediate effects on the level of production. On the other hand, for the case of exporting companies, the prospects are rather dubious. As mentioned in the section on *External Demand*, no recovery in the area of non-traditional industrial exports is projected in the short run.

C. Salaries and employment

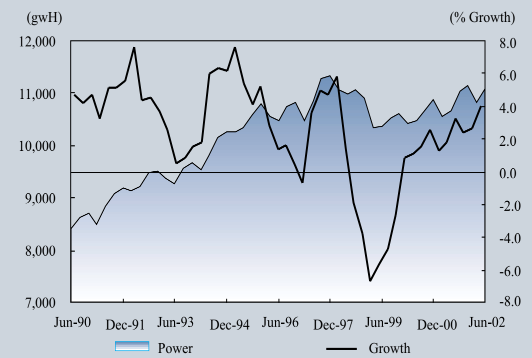
1. Industrial salaries

For the month of April, 2002, the rhythm of adjustment of nominal salaries in the industrial sector continued falling, although at a slower speed as compared to that observed the previous year. For this month, the annual variation of the last 12 months for nominal salaries for the entire group of workers in the sector was 7.9%, that is, 4.0 percentage points lower than that observed for the same month the previous year. This decrease was greater than the reduction in inflation for the same period (2.3 percentage points), so that real salaries showed a slower adjustment rhythm.

Benefits paid to the workers of the sector showed similar behavior to that of nominal salaries (they continued to decrease their rhythm of adjustment, although at a slower pace than in previous quarters). As of the month of April, 2002, the annual growth over the last 12 months of benefits paid to the total number of workers (blue and white collar) was 6.3%, which represents a decrease of 2.8 percentage points with respect to the variation observed in April, 2001.

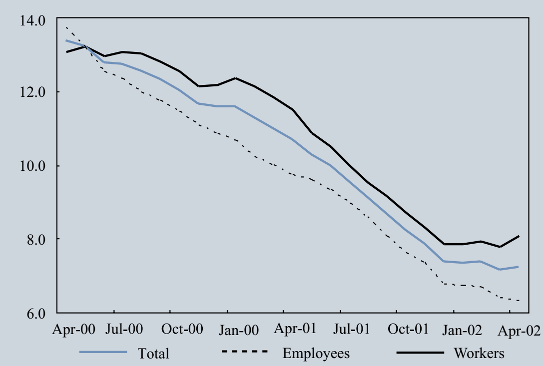
As we have observed so far in the previous quarters, the lower adjustments in salaries and benefits brought about a growth in total remuneration (salaries + benefits) of sector workers, more in accordance with inflation goals by the Central Bank (Figure 47). Thus, by the month of

FIGURE 46
QUARTER DEMAND FOR POWER
(ANNUAL GROWTH)



Source: ISA.

FIGURE 47
ANNUAL GROWTH OF NOMINAL INDUSTRIAL REMUNERATION LAST 12 MONTHS
(PERCENTAGE)



Source: DANE.

April, 2002, growth of total remuneration of workers was 7.2%, less than that observed in December, 2001 (7.4%). This more moderate increase in nominal salaries throughout the year was not sufficient to compensate for the drop in worker productivity throughout the first four months of the year. Therefore, it can be seen that the real unit cost of labor (CLUR) experienced an important comeback during the first quarter of the year, but did register a low level during the month of April (Figure 48). Once more, the Easter Week phenomenon can largely explain the lower productivity, which unleashed a temporary increase in the CLUR. Taking into account that the variation observed in the CLUR during the first three months of the year is the result of a statistical phenomenon, and that its level in April returned again to a value similar to that observed at the end of 2001, inflationary pressure is not expected for the rest of the year with respect to industrial salaries.

2. Employment

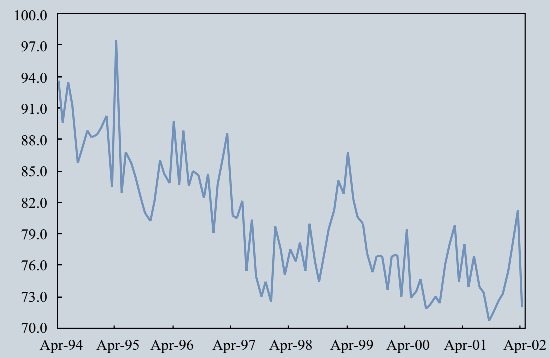
For the month of May, the rate of unemployment in the 13 principal urban areas, was 17.5%, 0.6 percentage points less than that registered for the same month of the previous year. (Figure 49). In the national total, the rate of unemployment was 15.3%, 0.9 percentage points greater than that in May 2001.

The lower rate of unemployment in the 13 cities can be explained due to greater dynamism in the creation of employment, which compensated a greater labor supply. The rate of occupation was 1.2 percentage points greater than that of the same month of the previous year, compensating (positively) for the increase in the global rate of participation, which was 1.0 percentage point higher than in May, 2001.

The greater activity in the generation of employment is associated with the positive performance that manual labor-intensive activities have had throughout the year. Such is the case of building construction, which as mentioned in the section on investment, is expected to be the most dynamic sector of the economy during this year. The same phenomenon occurs with business activity, which in the case of the large stores and wholesale supermarkets, increased their real sales 4.4% annually in the first quarter of the year, and increased 1.6% the personnel employed in the same period of time. With respect to retail business, employment increased 3.3% in the first three months of the year.

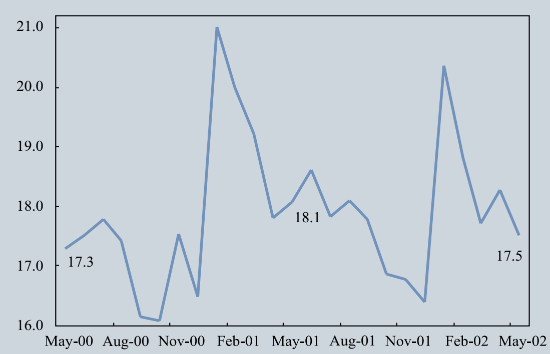
For the rest of the year, the results of the expectations survey by the Central Bank, in the month of April, are not so optimistic as the survey of January in the area of employment. With respect to the evolution of personnel employed for the next three months, the percentage of interviewees that stated that they would be prepared to increase hiring was 9.9%, only about half of those answering affirmative in January (Figure 50). Similar behavior was observed in the evolution of responses for the number of employees within a term of six months, where the percentage of interviewees that stated they had plans to increase their payroll was 8.6% (Figure 51).

Figure 48
Real unit labor cost
For workers of the industrial sector



Source: DANE.

Figure 49
Unemployment rate for 13 cities
New methodology
(Percentage)



Source: DANE, continues household survey (ECH).

3. Agreements for salary increases

Figure 3 shows the percentage of workers benefited by ranges of salary increases agreed to over periods of one and two years in the collective bargaining agreements reported by the Ministry of Labor and Social Security.

The first part of the graph shows the percentage of workers benefited by salary increase negotiations over one year, during the first semester of the year. It should be pointed out that a relatively uniform distribution occurred, with ranges of [6.5% - 8.0%] and [8.0% - 10.0%], which covered the greatest number of workers benefited: 62.7%. At the same time, as compared to the reports for the same period in 2001, the workers benefited showed a redistribution. Therefore, while in 2001 only 3.0% of the workers benefited made agreements in the range from 6.5%-8.0%, in 2002 this percentage had increased to 29.7%. Likewise, the range between 8.0% and 10.0% in 2001 included 69.3% of those benefited, but in 2002 this percentage dropped to half: 33.0%. The foregoing shift is a reflection of both lower expectations for inflation, and greater credibility in the Central Bank's inflation goals.

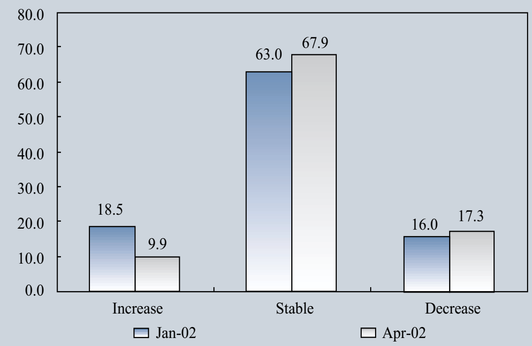
Similarly, in the second part of Table 7, we can see the percentage of workers benefited by salary increase ranges for two years ahead, again between January and June, 2002. It can be seen that approximately 85.0% of the workers benefited are nested in the range of the IPC and the IPC+2.5. This percentage is 8.0 percentage points above that reported for the same period of 2001.

D. Utilization of installed capacity and product gap

Indicators for utilization of installed capacity presented in this report coincide in their recording lower levels of utilization than the historical average for the month of May.

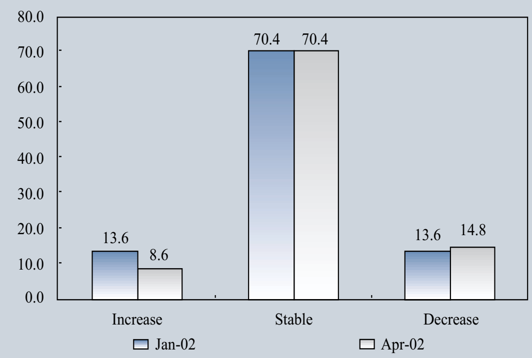
According to the EOE of Fedesarrollo, for the month of May, utilization of installed capacity for the period between March and May, 2002,

Figure 50
Evolution of personnel for businesses in the next three months
(Percentage)



Source: Central Bank. Expectations survey, April, 2002.

Figure 51
Evolution of personnel for businesses in the next six months
(Percentage)



Source: Central Bank. Expectations survey, April, 2002.

Table 7
Percentage of personnel benefited by level of salary increase agreed to
(January-June, 2002)

Negotiations one year ahead

<6.5	[6.5-8.0]	[8.0-10.0]	[10.0-12.0]
13.4	29.7	33.0	23.8

Negotiations two years ahead

<6.5	[6.6-11.0]	IPC	[IPC + 0.5-IPC + 2.5]	SML	Others
2.7	10.6	39.5	45.1	0.8	1.3

SML = Legal minimum wage.
Source: Ministry of Labor and Social Security.

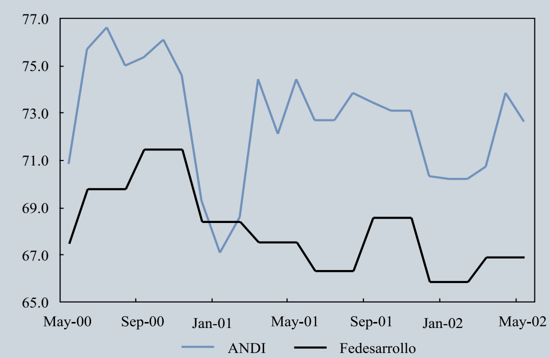
was 3.2 percentage points less than the average observed in these same months over the last 11 years. On the other hand, the indicator obtained with the EOIC and the ANDI was less by 1.8 percentage points than the average registered in the month of May in the last eight years (Figure 52).

The lesser utilization of installed capacity in industry can be explained by the important process of technological modernization and replacement of equipment that occurred the previous year, which has not been compensated with a reactivation of production, resulting in an increase in idle installed capacity.

The estimated product gap, based on demand for productive factors (production approach) confirms the existence of substantial unused installed capacity within the economy as a whole. During the first quarter of 2001, the gap equaled 3.5% of the GDP and it is expected to remain at that level for the rest of the year, and moreover, the growth target for the economy for this year dropped to 1.5% (Figure 53).

