Inflation report

December 2002

Banco de la República

ISNN-1657-7973

Presentation, summary and conclusions

✠ Annual inflation for the consumer in December was 6.99%, that is 0.99 percentage points higher than inflation recorded for the previous quarter, but 0.6 percentage points lower than in December, 2001. This annual inflation figure is the lowest for any December, since 1970 (when it registered 6.8%). Even though inflation at year end was higher than the target of 6%, this was largely due to the notable recovery in the price of potatoes, a transitory phenomenon. If the price of potatoes is disregarded, inflation to the consumer would be 6.1%.

✠ Discounting temporary impacts on prices, just as basic inflation is measured, the inflation target was met. The average of the three measurements for basic inflation, calculated by the Bank was 5.6%. Even thus, the three indicators rose with respect to the level reached in September, thereby breaking the downward tendency that had been exhibited by basic inflation since early 1999.

✠ The increase in consumer inflation in the last quarter can be explained by three causes. The most important has to do with a reduction in agricultural supply, especially in the case of some of the tubers, such as potato. This phenomenon caused inflation in foodstuffs to rise from 8.6% in September to 10.9% in December. Secondly, the high level of nominal devaluation recorded since mid-year, which began to spill over to consumer inflation as of October, provoked price hikes in traded goods, such as medicines, fuel, personal care items and some processed foods, among others. Lastly, the increase in several international prices, such as fuel, cereal, cacao, oil and fats brought about significant increases in gasoline and food prices, particularly.

✠ One sign of the pressures exerted by devaluation and international prices is the increase in the inflation of tradable goods. In December this indicator was at 6.6%, notably higher than the figure (5.4%) for September.

✠ With respect to food prices, it should be pointed out that they began to relax in December. This situation is, to a large extent, a reflection of the fall in the price of potatoes, which had an annual variation in December of 89.8% compared to 121% in November. It might be further added that information for the first two weeks in January from the agricultural sector price information system (SIPSA), data on the Producer Price Index (IPP) for November and December and the forecasts of the Assistant Manager for Economic Studies (SGEE) suggest, in general terms, an important correction in the drop in inflation for the perishable food category at the beginning of 2003, largely, based on a strong drop in the potato price.

✠ Annual producer inflation showed an important comeback during the last quarter, rising from 6.8% to 9.3%, as a consequence almost exclusively of devaluation, as shown by the increase in inflation of imports (from 4.6% to 16.0%). To judge by this important recovery and above all by the component mentioned, it is probable that there will continue to be a backlog of inflationary pressure on the CPI, which could manifest itself in coming months.

✠ Everything would seem to indicate that the economy continued to accelerate its growth rhythm during the second half of the year. The GDP figures for the third quarter indicate that the economy expanded at an annual rate of 1.9% during this period, above the rate reported for the first semester of the year, which was 1.4%. Compared to the second quarter, growth was lower, but as mentioned on previous occasions, growth for this period was high as a result of a low base for comparison in 2001, associated with a lesser number of working days.

✠ For the fourth quarter, various sector indicators, such as production and industrial sales, building licenses and surveys on commercial activity and tourism suggest that growth tendencies remained stable. Therefore, it can be expected that in the last months of 2002, economic growth accelerated a little and that growth for the entire year would slightly surpass the government's goal (1.6%).

✠ Just as was expected, growth in the second semester continued to be driven by domestic private demand, basically by household consumption and by investment in buildings. On the other hand, external demand has been a source of contraction, due to lower oil and coal exports and due to the reduction in non-traditional exports aimed at Venezuela and the U.S.

✠ For the coming year, it is expected that private domestic demand will continue to be the main source of growth. However, its ability to pull the rest could be limited by the effect on available income of the recently approved tax reform and by the second and third installments of the capital tax, among other factors. With respect to external demand, it will continue to be strongly affected by the political crisis in Venezuela, at least in the first months of the year, and therefore not contribute to growth. Exports to the U.S., although picking up due to ATPA and greater dynamism in the economy, will not be sufficient initially to compensate for the alterations in exports to Venezuela.

✠ At year's end, some of the risk factors for growth that were identified in the September Inflation Report had diminished. This is the case of the nervousness shown in capital markets at mid-year with respect to Latin American economies, as a result of the doubts generated by political transition in several countries of the region, headed by Brazil. To date, markets seem to have given some breathing room to the governments of Brazil and other economies, by virtue of which the country risk premiums could be corrected downwards with respect to the high levels reached at mid-year. Public debt placements undertaken by some countries in the region, including Colombia, in December and early in the year, also constitute a favorable indicator.