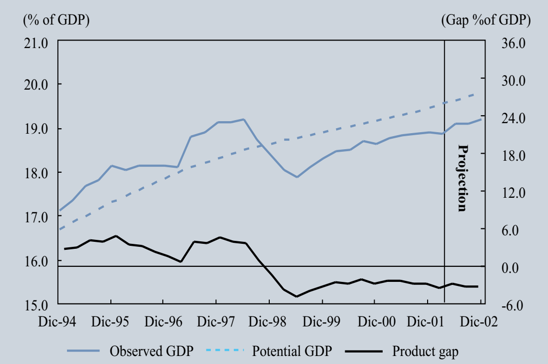
The foregoing implies that for the rest of the year there should not be inflationary pressures with respect to demand, at least in the area of industrial goods.

Figure 52
Utilization of installed capacity



Source: ANDI and Fedesarrollo.

Figure 53
Product GAP
(Trillions of pesos of 1994)



Source: Central Bank, SGEE.

E. Fiscal situation

At closure of the first semester, cash operations by the Central National Government registered a deficit in the amount of $5.197 billion, equivalent to 2.5% of the annual GDP. As noted in the March report, these operations constitute an approximation of the fiscal situation of the Government, in spite of the fact that they only take into consideration the flows of income and expenditure that take place through the General Treasury of the Nation. (Table 8).

As compared to the first semester of the year 2001, income decreased 0.5% and expenditure increased by 9.7%. Cash income was affected by the behavior of taxes, the collection of which decreased by 1.5%. The greatest drops in collection occurred in gasoline tax and import taxes. In the former case, the reduction in collection reflects both a decrease in the rate, as well as a lower rhythm of economic activity throughout the year. In the second case, the collection of external added-value tax and customs tariffs was affected by the slow dynamism of imports and by the revaluation of the period. Income tax registered a drop of nearly 2.0%, especially as a consequence of the low level of economic activity in 2001.

On the expenditure side, a growth of 6.5% in interest can be seen, 10.4% in operations and 13.4% in investment. Within payments for operations, personal services grew 10.7% and transfers 12.3%. General expenses, on the other hand, dropped 9.2%, due to application of Law 617 of 2000, according to which annual growth for this category, with the exception of payment associated with the health sector and military forces, will not exceed, on the average, 50.0% of the inflation target.

Financing of the deficit was carried out with domestic credit resources. Net foreign debt was negative by $1,396 billion with payments for $693 billion and amortizations for $2,089 billion. Furthermore, net internal debt reached $5,072 billion with payments for $9,645 billion and amortizations for $4,573 billion. Among payments on internal credit, placements of TES B certificates rose to $9,193 billion, of which $4,967 billion correspond to auctions, $3,071 billion to programmed investment and $1,154 billion to obligatory investments.

TABLE 8
CENTRAL NATIONAL GOVERNMENT
EFFECTIVE CASH OPERATIONS, JANUARY-JUNE: 2001-2002
(BILLIONS OF PESOS)

		2001	2002	Annual growth 2002/2001
I.	**Total income (A + B)**	15,671.0	15,589.0	(0.5)
	A. Taxes	13,056.0	12,864.0	(1.5)
	Income	5,963.0	5,858.0	(1.8)
	Domestic value-added	3,232.0	3,452.0	6.8
	Foreign value-added	1,507.0	1,408.0	(6.6)
	Tariffs	1,044.0	968.0	(7.3)
	Gasoline	577.0	480.0	(16.8)
	Financial transactions	712.0	682.0	(4.2)
	Others	21.0	16.0	(23.8)
	B. Other income	2,615.0	2,725.0	4.2
II.	**Total Expenditures (A + B + C)**	18,954.0	20,786.0	9.7
	A. Interest	4,983.0	5,307.0	6.5
	Foreign	1,656.0	1,896.0	14.5
	Domestic	3,327.0	3,411.0	2.5
	B. Operations	11,944.0	13,181.0	10.4
	Personal services	2,783.0	3,081.0	10.7
	General expenditure	882.0	801.0	(9.2)
	Transfers	8,279.0	9,299.0	12.3
	C. Investment	2,027.0	2,298.0	13.4
III.	**Deficit (-) or surplus (+) in cash (I - II)**	(3,283.0)	(5,197.0)	58.3
IV.	**. Financing (A + B + C + D)**	3,283.0	5,197.0	58.3
	A. Net foreign credit	4,625.0	(1,396.0)	(130.2)
	Disbursements	7,486.0	693.0	(90.7)
	Amortization	2,861.0	2,089.0	(27.0)
	B. Net domestic credit	1,672.0	5,072.0	203.4
	Disbursements	6,685.0	9,645.0	44.3
	Amortization	5,013.0	4,573.0	(8.8)
	C. Sale of assets	181.0	0.0	(100.0)
	D. Others	(9,761.0)	(8,873.0)	(9.1)
V.	**Deficit as percentage of GDP**	(1.7)	(2.5)	-

Source: Director of National Treasury.

II

Contexto internacional

During the first quarter of the year, the world economy picked up as a result principally of growth in the U.S., which turned out to be somewhat more vigorous than initially forecast. Nonetheless, in the face of recent weakness of the dollar, the drop in stock market indices on Wall Street, the sluggishness of consumers and growing fiscal and foreign imbalances in the U.S., doubt is presently being cast on the solidity of this economic recovery and their capacity to pull along the Japanese and European economies. If we add to this panorama, the weakening of domestic demand within the Euro zone and Japan for the rest of the year and the crisis Latin American economies are undergoing, the result will be a decrease in the prospects for world growth for 2002 and 2003 as compared to forecasts made three months ago (Table 9).

TABLE 9
ANNUAL GROWTH RATE AND FORECASTS FOR PRINCIPAL ECONOMIES OF COLOMBIA'S TRADE PARTNERS

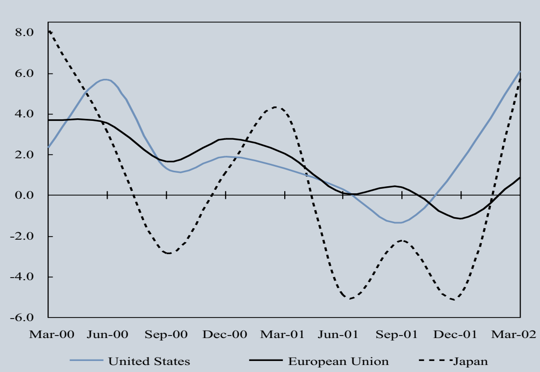
	2001	2002	2003
World			
United States	1.2	2.7	3.6
Euro zone	1.5	1.4	2.3
Japan	(0.4)	(0.5)	1.1
Latin America			
Argentina	(3.7)	(13.4)	0.5
Brazil	1.5	2.1	3.6
Chile	2.8	2.9	4.7
Ecuador	5.2	3.8	4.0
Mexico	(0.3)	1.6	4.4
Peru	0.2	3.3	3.7
Venezuela	2.7	(3.8)	0.7

Fuente: Source: Datastream based on forecasts in *Consensus Economics*. The figure for Ecuador is taken from Idea -Global (June, 2002).

A. General overview

In the first quarter of the year, the economy of the U.S. reached a rate of annualized growth of 6.1%, a much higher figure than that forecast last March (4.5%). This strong recovery was driven principally by a comeback in inventories, which showed the first positive growth rate after six quarters of continual downslide and to a lesser degree for the positive performance of household consumption. Reactivation of demand made it possible for imports to expand, the first of such movements after five quarters of continual contraction (Figure 54).

FIGURE 54
ANNUALIZED QUARTER GROWTH OF GDP UNITED STATES, EURO ZONE AND JAPAN
(PERCENTAGE)



Source: Datastream.

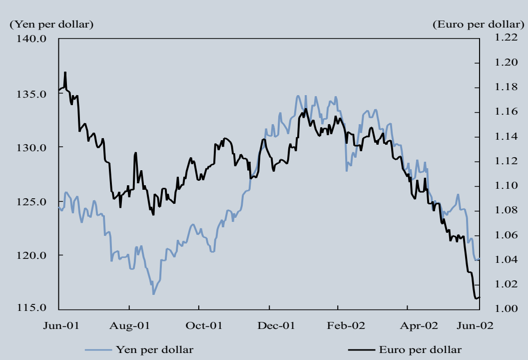
Despite this healthy economic activity, by the end of June the U.S. economy showed worrisome signs of weakening, which added uncertainty as to the solidity of its recovery. First, we may point to the reigning anxiety in financial markets due to the scandals associated with transparency in the corporative sector (Enron, World Com cases among others) and with the apparent overvaluation of share prices. Second, and in part, as a consequence of the negative wealth effect which presupposed a fall in stock market indices, we find a relatively more moderate path being adopted by household consumption, just as lower retail sales in May suggest and a drop in the sentiment index for consumers in June. By the end of June, uncertainty with respect to the sustainability of the already swollen fiscal and commercial deficit of the U.S. began to increase, as a reflection of the exodus of capital from the country toward safer and more transparent markets, generating a rapid devaluation of the dollar compared to the Euro and the yen (Figure 55).

Despite the situation described above, during the second quarter of the year, positive performance shown by a series of supply indicators still allow a certain confidence in moderate growth for the rest of the year. Among these indicators it must be pointed out that the industrial production index and orders, recovery in the level of inventories, growing utilization of installed capacity and greater labor productivity reported. On the other hand, the current laxity in fiscal and monetary policy must continue to be an incentive to economic growth, if in fact the majority of the effects of this relaxation has already been reflected in greater rates of private consumption growth during the fourth quarter of 2001 and the first of 2002.

Presently, international analysts consider that sustained growth in the U.S. will depend on results productivity gains registered in previous years and in the improved corporate balances expected, while they also expect positive factors to full counteract the negative impact of greater uncertainty, devaluation of the dollar and possible debility of consumption in the private sector. Thus, the consensus among international analysts is that the U.S. economy will reach a growth rate of about 2.7% in 2002 and also foresee more vigorous growth (3.6%) for 2003 (Table 9).

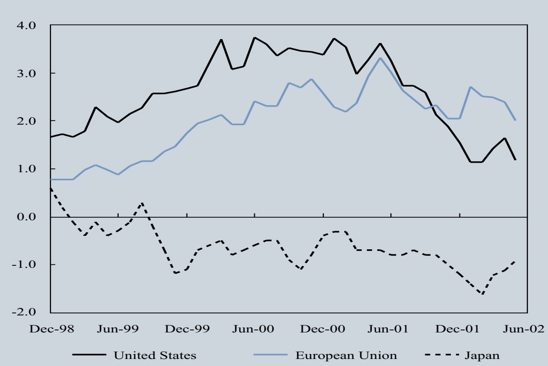
For the second semester of the year, monetary policy should contribute to economic reactivation of the U.S., as long as inflation seems to be controlled. In fact, during the second quarter, an important decline in inflation was recorded. The total consumer price index in May reported an annual increase of 1.2%, while basic inflation remained stable, fluctuating around 2.5% (Figure 56).

FIGURE 55
EXCHANGE RATES FOR YENS AND EUROS PER DOLLAR
(DAILY SERIES)



Source:Datastream.

FIGURE 56
INFLATION RATE FOR INDUSTRIALIZED ECONOMIES
(PERCENTAGE)



Source: Bloomberg.

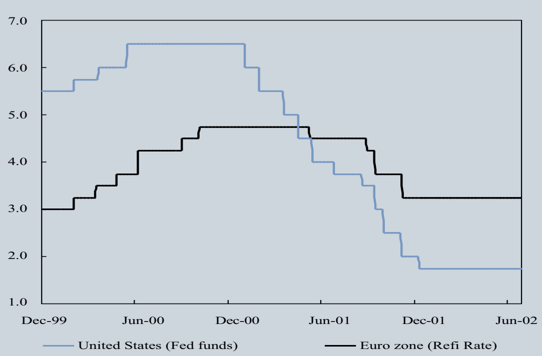
Recent devaluation of the dollar can create a new outbreak of inflation. However, several international analysts due not consider it feasible, since the estimated switchover from devaluation to inflation is less than 20.0%. Additionally, thanks to lower inflation expectations, utilization of installed capacity, which remained below its historically low level, and reported gains in labor productivity, it is expected that inflation will remain moderated during the entire year of 2002.

These lower prospects for inflation, added to the current uncertainty as to economic recovery allowed the open market operations committee of the Federal Reserve last June 26 to sustain its accommodating monetary policy with an unaltered intervention rate of 1.75% (Figure 57). Presently, the statements of members of this institution ratify the commitment of the organization to sustainable growth of the economy, given that international analysts do not consider an increase in the interest rate feasible prior to November, while at the same time, they foresee that it will not exceed 25 pb. If economic recovery can be consolidated in the coming months, it is possible that the Fed will rapidly increase its intervention rate until it is situated at about 3.5% around June, 2003.

The economic recovery of the U.S. had a favorable repercussion on growth dynamics of the other industrialized economies. Thus, in the first three months of the year, the European economy achieved annualized quarter growth of 0.9% following the contraction they had experienced at the end of 2001. This was possible thanks to the positive foreign balance in the zone, which was able to compensate several times over the setback in internal demand. Something similar can be said with respect to the Japanese economy, which recovered and reported an annualized quarter growth rate of 5.7% in the first quarter of the year, the first positive rate after four quarters of contraction (Figure 54).

Nevertheless, in spite of this acceptable growth, the future of economic activity in the Euro zone and in Japan has been affected. With respect to the Euro zone, in spite of the greater demand for exports, weakness in the industrial sector has not contributed to recovery of employment nor of internal demand, and negative perspectives of investors toward regional growth has been evident. In the same way, the flight of capital from the U.S. toward Europe should have been reflected not only in the appreciation of the Euro, but also in the recovery of its market indices, and in this way in the performance of real sector indicators. However, until now, in the short run, the latter has not been verified. Another stain on regional growth, as explained in the last inflation report, is the rigid fiscal stance that countries in the zone are subject to. This position does not allow the implementation of counter-cyclical policies that will help reactivate weak internal demand. With respect to the Japanese economy, there is not currently any great divergence between the performance of foreign and domestic demand. So, while the former has recovered in tow behind the U.S. and Eastern Asian economies and has had positive repercussions on industrial production, the latter continues to be depressed due to the lower income of households and poor conditions that the labor market is going through. Finally, recent revaluation of the Euro and the yen (Figure 55) together with the high degree of exposition of European and Japanese companies

Figure 57
Interest rates for industrialized economies
(Percentage)



Source: Bloomberg.

to the performance of the American economy, they constitute a stain on the rhythm of economic expansion to the extent that it confirms the less solid recovery of the United States.

With respect to future growth in the Euro zone, the consensus among international analysts expects exports to continue to be the driving force behind regional growth. Additionally, it is foreseen that weak internal demand, the satisfactory behavior of total inflation (Figure 56), and the significant revaluation of the Euro, the European Central Bank will keep its already relaxed monetary position. Thus by the end of 2002 and in 2003 the region should reach growth rates of about 1.4% and 2.3% respectively (Table 9).

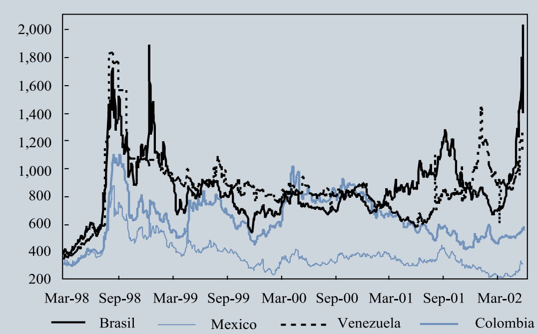
For Japan, on the other hand, international analysts highlight the fact that even though the short run economic panorama has improved more rapidly than predictions made three months ago, its economy is currently far from self-sustaining recovery. The fiscal policy continues to be very restrictive, the financial system very weakened, demand for credit scarce and deflationary pressures continue, even in the face of higher oil prices and the recent appreciation of the yen (figures 55 and 56). Therefore, the consensus of international analysts is growth around -0.5% and 1.1% in 2002 and 2003 respectively for Japan. These forecasts are greater than the previous ones.

B. Latin America

In Latin America, the greatest uncertainty regarding reactivation of industrialized economies, together with the risks associated with political turbulence, a resurgence of the contagion effect and the unforeseen greater aversion to risk by international investors,[6] has generated a drastic deterioration in its prospects for economic growth, and also in the last two months of its stock indices, of sovereign debt spreads and a sharp weakening in exchange rates (Table 9, Figure 58 and Table 10).

In Brazil, the results of the surveys on intentions for presidential votes and the corporate scandals exploding in large U.S. enterprises exacerbated the prospects for foreign investors, which currently reflect a deterioration in the foundations

Figure 58
Sovereign debt spreads at ten years
Latin American countries
(Basic points)



(*) Data up until July 9.
Source: Bloomberg.

Table 10
Devaluation of Latin American currencies with respect to the U.S. Dollar

	Month of June	Annual	Year to date
Argentina	7.0	282.0	282.3
Brazil	11.9	22.5	21.9
Chile	4.7	9.5	3.8
Mexico	3.3	9.9	8.8
Peru	1.4	0.0	2.0
Venezuela	19.5	88.2	76.4
Uruguay	12.8	37.5	26.8

Source: Datastream, June 28, 2002.

6 In its July 3, 2002 report *(World Outlook, Q3,2002)*, the Deutsche Bank stated that up to that point in the year, Latin America had lost capital in the amount of almost 5% of the regional GDP. For Venezuela and Argentina this figure hit 10% of their respective GDPs.

of their economy. This negative perception created a rapid capital flight, which depreciated domestic currency significantly (real) while at the same time strongly affecting the spread of sovereign debt, increasing it by 861 pb during the month of June. At closing of the second quarter, the spread had reached a higher level than that observed during the 1998 crisis.

The reaction by Brazilian economic authorities has been rapid. In order to try to reestablish trust in the economy, the Brazilian Central Bank kept its intervention rates unaltered in spite of greater inflation and devaluation, while it increased the range of inflation targets for 2003 and 2004. The government, in turn, also expanded the fiscal deficit goal for 2002 and has been holding talks with the International Monetary Fund (IMF) to ensure future disbursements. Nevertheless, in the opinion of external analysts, this economic shakeup will continue at least until the presidential elections coming in October and until other measures such as tax and retirement benefit reforms are implemented. In this way, the projections of three months ago have been readjusted by consensus of the analysts to drop expectations by at least a half point for growth in 2002, situating it around 2.1% (Table 9).

It is important to warn that the current situation in Brazil is especially critical for the countries of the region. The potential risk of spread is greater than in the case of the Argentine crisis, due to the greater vulnerability of the regional financial system and the large volume of regional trade this economy deals in.

Together with Brazil, Venezuela is another economy that may compromise greater regional growth. First, the political crisis has become more acute and its final development is still unknown. Second, their hefty fiscal deficit, which is estimated at about 4.0% of GDP this year, in spite of higher oil prices, has created a strong depreciation of the bolivar and has abruptly curbed internal demand. Finally, the fragility of its government's relations with multilateral organizations, including the IMF, limits the country's access to outside financing. In view of the foregoing factors, perspectives for an economic recovery in the short run are null. International analysts expect that during 2002, this country will face shrinkage of approximately 3.8%,

In Ecuador, the economic panorama appears to be more favorable. It is estimated that this economy can reach an annual growth rate for 2002 of 3.8%, the highest for the subregion. Likewise, inflation continues to decline, greater oil income is expected and there is a more favorable atmosphere to be able to reach a new agreement with the IMF. However, for this to happen, the government must undertake a number of reforms, such as the liquidation of the country's largest state bank, a fiscal reform, cutbacks in public expenditure, and confir-mation by the Paris Club that it has received all amortization payments due. According to foreign analysts, it is not probable that these reforms will take place before presidential elections to be held in four months. Nonetheless, it is hoped that the IMF will be relatively flexible, inasmuch as the country has shown its intention to adopt them.

Finally, the notable exception in the region, Mexico, a country that has shown a certain degree of imperviousness to regional financial, economic and political agitation. Thus its prospects for economic growth (1.6% for 2002) remain unaltered, even with the greater peso devaluation experienced in the month of June and the slight broadening of spread in its sovereign debt.

C. Basic product prices

Following observed sustained growth between October of last year and March of this year, the price index for the main basic products listed by *The Economist* registered a slight decline last April and May. However, in June it recovered its rising trend and ended at 1.1% above the level observed at the end of the first quarter last year. Annual variation in the index for the month of June was 2.1%, the first positive figure since July of 2000 (Figure 59).

By groups of goods, performance of the price index for basic products in the second quarter of the year, was basically due to the increase in the subindex for food prices. Between March and June, this group grew 0.7%, situating itself 4.6% higher than it was in June last year. On the other hand, the subindex for industrial goods prices increased 1.6%, although this subindex had been 1.3% lower last June than in the year before that.

Taking into account the latest growth forecasts for the world economy (see the preceding section) it is expected that during the next months the prices of basic products will maintain their rising tendency as observed so far this year, although to a lesser degree than that expected three months ago.

1. Petroleum

During the second quarter of the year the prices of crude oil fluctuated within the ranges defined by the Organization of Petroleum Exporting Countries (OPEC) in its reference band.[7] In this period the average price of WTI petroleum was US$26.3 per barrel, a level that is 21.7% higher than that registered for the preceding quarter, but less by 5.8% than that registered for the same period of the year 2001 (Figure 60).

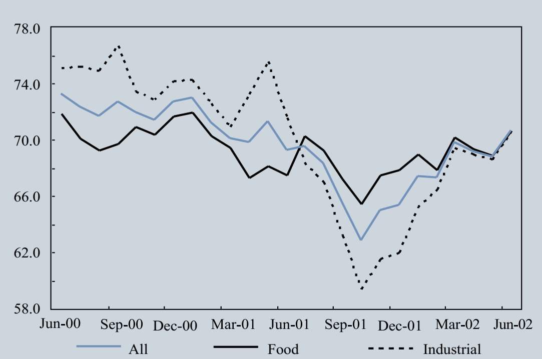
The uncertainty provoked by the Middle East conflict and the instability of Venezuela led to increases in the petroleum price during the months of April and May, reaching levels higher than US$29.0 per barrel in the latter month. At mid-May the rising tendency in crude prices turned around, reflecting less doubt in the market over crude oil supplies. Thus, by the month of June, the price of oil fluctuated between US$24.1 and US$26.9 per barrel.[8]

As indicated in the previous report, there are two principal factors that can determine the performance of petroleum prices during the remainder

[7] The limits of the referente band are US$22 and US$28 per barrel for the OPEC's crude basket. These prices in the U.S. West Texas Intermediate (WTI) indicator are approximately equivalent to US$25 and US$30 per barrel.

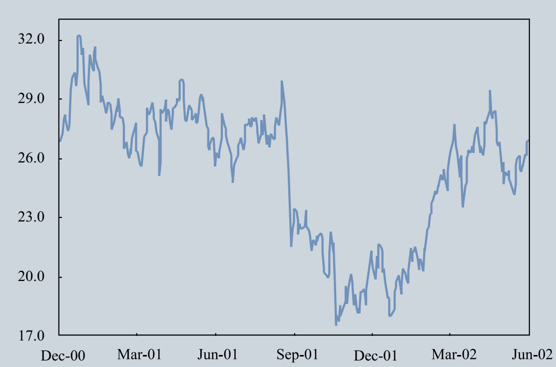
[8] So far this year, OPEC has maintained its production policy. The last production cutback that took place was 1.5 million barrels per day and took effect January 1st of this year.