✠ However, it is possible that this dynamism in foreign capital markets for Latin America will not be sustainable throughout the year due to vulnerabilities the region faces: the political crisis in Venezuela, the economic crisis in Argentina, the risk factors in Ecuador, uncertain recovery in the U.S. economy and weakening of the dollar, among other things. For the year as a whole a pickup of capital flows in the region is not expected, and neither is a greater correction downward of spreads.

✠ Colombia could achieve some degree of differentiation in the region, as recognized by some by the risk qualifying agencies themselves, due to its success in the recent approval of tax, labor and pension reform by the Congress of the Republic, and due to the backing of multilateral credit institutions, including the International Monetary Fund (IMF) with which a standby agreement was signed. Nevertheless, culmination of this process critically depends on popular approval of the referendum, which constitutes an important factor of uncertainty, even though the majority of the analysts take this result for granted. But, even if its probability is considered to be low, failure to approve the referendum could drastically affect risk perception in the economy, devaluation expectations and financial flows towards the country, given the scarce margin of fiscal maneuverability the government has. On the other hand, the Venezuelan crisis, with its uncertain resolution, continues to be a factor that affects, and could affect even further, growth prospects for important industrial and trade sectors in Colombia.

✠ Taking into account the foregoing, it is expected that the Colombian economy will continue to exhibit positive growth rates for the coming year, even though it is considered improbable that there will be any significant acceleration with respect to the results observed in 2002. These forecasts are in line with the growth goal the government has set for 2003 of 2%. In view of this, and the low levels that in November continued to be reported for the various installed capacity indicators as compared to their historical averages, important demand inflationary pressures are not foreseen for the early months of 2003.

✠ During the fourth quarter, the Board of Directors of the Bank kept its intervention rates stable. At the end of December the rates were the following: Lombard expansion, 9.0%; auction expansion, 5.25%; auction contraction, 4.25%, and Lombard contraction 3.25%.

✠ Since mid-year, the Bank has granted ample liquidity to the markets, which has allowed it to attend to the strong year-end demand without inconveniences. Particularly, in the last three months of the year, the Bank continued to purchase TES and to exercise options for accumulation of reserves and thus supply a constant flow of liquidity. The total amount of permanent TES purchases in this period reached \$139.8 (mm) billion, with which purchases for the entire year rose to \$1,208.4 (mm) billion. At the same time, through exercise of options for reserve accumulation expansion of \$141.8 (mm) billion in the quarter took place, equivalent to US\$50 million. Through this set of mechanisms, the Banco de la República provided permanent liquidity during the last three months of the year for a value of \$281.8 billion.

✠ In the last few months a reduction of demand has been observed as suggested by the low demand for 30-day expansion Repos. With the year-end liquidity program, the Bank defined expansion Repos at 30 and 90 days for a total of \$2,100 billion, of which only \$1,105.9 billion were demanded. Likewise, during the fourth quarter, growth of the most liquid monetary aggregates has decelerated significantly. As of December, the monetary base grew at an annual rate of 20.3%, while M1 did so at 18.3%. With respect to M3, its growth also decelerated, dropping from 8.8% in September to 7.4% in December.

✠ The deceleration of monetary aggregates did not impede a significant acceleration of the growth of total nominal portfolio for the financial system, which rose from an annual growth rate of 1.6% in September to 4.1% in December. The acceleration occurred fundamentally in the portfolio of non-mortgage banking, which grew at an annual rate of 6.6% in December. Likewise, with figures for November, acceleration was also observed in commercial portfolio and consumption. Recovery of portfolio occurred simultaneously with a reduction in TES placements by the government.

✠ Recovery of portfolio and lower growth of monetary aggregates did not turn into pressure on nominal market interest rates. Throughout the fourth quarter, the interbank rate was situated slightly above 5.0%. In December, its level was 5.0%, 30 basic points less than in September. As for the DTF, in December it was at 7.7%, 20 bp lower than the figure three months before, reaching its historically lowest level. Finally, the active nominal rates for all types of credit were reduced between 20 bp and 50 bp in the last three months.

✠ Meanwhile, the TES rates in the secondary market, between September and December showed an important correction downward in all of the sections of the yield curve. By December, the level observed for these rates for various terms was slightly higher than at mid-year, prior to the third quarter comeback. The reduction, which is largely associated with a lower risk perception for internal and foreign markets, was greater in the case of short term rates than for long term rates. Furthermore, in December the long term rates showed a slight recovery that can be reflected in an increase in expectations for inflation in the market.