Figure 59
Monthly index of principal basic products
(1995 = 100)



Source: *The Economist.*

Figure 60
WTI petroleum price
New York exchange
(Dollars per barrel)



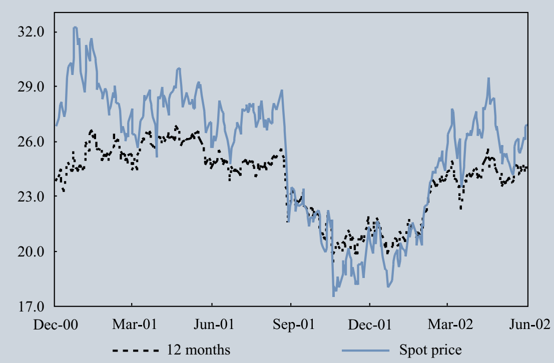
Source: Bloomberg.

of the year. First, the effectiveness of the production cutbacks OPEC implemented beginning in January, 2001, which totaled 1.5 million barrels per day, could eventually reduce the level of inventories during the next months. Second, although growth projections for world economic growth, and especially for the United States have been recalculated downward, an expansion of the economy is still expected for the second semester, which could increase the demand for crude oil in the coming months in relation to that observed in the first half of the year. Additionally, the uncertainty of the market as regards the situation in the Middle East is still latent and an influence on prices again in the future cannot be disregarded.

According to the above, and taking into account that OPEC production quotas will continue unchanged until its next meeting in the month of September, inventories of crude oil could drop during the second half of the year, creating pressure on international prices. Thus it is estimated that in the coming months, oil prices will fluctuate in the coming months between US$26.0 and US$27.0 per barrel, which would mean an average price in the year of US$25.0 or US$25.5 per barrel.

The performance of oil prices during the quarter and market expectations for the coming months are reflected in New York stock exchange prices for futures contracts. In fact, for the end of June the quotes on 12-month futures contracts was at US$24.6 per barrel, a level that is slightly higher than that observed in mid-March (US$23.5 per barrel) indicating that agents expect less availability of crude oil supplies during the remainder of the year. (Figure 61).

Figure 61
Futures contracts WTI petroleum price New York exchange
(Dollars per barrel)



Source: Bloomberg.

2. Coffee

The international price of coffee dropped significantly during the second quarter, as has happened since 1999, reaching its lowest level in recent years. In this period the price of the bean was, on the average, US$60.9 cents/lb., that is, 17.0% lower than the same quarter of 2001 and 2.7% less than the average price recorded in the first quarter of the year. (Figure 62).

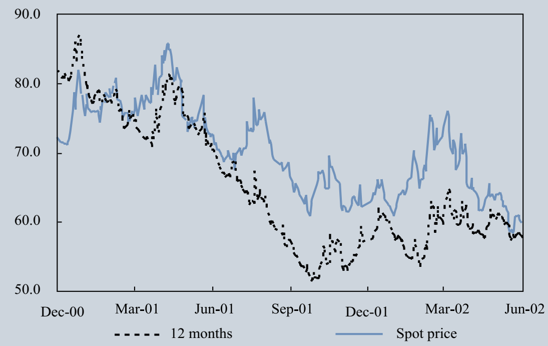
The performance of the international coffee price was likewise observed in the futures contract prices set on the Exchange in New York. By the end of June, the price of contracts one year in advance was US$57.7 cents/lb., that is, 4.4 cents lower than at the end of the first quarter of the year (Figure 63).

Just as has been indicated in previous reports, the continual descent in the price of coffee over the last few years has been the result of an excess supply of the grain, which has brought about an accumulation of inventories in consuming countries. Current market conditions do not suggest a recovery in coffee prices for the rest of the year, and the average price is, therefore, expected to be about US$66.0 cents/lb.

Figure 62
Arabic-colombian coffee prices
New York exchange
(US$cents per pound)

Source: Bloomberg.

Figure 63
Futures contracts Arabic coffee
New York exchange
(US$cents per pound)



Source: Bloomberg.

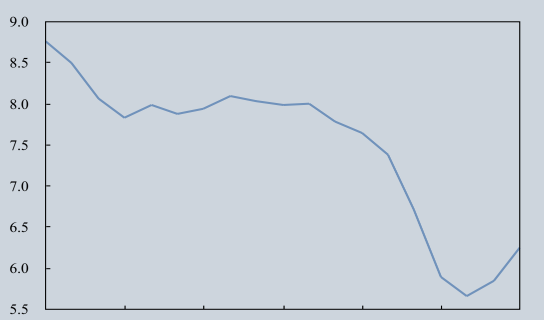
III

Evolution of inflation

A. General aspects

Annual inflation for the consumer over the last 12 months was 6.2%, a lower record by 0.3 percentage points than last March (Figure 64 and Table 11). The average annual inflation for the second quarter of the year 2002 was 5.9%. This average inflation was above the forecasts made by the Central Bank three months before. The forecast in March indicated that average inflation for the second quarter would be about 5.7%, a lower level by 0.2 percentage points than that observed. At the same time, the forecast for infla-tion without food was closer to the data actually recorded. In March an estimate was given for average inflation without food for the second quarter of 5.0%, very close indeed to the 5.1% actually observed. In the preceding report an inflation forecast for food for the second quarter

Figure 64
Annual inflation for consumers
(Percentage)



Source: National Administative Department of Statistics (DANE), Central Bank calculations.

Table 11
Inflation indicators
(Annual percentage variations)

	Dec-01	Mar-02	Jun-02
I. IPC	7.6	5.9	6.2
Food	10.5	7.2	9.2
Housing	4.3	3.8	4.2
Clothing	2.6	2.2	1.1
Health	10.9	9.3	9.7
Education	10.2	9.3	6.7
Culture and entertainment	7.1	7.0	5.9
Transportation	8.9	5.8	5.0
Various expenses	7.6	6.7	6.8
II. Basic inflation 1/	6.7	5.6	5.3
IPC without food	6.5	5.3	5.0
Nucleus **2/**	7.4	6.0	5.9
IPC without primary food, fuel and public utilities	6.1	5.4	5.1
III.IPP	6.9	3.6	2.9
According to use or economic end			
Intermediate consumption	5.8	2.9	1.2
Final consumption	8.5	4.3	4.6
Capital goods	5.7	2.4	2.8
Construction materials	7.4	5.0	5.0
According to origin			
Produced and consumed	7.7	4.4	3.4
Imported	4.6	0.8	1.6
Exporteds **3/**	(7.9)	(7.1)	(2.4)
According to industrial origin (CIIU)			
Agric, Forestry, Fishing	7.6	2.4	2.1
Mining	(1.3)	1.7	2.1
Manufacturing industry	7.0	3.9	3.2

1/ Corresponds to the average of the three basic inflation indicators calculated by the Central Bank.

2/ 20% of the weighted average with those items are excluded from IPC, which registered the greatest volatility of prices between January, 1990 and April, 1999.

3/ The total IPP does not include exported goods, its calculation is done with the weighted sum of produced, consumed and imported goods.

Source: Central Bank, SGEE. Tabulation of IPP and IPC, DANE.

was given as 7.2%, compared to the 7.8% actually observed. This underestimation of food inflation was due to the early comeback in potato prices in May and June.

As seen in Figure 64, annual inflation dropped drastically during the first four months of the year, and then turned up again in May and June. Basically, this turn around can be explained by the even sharper adjustment in food price inflation, which rose from 7.2% in March to 9.2% in June. According to a survey of expectations carried out by the Central Bank, private agents anticipated the rise in prices during the second quarter with great precision, by estimating in March that a jump in inflation would occur from 5.9% to 6.2%, as in fact occurred.

Inflation during the first semester of the year (4.8%), represents 80% fulfillment of the goal established for 2002. This percentage fulfillment of the goal was greater than the accumulated inflation for the first six months of last year, which was 77%. If the inflation goal is to be met in 2002, accumulated inflation for the second semester of this year must necessarily be lower than the accumulated figure for the second semester of last year (1.4%), in keeping with the narrow margin needed for the second semester of this year in order to fulfill the goal.

For the third quarter inflation is expected to stay at levels near those observed in June or perhaps slightly above, due to the greater adjustment foreseen in food prices, while for the fourth quarter a slight drop is foreseen, which would allow inflation to end up near the 5% goal set.

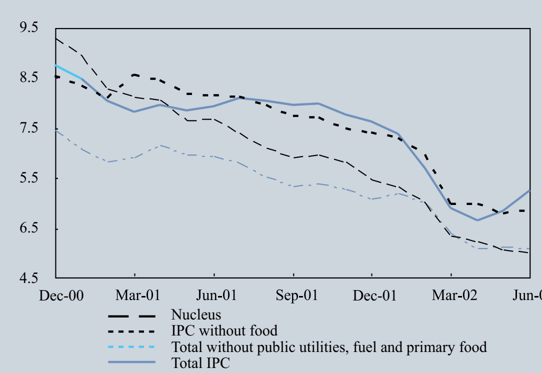
B. Basic inflation

In June, the average of the basic inflation measurements used by the SGEE (consumer price index (IPC) without food, the inflationary nucleus, and the IPC without primary food, fuel and public utilities) was 5.3%, that is, 0.3 percentage points below that of March, 2002 and 2.3 percentage points below that of June, 2001. In the last three months, the indicators that dropped the most were inflation without food and IPC without primary food, fuel and public utilities, each of which fell by 0.3 percentage points. On the other hand, nucleus inflation dropped 0.1 percentage points as compared to last March. At the end of the first semester of the year, all basic inflation indicators show a lower level than observed inflation and the inflation goal for the year 2002 (Table 11 and Figure 65).

Analysis of the principal inflation components without food, shows that basic inflation has been favored by the positive performance in prices of groups such as clothing, education, entertainment and transportation, the inflation of which has maintained the same level or followed a declining curve throughout the second quarter (Figure 66). To the contrary, the recent annual adjustments in the IPC for housing and health, for recent months, have not allowed basic inflation to be lower.

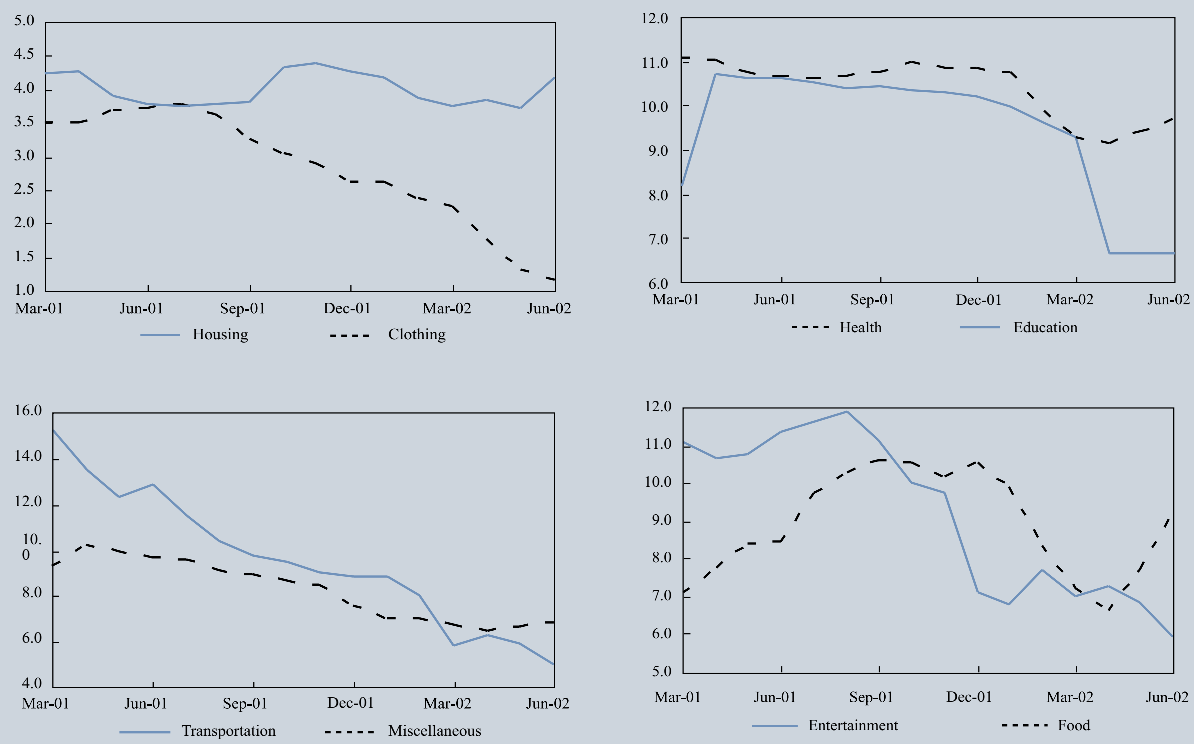
Without the housing group there are two contra-dictory behaviors. The first corresponds to the expenses of housing occupation (rents), the inflation level of which was moderate as of June (2.9%), but with a rising tendency as of mid-

Figure 65
Evolution of total and basic annual inflation
(Percentage)



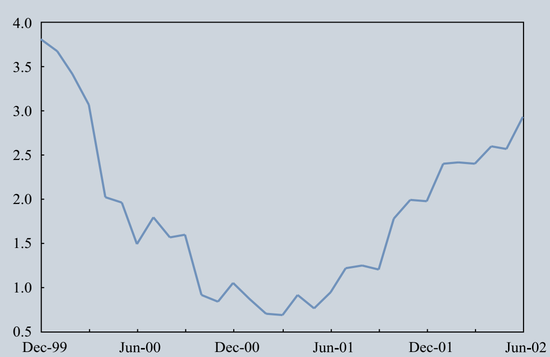
Source: DANE, calculations by Central Bank.

Figure 66
Annual IPC inflation by groups
(Percentage)



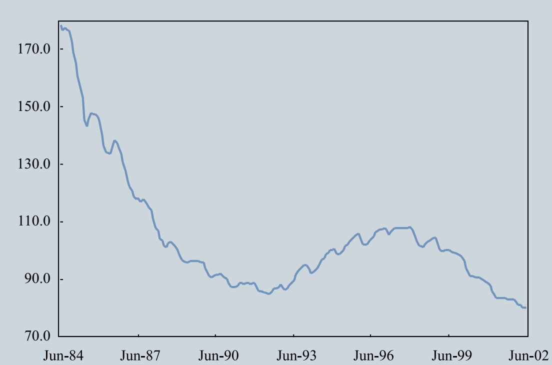
Source: DANE, calculations by the Central Bank

Figure 67
IPC, housing occupation expenses
(Annual percentage variations)



Source: DANE, Central Bank calculations.

Figure 68
Relative rent prices
1984: 06-2002:06
(December, 1998 = 100)



Source: Central Bank, SGEE.

year 2001 (Figure 67). The price of rent has characteristically exhibited relatively long cycles without any notable change in relative prices for the time being, which could be a sign of increases near or higher than observed inflation (Figure 68). Recovery of real price will be gradual and it is expected that in the medium term it will not reach levels observed at mid-year during the

90s. For the time being, it is expected that inflation in this housing component will continue with prices on the rise until the end of the year without exceeding the 6% goal.

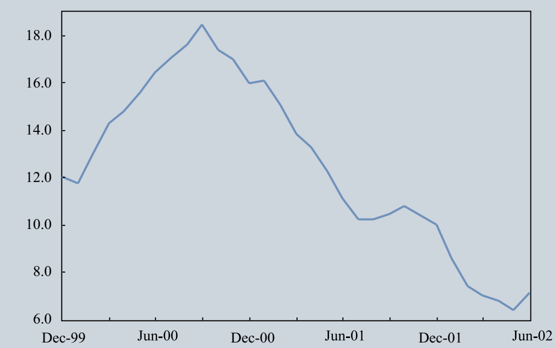
On the other hand, since the end of last year, the other housing group component, that is, "public utilities and others", has shown significant deceleration, although in June it experienced a small comeback (Figure 69). It is expected that its annual growth will close near the inflation goal by year's end, given that authorized increases by some service providers are tied to inflation for the year to date.

In the case of health, the medicine component is responsible for the recovery of prices observed in the last few months in this group (Figure 70). This subgroup, usually sensitive to the exchange rate, reduced its annual inflation in the first quarter of the year, partly as a consequence of the revaluation of the peso. However, in the months of May and June it has again showed annual inflation on the rise, reflecting greater devaluation in the exchange rate over the last few months. The other component of health, professional services, continued to show declining inflation rate in the second quarter. For the second half of the year it is expected that this group will converge on the inflation target of 6%.

The declining tendency that has been shown over several months in basic inflation is the consequence of the joint influence of several factors. On the one hand, the gap between negative product and the low level of utilization of installed capacity by industry throughout the second semester, are signs of slow orders and weak demand. Given that for this year moderate growth in GDP was expected, about 1.5%, there should not be any significant demand pressure that will impede achievement of the inflation target. Additionally, the proxy of marketing margins (IPC without utilities/producer price index (IPP) end consumption) shows that in the months of May and June, basic inflation was reduced, also, due to the lower perceived gains by intermediaries in the marketing chain for products traded in the economy. These lower marketing margins are the reflection of the weakness of internal demand (Figure 71).

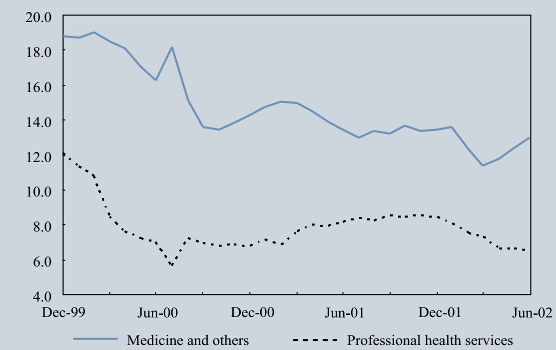
Another component that favors lower basic inflation are labor costs. To judge by the information on salary raises negotiated with the Ministry of Labor (see Chapter 1) inflationary pressure from salary increases have been significantly reduced. Likewise, the last survey on expectations by the Central Bank, carried out last April, showed that agents expected salary increases to be kept on a diminishing path.

FIGURE 69
IPC, PUBLIC UTILITIES AND OTHERS
(ANNUAL PERCENTAGE VARIATIONS)



Source: DANE, Central Bank calculations.

FIGURE 70
IPC, PROFESSIONAL HEALTH SERVICES, MEDICINE AND OTHERS
(ANNUAL PERCENTAGE VARIATIONS)



Source: DANE, Central Bank calculations.

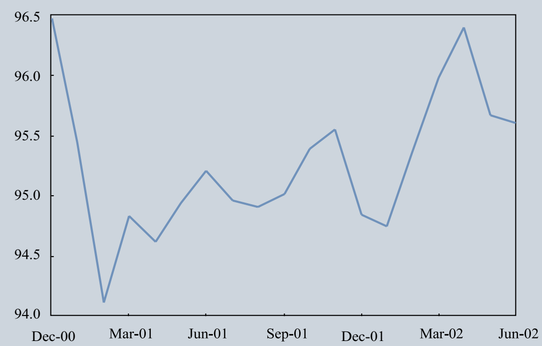
Last, the positive results currently obtained in basic inflation, also respond to the monetary policy adopted by the Board of Directors of the Central Bank in the past, which have been coherent with the inflation targets and the objective of stabilizing prices in the long run. This has gained the Bank credibility and has managed to significantly reduce agents' inflation expectations, as shown by the fact that the indexed component of inflation has even been adjusted to levels below the inflation goal in recent years.[9] (Figure 72).

Recently a new upward factor appeared in basic inflation, the non-labor costs captured by IPP inflation of imports. After having dropped for five consecutive months, they showed a rise recently during the months of May and June. This behavior is associated with devaluation in the exchange rate that began to be transferred in the last two months, both to producer inflation and even not as clearly to consumer inflation (Figure 73). The low sensitivity that consumer inflation now shows to positive adjustments in the exchange rate may be due to a reduction in marketing margins that compensated for higher costs due to depreciation in the exchange rate. Additionally, the greater devaluation of the peso could be compensated by lower international inflation, and international price stability, a reflection itself of low growth rates in the U.S., Europe and Asia.

C. Temporary inflation

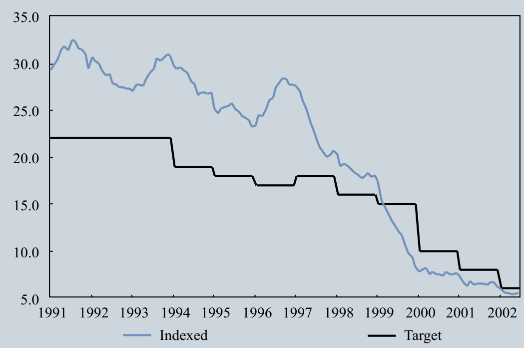
Food inflation that had decreased during the entire first quarter of this year, made a comeback beginning in April, becoming the principal source of greater inflation. At the close of the

FIGURE 71
RELATIVE PRICES
IPC WITHOUT UTILITIES/IPP FINAL CONSUMPTION
(DECEMBER, 1998 = 100)



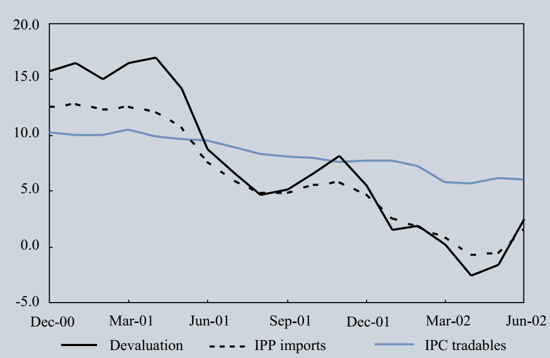
Source: Central Bank, SGEE.

FIGURE 72
IPC OF INDEXED ITEMS AND INFLATION TARGET
1991:01 - 2002:06
(ANNUAL PERCENTAGE VARIATIONS)



Source: DANE, Central Bank calculations.

FIGURE 73
EVOLUTION OF IPC AND IPP
(ANNUAL PERCENTAGE VARIATIONS)



Source: DANE, continuous household survey (ECH).

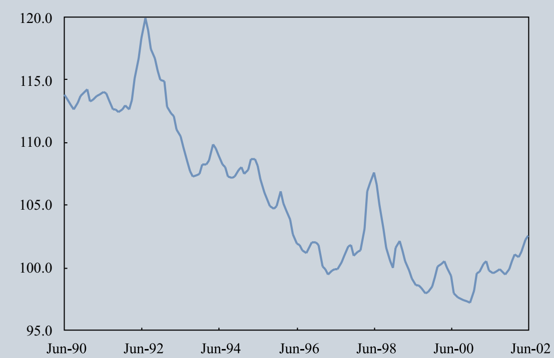
9 The IPC goods indexed are those whose category depends basically on past inflation. Public, transportation, education, real estate and financial services make up this component.

second quarter, food inflation was about 9.2%, two percentage points above that observed three months ago. This recovery, which had already been anticipated in the last inflation reports was the consequence of the increase in potato and meat prices, basically.

As previously commented in the March report, the encouraging performance of food during the first quarter is not likely to be seen for the rest of the year, due to three factors. First, because the level of relative prices for food is still quite low with respect to its historical average (Figure 74). Second, the phase of cattle retention should last at least until the end of 2002, which will lead to continually rising meat prices, above average inflation. Third, due to low potato production projected for the second semester of the year, a reflection of the low level adjustments in prices during the first semester of the year, which will affect decisions to increase planted areas at mid-year. To the foregoing, we must add additional inflationary pressure due to the effects of El Niño phenomenon, which according to the latest report by the U.S. Oceanography and Atmosphere Agency (NOAA), became stronger in May and June, and the fact that its presence during the second semester of the year and beginnings of 2003 is a fact. The Niño phenomenon will create negative effects on agricultural productivity (estimated at a fall of nearly 5.0% in agricultural yield, according to the Hydrology, Meteorology and Environmental Studies Institute, IDEAM) above all during the last quarter of the year.

Another factor that could impulse inflation, albeit temporarily, is the price of petroleum. As mentioned in the previous price report, a new source of inflationary pressure appeared during the first quarter, associated with increases in international oil prices. This rise in quotes on crude oil continued during the second quarter of the year, and according to the most recent appreciations

FIGURE 74
RELATIVE FOOD PRICES
(DECEMBER, 1998 = 100)



Source: Central Bank, SGEE.

from various agencies, such as the OPEC and International Energy Agency, the price of crude oil should remain stable or increase slightly toward the end of the year (see Chapter II). To the extent that the government is willing to transfer the rise in international oil prices to domestic prices for fuel, it can be expected there will be an acceleration in internal inflation on the order to 0.3 percentage points above an additional 10.0% growth in the internal price of gasoline, and of 1.4 percentage points over an increase of 10% in transportation.

Last, with the change of presidential administration, there may be in medium term a temporary shock upwards in inflation, associated with an eventual tax reform. If the value-added tax (IVA) becomes universal or if the rates are readjusted, inflation will shift upward. One exercise undertaken by the Central Bank in this sense on the input-product matrix, indicated that if the IVA tax were readjusted by one percentage point, inflation would increase by 0.81 percentage points. An increase in inflation brought about by an increase in indirect taxes would be in any case a temporary phenomenon, since it is not to be expected that there would be any accommodation by monetary policy.

Evaluation of some basic inflation indicators in Colombia

The distinction between supply and demand inflation is important for monetary policy decision-making to the extent that information is required about demand pressures in the economy in order to control inflation of a monetary nature, on which policy instruments may act.

Therefore, the consumer price index (IPC) with which inflation is calculated, is not always a good indicator for decision-making, since it simultaneously includes both supply and demand pressures. Changes in inflation can be the result of both excess demand, produced by excess liquidity, and factors outside this demand, related to disturbances in supply, which can induce important, although temporary changes. For this reason, most central banks, and the Central Bank is no exception, use alternative indicators to trace prices, such as basic inflation indicators that will filter the temporary effects caused by supply disturbances and appropriately measure variations in prices associated with monetary policy.

Among the various basic inflation indicators recognized in economic literature1, the Central Bank has been mainly using those that measure the generalized component of inflation, that is, the one which simultaneously, persistently and to the same degree affects a broad range of goods included in the IPC basket. This type of measurement is obtained by suing an estimate of a reduced price index, excluding those goods whose price movements often differ from the rest of the general price trends.

Although the indicators used by the Bank seem to follow the long term tendency of inflation, recent inflation behavior and the importance of having some good basic inflation indicators make it necessary to carry out a new evaluation of both the indicators used, that is the 20 nucleus2, inflation without food, inflation without public utilities, fuel and primary food products, the mean cutoff at 10% and asymmetric mean 15-13, as well as new indicators, following the criteria used in a previous evaluation made for the period 1988:12-1998:103 (see Jaramillo, C.F. (1999)).

The main characteristics that any basic inflation indicator must have are4:i) less variability than the inflation measured by IPC, ii) an average level similar to observed inflation (avoiding it being systematically above or below the IPC inflation), iii) a close adjustment to persistent inflation, measured as the IPC softened inflation, iv) its capacity to predict future inflation, and v) its relationship to monetary aggregates.

This note summarizes the main results obtained from a broader evaluation, which is presently being prepared. The following table shows the main results of the five criteria used for the period December, 1989 to May, 2002. The "X" indicates that the indicator fulfilled the respective criteria. In general terms, the indicators showing less variability5 than the one for inflation measured by the IPC are exclusion indicators, except inflation without state services, the various nuclei and the Hodrick-Prescott filter. The result for the latter was to expected given the very nature of its calculation methodology. With respect to the bias criteria, measured by comparing historical averages of each one of the basic inflation measurements with average observed inflation, it was found that both the mean cutoff at 10% and the new 10 nucleus and the new 20 nucleus showed a mean that is not significantly different from IPC inflation.

With respect to the softening, indicators that adjusted the best to IPC inflation are: the inflation without primary food and the nuclei, except the new 40 nucleus, as well as the Hodrick-Prescott filter, which showed better performance, as in the case of biases. The other indicators are far from softened inflation6. The results of total inflation prediction error at a 12 month horizon, indicate that under different alternative criteria, all the measurements considered without exception, predict total inflation better than it itself.

Summary of basic inflation indicator evaluation results (December, 1989 to may, 2002)

Indicator	Variability	Bias	Softening	Prediction capacity (12 months)	Relation to Monetary Aggregates	
					R-squared relation to M3	Money Price causality
SINALI	x			x	x	
SINEST				x	x	x
SINPRI	x		x	x	x	
SINEYP	x			x	x	
SINSPYP	x			x	x	
SINASPYP	x			x	x	
M10		x		x		x
M1513				x		x
20 Nucleus	x		x	x	x	x
New 10 nucleus	x	x	x	x		
New 20 nucleus	x	x	x	x	x	
New 30 nucleus	x		x	x	x	x
New 40 nucleus	x			x	x	x
HP144INF	x		x	x	x	

SINALI: inflation without food.
SINEST: inflation without state services.
SINPRI: inflation without primary food.
SINEYP: inflation without state services and without primary food.
SINSPYP: inflation without public utilities and without primary food.
SINASPYP: inflation without some public utilities, without fuel and without primary food.
M10: mean cutoff at 10%
M20: mean cutoff at 20%.
M1513: asymmetric mean cutoff at lower 15% and upper 13%.
20 Nucleus: inflation of the 20 nucleus using the period Dec/88 - April/99.
New 10 nucleus: inflation of the 10 nucleus using the period Dec/88-May/02.
New 20 nucleus: inflation of the 20 nucleus using the period Dec/88-May/02.
New 30 nucleus: inflation of the 30 nucleus using the period Dec/88-May/02.
New 40 nucleus: inflation of the 40 nucleus using the period Dec/88-May/02.
HP144INF: Hodrick-Prescott filter of total inflation, with constant softening 14400.

The results of the degree of adjustment (R-squared) of the regressions in which annual inflation is explained by lapses (24) of annual variation of the monetary aggregate, indicate that all the aggregates used (cash, base, adjusted base, M1, M2 and M3) explain better the different measurements of basic inflation than inflation measured by the IPC. Given that the monetary aggregate that best explains inflation is M3, the table reports the corresponding results for it, for which the three cutoff means and the new 10 nucleus show an equal or lower degree of adjustment than that obtained from IPC inflation. Another way to evaluate the relationship between the monetary aggregates and inflation is the causality tests of the Granger type, which in very few cases yielded the expected results, that is, monetary aggregate causes basic inflation, but not the opposite. The indicators that fulfill these criteria are: inflation without state services, the mean cutoff at 10%, asymmetric mean, 20 nucleus and the new 30 and 40 nuclei.

In conclusion and taking into account the six criteria, the best indicators are the old 20 nucleus and the new 20 and 30 nuclei, which fulfill five of the six criteria evaluated. In order, the following that fulfill four of the six criteria are inflation without primary, new 10 nucleus, new 40 nucleus and the Hodrick-Prescott filter.

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[1] For further detail, see Jaramillo, C.F. (1998). "La inflación básica en Colombia: evaluación de indicadores alternativos", in *Ensayos sobre política económica*, No, 34, December, Central Bank, pp. 5-38.

[2] This refers to inflation in the IPC basket, alter eliminating the most volatile goods and services corresponding to 20% of the weighted basket during the Dec.88 to April 99 period.

[3] Jaramillo, *Op. Cit.*

[4] *Ibid.* (1999).

[5] Variability is measured by the root mean square error (RMSE), of basic inflation with respect to its Hodrick and Prescott filter.

[6] Measured with the same four alternatives used in the referente work.

IV

Inflation Predictions

Results of the exercise of predicting inflation carried out by the Central Bank with figures observed for prices in June, 2002 are given below. These predictions take into account the views of the technical team of the Bank on the present day economic situation that has been explained in preceding chapters. The results are shown for one to eight quarters ahead for total inflation, basic inflation (IPC without food) and food inflation. In addition to the predictions, this section gives a summary of the main assumptions used, with emphasis on the form in which they changed as compared to the same informa-tion in the March report. Finally, this chapter also identifies the risks to be confronted by inflation reduction strategy in coming quarters.

A. Assumptions underlying inflation predictions

Colombian economic growth during the first quarter of the year was weaker than the predicted, even after eliminating the Easter Week phenomenon. This lesser dynamism is attributable both to the poor performance of external demand, because of problems faced by non-traditional exports in U.S and Venezuelan markets, and a weak internal demand. Presently, it is likely that one of these negative tendencies will become more intense, given that growth prospects for the remainder of the year have been reduced in this report as compared to those presented in the March report.

1. The foreign context

On the foreign front, the last few months have seen some deterioration in growth possibilities for the world economy as a consequence of problems related to confidence affecting U.S. stock markets. These problems with their roots in the continual news on alterations in the financial balances of large corporations have caused the main stock indices to drop considerably.

The consequences of this situation for U.S. economic growth stem from two main sources. On the one hand, to the extent that these practices implied significant over estimates of profit margins for the companies involved could contribute to an overly optimistic panorama of corporate investment profitability in the last few years in the U.S. A realistic reevaluation of balances, ostensibly reducing profit margins would mean that there are sizeable surpluses of investment in several sectors of the American economy, thereby possibly leading to the postponement of projects. This would have a direct effect on the growth of the United States through less expenditure in investment.

On the other hand, the drop in stock indices can mean significant losses in the wealth of a notable group of U.S. consumers. This situation could affect, not only the confidence of consumers but also their expenditure capacity, which would also affect demand for consumer goods and weaken economic growth.

As a result of this decline in stock markets, uncertainty about future performance of the U.S. and world economies has loomed large. Several analysts consider that this situation will be reflected in a slight deceleration in the growth of the U.S. economy during the second half of the year, as compared to the predictions of three months ago, without major consequences on world growth. Other more pessimistic analysts, however, consider that the problems of confidence are serious enough to completely frustrate the recovery of the U.S. economy, seriously weakening growth of other developed and emerging economies.

For this report, expansion of the U.S. economy for 2002 is still foreseen. Nevertheless, it is considered that growth for the second semester will suffer a little with respect to the predictions of three months ago, due to these problems of confidence generated by the financial scandals of the last few months.

For the Colombian economy, the reduction in the growth prospects of the United States can mean less demand for non-traditional[10] exports toward that market and lower export prices for products of primary origin, such as coffee, banana and oil.[11] The effect this change in the international scenario will have on growth and inflation is complex. On the one hand, fewer exports reduce the possibilities of growth for the country and, through the demand channel decrease inflationary pressures. This effect on inflation is reinforced by the decrease in the dollar price of goods imported by Colombia, which is usually accompanied by lower global growth. Meanwhile, net deterioration in the trade balance and less exchange supply resulting from it tends to depreciate the exchange rate, which in turn could give rise to pressures on costs and domestic prices, depending on demand conditions and the degree of competitiveness of internal markets.

Additionally, a lower growth of the United States is usually accompanied by a more lax monetary policy in that country. Under current conditions, this could mean that the Federal Reserve would delay even more an increase in its reference rates, thereby allowing market rates to remain at historically low rates for longer than predicted three months ago. This circumstance could have consequences for the Colombian economy if it facilitates a greater net flow of capital toward the region and toward Colombia in particular. This movement could compensate for devaluation effects of the deterioration in the trade balance mentioned above.

Last, given the extensive financing needs of the Colombian government over the next year, lower interest rates would decrease the pressures on the public budget for debt servicing, improving the country's payment capacity and allowing greater stability in the country's risk premium. In the short and medium run, the result could be greater stability in the exchange rate and less pressure on inflation through costs.

Aside from greater uncertainty present in the estimates for U.S. growth, other problems have arisen on the foreign front that could alter the economic scene for Colombia. One of these is the greater risk with which the financial markets are viewing investment in Latin America as a result of the political events in Brazil and the possibility that it will affect the country's capacity to pay its foreign debt. This situation added to

[10] As mentioned in Chapter 1, the growth possibilities for non-traditional Colombian exports to the U.S. has been limited this year. The main reason lies in the loss of competitiveness of our products in this market with respect to those from Central American and Caribbean countries, which enjoy preferential tariffs. For this reason, it is considered that one requirement for Colombia to recover this market is to receive final approval for ATPA, under reasonably favorable conditions.

[11] The effect of lower U.S. demand on the price of oil could be counteracted by the reduction in crude oil inventories and the uncertainty reigning in the Middle East (see Chapter II).

that of the Argentine crisis has threatened to infect several economies in the region as seen in the greater devaluation they have seen in their currencies, accompanied by an increase in the premiums on sovereign risk. In the case of Colombia, a permanent increase in the risk premium would reduce the net flow of capital into the country, reducing the expenditure on investment and consumption and affecting devaluation.

Finally, with respect to the performance of the Venezuelan economy, the previous report had already foreseen a significant deterioration in performance due to a number of factors, including the unstable political situation. Nevertheless, taking into account that the latest figures available for the first quarter of the year show an even greater contraction than had been foreseen, this report has again revised the drop in growth in our neighboring country, in line with the downward correction made by the majority of analysts (for greater detail, see chapter II).

The weakening of the economy of our neighboring country, together with the considerable devaluation of the bolivar, will have important effects on non-traditional exports and industrial performance. Presently, it does not seem likely that the economic panorama in Venezuela will improve quickly. During the first semester of the year a reduction in the growth of exportation of non-traditional Colombian exports to that market had already become evident. Since it is not likely that the economic situation in Venezuela will improve quickly, it is expected that the weakening in exports to that country will become more acute in the second semester, and there is no way to discard the possibility of extending into the beginnings of next year.

2. The internal context

In the last few months, some of the assumptions incorporated into inflation projections presented in the March report have changed slightly. The first of these has to do with the size of fiscal adjustment and its effect on economic growth in the short run.

The results of growth by March showed that the impact of the fiscal adjustment strategy on public investment was greater than initially estimated. By trying to incorporate this behavior into this report it is seen that in the short run GDP growth will suffer from the cutback in public investment to a greater extent than was anticipated in the March report.

With respect to the exchange rate, this report continues to assume a central scenario in which the ITCR will not vary much from the average level shown over the last year and a half. However, the behavior of the exchange market over the last few seeks suggests that expectations for nominal devaluation might have increased due to mainly external events. This greater uncertainty will negatively affect growth, by striking a blow to the expenditure intentions of investors and consumers by increasing disbursements for foreign debt servicing.

The effect on inflation of greater devaluation, however, will be mixed. On the one hand, it will create greater inflationary pressure through the cost channel. But, on the other, it will exert deflationary pressure if it reduces prospects for economic growth based on the reasons already indicated.

It should be said, however, that a shift of greater devaluation toward prices through the cost channel could also be greater now than that contemplated in the models being employed by the SGEE. Estimates made by these models are strongly influenced by the events of 1997 and 1999, when the devaluation recorded in those years was passed along to prices in a very partial way, thanks to the fact that companies were able to assimilate the increases in cost, sacrificing profit. Currently, however, companies have smaller profit margins, which leads them to pass along more quickly and completely the higher costs resulting from devaluation. One sign of this could be the important increase recorded in negotiable goods like medicine, in the last year up until June, in spite of moderate devaluation during that period. Calculations done by SGEE show that further high devaluation for 2002 and 2003 could complicate the fulfillment of the inflation goal for the coming years.

Growth during the second half of the year will continue to be limited by problems of confidence among investors and consumers. Just as was supposed in the March report, this one foresees that the credit channels will continue to be half-way operative. To date, however, the political panorama is somewhat clearer than three months ago. This has probably improved the sentiments in the markets, as reflected in recovery of the confidence index of consumers in May and June and the positive performance of the stock exchange (for details, see chapter I). Likewise, it is estimated that the low intervention interest rates of the Central Bank will continue to allow reductions in active rates that stimulate expenditure in consumption and investment.

Finally, on the domestic front the appearance of the Niño phenomenon is still expected with moderate intensity, but this time with 100% probability (the previous report had prognosticated a probability of 75%). Presently, its appearance has practically been confirmed by the principal meteorological agencies around the world.[12] As anticipated, this could have an effect on food prices, by reducing the productivity of crops and providing a negative incentive to planting. In addition to the Niño phenomenon, other inflationary pressures are expected to continue appearing through the prices of meat, given that supply will continue to be limited by the presence of the cattle retention cycle.

[12] In a comunique dated July 11, 2002, the US Oceanography and Atmospheric Agency (NOAA) confirmed the presence of a Niño phenomenon that would develop toward the end of 2002 and beginnings of 2003.

B. Risks

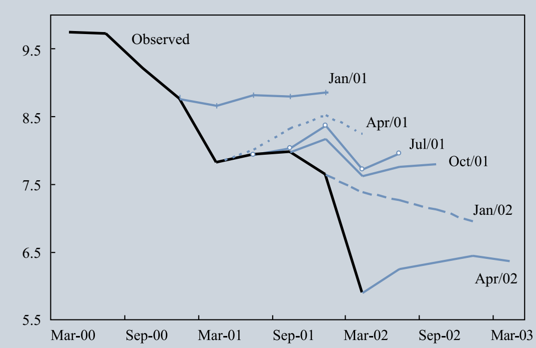
In June, the uncertainty over the future performance of the world economy increased considerable due to the relapse of stock markets and of the greater perception of risk with respect to Latin American markets. The effect of an adverse development on these two fronts on the Colombia economy is far from being clear and could very well exceed predictions in this price report.

The possible impact on devaluation expectations of a more complicated Brazilian situation as far as servicing their foreign debt is concerned is especially worrisome. The possibility that nervousness about markets will extend to Colombia due to the contagion effect is not to be underestimated, particularly given the size and recent evolution of the country's debt and the not very favorable scenario faced by income from exports in the coming months. Acceleration of devaluation will have some effect on the inflation observed and on inflation expectations, additional to that contemplated in the central forecasts for inflation given below.

Just as in the March report, primary food price behavior continues to be a source of uncertainty given the high volatility of the supply and its sensitivity to climatic conditions. At the latter level, even though forecasts contemplate an increase in inflation for food as a result of a moderate Niño phenomenon, the intensity of the event is still uncertain. A very intense phenomenon would probably induce a greater increase in food prices than that forecast in this report. The opposite would occur if the intensity of the phenomenon is low.

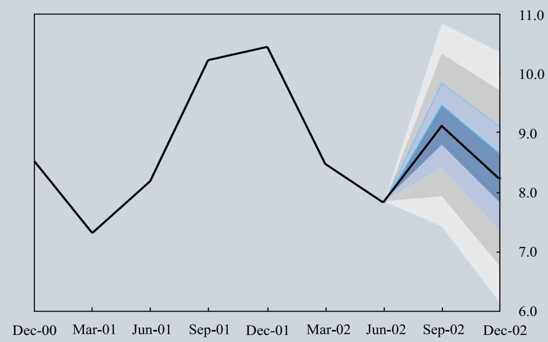
Last, another risk to consider this time has to do with inflation expectations. The last survey undertaken by the Bank of the Republic shows a significant reduction in inflation expectations for December, 2002 and the first quarter of 2003

Figure 75
Observed inflation and evolution of inflation expectations
(Annual inflation)



Source: Central Bank. Expectations Survey, April, 2001.

Figure 76
Inflation forecast for food for the year 2002
(Central scenario and risk balance)



Source: Central Bank.

Period	90%	50%	25%	Central	25%	50%	90%
Mar-02	8.5	8.5	8.5	8.5	8.5	8.5	8.5
Jun-02	7.8	7.8	7.8	7.8	7.8	7.8	7.8
Sep-02	7.4	8.4	8.8	9.1	9.4	9.8	10.8
Dec-02	6.1	7.4	7.8	8.2	8.6	9.1	10.3

Note: Forecasts for the year 2002 correspond to the short-term forecast, based on monthly models, calculated by the SGEE. The 2003 figures are generated by the transmission mechanisms model, based on short-term forecasts.

as compared to the records for the two previous quarters. In April, agents surveyed expected inflation for consumers in December of 6.4%, slightly higher than the goal for this year, but lower than that expected three months ago (7.0%) (Figure 75). Nevertheless, these surveys did not include the reaction of the agents surveyed as a consequence of the increased inflation in May and June. For the third and fourth quarters there could be new peaks pushed by increases in food prices. In spite of the initially temporary nature of these increases, the effect could be permanent if it affects inflation expectations, stimulating price adjustments and higher salaries than the goal. This risk, which must not be underestimated, given the numerous indexing mechanisms existing in Colombia is not fully captured in the central SGEE forecast.

C. Inflation Forecast

At this time, inflation forecasts for food, non food and total showed upward adjustments in comparison to March. In the case of food, the Central Bank forecast average inflation for the fourth quarter of this year of 8.2%, slightly higher than that forecast three months ago (Figure 76). The small increase in the path of central food inflation for the rest of the year is the result of correcting the underestimate made by the Central Bank's forecast for June and was due mainly to increases in the prices of some primary foodstuffs, such as potato, which had not been fully foreseen. At this time, everything seems to indicate that what happened at the end of the second quarter was an anticipation of increases expected by the Bank for the third quarter, without this implying substantial changes in the current situation of food prices.

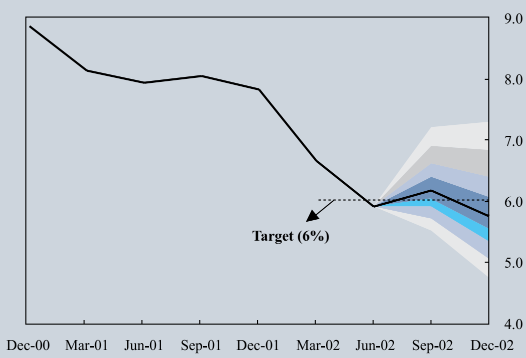
The central path for food inflation projected by the Bank, presupposes a moderate Niño phenomenon. However, recognizing the fact that it is equally probable that there will be a Niño phenomenon of greater intensity than foreseen, the risk balance that accompanied the central path has been defined without bias.

With respect to basic inflation without food, forecasts this time underwent a significant correction upward for all points in time. For the average of the fourth quarter of 2002, the central path of the forecast indicates that inflation without food would be 4.7%, that is, higher than the expectations given in the March report by 0,9 percentage points. For the fourth quarter, 2003 average, the current forecast from the transmission mechanisms model (MMT) is 4.8%, that is, 1.3 percentage points above that obtained in March (Figure 77). At the same time, the combination of forecasts shows projected inflation of 4.3% for June, 2003.

The increase in the basic inflation forecasts of the MMT are due to re-estimates carried out based on recent information and the change in the estimate for the product gap due to a reduction in the level and growth rate of potential product. Forecasts presented in March were done under the assumption of improved investment performance, both private and public, which was corrected downward, implying a smaller capital stock for this year and reducing the economy's production capacity as a whole. The correction downward for potential GDP was greater than the decrease in the new growth forecast by the government, creating a reduction in the product gap with respect to that contemplated in the previous report.

The risk balance, which accompanies the forecast presented in this report, is skewed upward. The

Figure 77
Inflation forecast for the consumer for the year 2002
(Central scenario and risk balance)

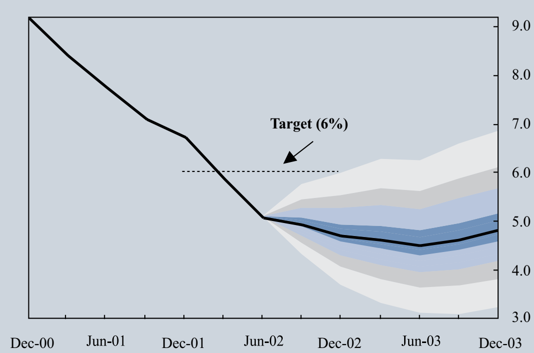


Source: Central Bank.

Period	90%	50%	25%	Central	25%	50%	90%
Mar-02	6.7	6.7	6.7	6.7	6.7	6.7	6.7
Jun-02	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Sep-02	5.5	5.9	6.0	6.2	6.4	6.6	7.2
Dec-02	4.7	5.3	5.6	5.8	6.1	6.4	7.3

Note: Forecasts for the year 2002 correspond to the short term forecast, based on monthly models, calculated by the SGEE. The 2003 figures are generated by the transmission mechanisms model, based on short term forecasts.

Figure 78
Inflation forecast without food for the years 2002 and 2003
(Central scenario and risk balance)



Source: Central Bank.

Period	90%	50%	25%	Central	25%	50%	90%
Mar-02	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Jun-02	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Sep-02	4.3	4.7	4.8	5.0	5.1	5.3	5.7
Dec-02	3.7	4.3	4.5	4.7	5.0	5.3	6.0
Mar-03	3.3	4.1	4.4	**4.6**	5.0	5.3	6.3
Jun-03	3.1	3.9	4.3	4.5	4.9	5.2	6.2
Sep-03	3.1	4.0	4.3	4.7	5.0	5.5	6.6
Dec-03	3.2	4.2	4.5	4.8	5.2	5.7	6.8

Note: Forecasts for the year 2002 correspond to the short-term forecast, based on monthly models, calculated by the SGEE. The 2003 figures are generated by the transmission mechanisms model, based on short-term forecasts.

fundamental reasons for this are the risks that have been identified in the foreign sector; in particular, recent volatility recorded in capital markets and Latin American currencies, reduced demand expected in Venezuela and the fall in U.S. stock markets and their possible effect on growth. Were they to become a fact, these aspects could imply a significant acceleration in devaluation, which would be seen as greater inflationary pressure over the next year and a half.

Finally, with the information on the second quarter and taking into account the higher forecasts for food and non-food inflation, the central path projected by the Bank indicates that in the fourth quarter of 2002, total inflation for the consumer will be at about 5.8%, 0.8 percentage points above the forecast presented in the March report, but below the target for this year. Taking into account the risks faced by basic or non-food inflation, the central forecast is also skewed upward (Figure 78).

Box 2

Forecasts by local and foreign analysts of the principal macroeconomic variables

The most recent forecasts made by local and foreign analysts for the principals variables in the Colombia economy for 2002 and 2003 are reviewed herein. It must be taken into account that when forecasts by local analysts were received they already had the official inflation figure for the second quarter of 2002.

Forecasts for 2002

Table 1 gives details for the forecasts made for the year 2002. The most important change in the forecast of local analysts, in the last quarter, corresponds to expected inflation. An average of three months ago, local analysts expected that inflation would be 6.6% for this year. After seeing the observed inflation for the first quarter, the expected figure on the average has been reduced by 0.4 percentage points, hitting 6.2&. It is worth noting that three of the five analysts are forecasting levels of inflation compatible with the target of 6% for this year, which indicates the amount of credibility that inflation targets as established annually by the Central Bank have gained.

Along with inflation, economic growth was another of the variables with a forecast showing greater variation with respect to the March report. On this occasion, the local analysts incorporated into their forecasts, the deceleration of the economy in the first quarter of the year and the new growth goal set by the government. Therefore, local analysts estimate GDP growth of about 1.4%, a lower level by 0.6 percentage points than that expected three months ago. The new growth forecast is very close to the new goal set by the government of 1.5%.

In accordance with these lower inflation and economic growth expectations, on the average, local analysts expect lower interest rates for the rest of the year. The forecast recorded a drop of 150 basic points, with the reduction of the nominal DTF expected three months ago from 11.2% to 9.7%. This lower prediction is tied not only to inflation behavior, but also to expansive monetary policy observed during the first semester of the year.

Table 1
Forecasts for the principal macroeconomic variables for 2002

	Forecast date	Real GDP growth %	IPC inflation %	Nominal exchange rate	Nominal DTF %	Deficit (% GDP) Fiscal[1/]	Current Acct.	Unemployment rate %
Local Analysts								
Diners Magazine	12-Jul-02	1.0	6.0	2.566	9.0	(3.5)	(2.5)	16.5
Suvalor-Corfinsura	12-Jul-02	1.1	5.7	2.456	9.0	(3.0)	(3.2)	n.a.
Corfivalle	02-Jul-02	1.7	6.4	2.486	9.7	(3.3)	(3.0)	17.0
ANIF	11-Jul-02	1.5	6.0	2.475	10.0	(3.3)	(3.2)	16.3
Fedesarrollo	15-Jul-02	1.7	7.0	2.579	10.7	(3.4)	(2.7)	16.7
Average		**1.4**	**6.2**	**2.512**	**9.7**	**(3.3)**	**(2.9)**	**16.6**
Foreign analysts [2/]								
Goldman Sachs	28-Jun-02	1.3	7.0	2.450		(3.0)	(2.0)	
IDEA global	17-Jun-02	1.5	5.5	2.415		(2.9)	(2.4)	
J.P. Morgan	06-Jun-02	2.0	6.5	n.d.		(3.0)	(2.0)	
ABN Amro Bank	12-Jun-02	2.0	8.0	2.414		(2.6)	(3.0)	
Salomon smith Barney	22-Apr-02	2.7	5.8	2.435		(2.9)	(3.1)	
Deutsche Bank	13-Jun-02	1.5	6.5	2.399		(4.8)	(2.3)	
Merrill Lynch	21-Jun-02	2.2	6.5	2.525		(3.0)	(3.0)	
Average		**1.9**	**6.5**	**2.440**		**(2.9)**	**(2.5)**	

n. a. not available

1/ Calculations of average fiscal deficit do not include Deutsche Bank forecasts since they refer to Central Goverment deficit and not to non-financial public sector deficit.

2/ Report "Como nos ven afuera?", SMT, June 28, 2002.

Nominal exchange rate was another macroeconomic variable for which two of the local analysts noticeably modified their forecasts compared to the last inflation report, thereby influencing the average of forecasts. In this way, devaluation forecasts have been modified by the performance of the exchange rate during the second quarter.

Forecasts made by foreign analysts, with the exception of expected inflation, do not significantly vary with respect to those presented in the first quarter of 2002. In the case of inflation, the average of forecasts was 0.4 percentage points lower than that presented last March. The lower inflation expectations can be explained largely due to the positive behavior this variable recorded during the first semester of the year.

Forecasts for 2003

In Table 2, details of forecasts for the year 2003 are given. The average forecast for inflation from local analysts increased by 0.2 percentage points (6.2%), while forecasts by foreign analysts decreased to the same degree (5.8%).

With respect to economic growth, both local analysts (2.3%) and foreign ones (3.2%) expect improved performance in 2003. However, the forecast by local analysts is noticeably lower than the one presented in the previous report (3.0%), reflecting the uncertainty that exists about the unwinding of current foreign events and their effects.

As regards the exchange rate for the year 2003, devaluation expectations by the local analysts were modified downward compared to the previous report. Local analysts expect a nominal devaluation of 6.4% for 2003, 1.3 percentage points less that that published in the March report. On the other hand, the foreign analysts did not modify their expected devaluation for the year 2003.

Finally, in the area of fiscal deficit, local analysts foresee deterioration in public finances of 0.4 percentage points comparing estimated deficit in the first quarter of 2002 (-2.9%) with estimated deficit this quarter (-3.3%).

Table 2
Forecasts of the principal macroeconomic variables for 2003

	Forecast date	Real GDP growth %	IPC inflation %	Nominal exchange rate	Nominal DTF %	Deficit (% GDP) Fiscal[1/]	Current Acct.	Unemployment rate %
Local Analysts								
Diners Magazine	12-Jul-02	2.2	6.0	2.750	12.0	(4.0)	(3.6)	16.0
Suvalor-Corfinsura [2/]	12-Jul-02	2.1	5.4	2.600	9.9	(2.1)	(3.5)	n.a.
Corfivalle	02-Jul-02	2.5	7.0	2.583	10.2	(3.3)	(3.0)	16.0
ANIF [3/]	11-Jul-02	2.5	5.5	2.658	11.0	(3.6)	(3.4)	16.0
Fedesarrollo	15-Jul-02	2.4	7.0	2.771	10.0	(3.4)	(2.2)	n.a.
Average		**2.3**	**6.2**	**2.672**	**10.6**	**(3.3)**	**(3.1)**	**16.0**
Foreign analysts [4/]								
Goldman Sachs	28-Jun-02	3.0	5.0	2.534		(2.5)	(2.0)	
IDEA global	17-Jun-02	3.5	5.0	2.560		(2.3)	(2.9)	
J. P. Morgan	06-Jun-02	3.1	6.0	n. d.		(2.5)	(2.3)	
ABN Amro Bank	12-Jun-02	3.0	8.0	2.558		(2.5)	(2.6)	
Salomon Smith Barney	22-Apr-02	3.2	5.3	2.577		(2.4)	(3.3)	
Deutsche Bank	13-Jun-02	3.2	5.0	2.543		(4.1)	(3.6)	
Merrill Lynch	21-Jun-02	3.5	6.0	2.650		(2.8)	(3.2)	
Average		**3.2**	**5.8**	**2.570**		**(2.5)**	**(2.8)**	

n. a. not available
1/ Calculations of average fiscal deficit do not include Deutsche Bank forecasts since they refer to Central Government deficit and not to non-financial public sector deficit.
2/ Forecast of fiscal deficit by Su Valor for 2003 implies a new tax reform.
3/ Forecast of fiscal deficit by ANIF for 2003 assumes no tax reform.
4/ Report "Como nos ven afuera?", SMT, June 28, 2002.

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