✠ During the fourth quarter, the exchange rate showed extreme volatility. Between September and mid-November a tendency to revaluation could be seen that was associated with a lower perception of risk by the market, in part, as a consequence of lower external uncertainty, but also as a result of the progress shown in tax and pension bills put before Congress and the support shown by multilateral banking. However, in the last month and a half, the exchange rate was devaluated again for reasons associated with a greater demand for exchange currency by the real sector and also the absence of exchange supply by the Nation's General Treasury. To this, we may add the low cash level of intermediaries in the exchange market, which means their response to higher demand is very limited. At the end of December, the representative market rate (TRM) was situated at $2,864.8 while year end devaluation was 25.0% with an average for the year of 9.1%.

✠ The Banco de la República foresees average inflation of 6.2%, without food for the fourth quarter of 2003, which is lower than the forecast presented in the September report (6.6%). This drop in the forecast is the result, among other things, of lower expected inflationary pressures on exchange markets, given the forecasts of September. In the area of food inflation, the forecast for the same period is 5.8%, higher than the forecast made three months ago (2.8%). Thus, total average foreseen inflation for the fourth quarter of 2003 is 6.1%, that is, greater than that shown in the previous report (5.5%).

✠ The SGEE considers that the effect of the IVA reform, to take effect during 2003, on inflation should be temporary and not very significant. However, we must not ignore the increases that it could cause on expected inflation, with which its effect could become prolonged over time.

✠ Risks to projected inflation continue to be considerable. Some of the most important are:

✠ The magnitude of net capital flow, both public and private that could enter the country during 2003. Although in the last weeks markets have shown signs of opening up, it cannot be said that this situation is stable yet, and there is still great danger of a new closing up in the face of changes in internal or external conditions. Among the latter, it is necessary to highlight the normal uncertainty surrounding approval of the referendum. Although several of the analysts consider this event improbable, a negative result could deteriorate the confidence markets feel in the consistency of the government's macroeconomic program, producing increases in the exchange rate and country risk at levels that are hard to foresee.

✠ Another important risk to inflation in 2003 is the possibility of greater inflationary expectations, given the break in the general tendency inflation has shown since the second semester of last year. Although this change in the tendency reflects transitory factors (associated with the shock from food supplies and the external financing shock), its effect on the inflation rate can become permanent if these inflation expectations are transmitted in the medium and long term. At this moment, information available to evaluate the recent changes in this variable are scarce, but the fact that long term rates on the debt have stabilized around 7.5% in real terms, as compared to 5.7% that had been reached as of last July, 2002, would show that in addition to the other factors, the market could be transmitting recent inflationary increases to long term rates and that it would not be possible to get lower rates on debt before the market has expectations of a clearer inflationary panorama in the medium term.

✠ On the other hand, the current level of real rates for expansion and contraction of the Banco de la República are -1.6% and -2.6%, respectively. These rates, the lowest of the largest economies in the region, have been reduced by 270 pb with respect to the level that they had in January, 2002, and near 100 pb with respect to June of the previous year.

✠ By contrast, no particular risks of consideration are associated with inflationary pressure on the demand side. For the moment, cost pressures are unknown and could result from the recent readjustment in minimum salary or increases in other salaries within the economy. There are also positive risks on inflationary behavior: the principal one is that with the approval of the referendum, an improvement will be wrought in country risk that induces greater net capital flows, both public and private, with a positive effect on growth and on expectations for devaluation. Every additional US$100 m of incoming capital diminishes average devaluation by about 80pb and induces a drop of 12 pb in basic inflation according to Banco de la República models.

✠ Based on the foregoing considerations and taking into account that in recent months a break in the basic inflation tendency has been observed, which can be attributed to greater peso devaluation with respect to the dollar and furthermore, failure to fulfill the goal in December could raise inflation expectations, the Board of Directors decided to increase the entire rate structure of Banco de la República intervention by 100 pb. In this way, the new intervention rates are the following: auction expansion: 6.25%; auction contraction, 5.25%; Lombard expansion, 10%; Lombard contraction 4.25%.

The Board is confident that with this measure it can control inflation expectations and increase the probability of fulfilling the goal for 2003 and 2004 without affecting the process of reactivation of the economy.

Board of Directors of the Banco de la República.

Inflation report

December 2002

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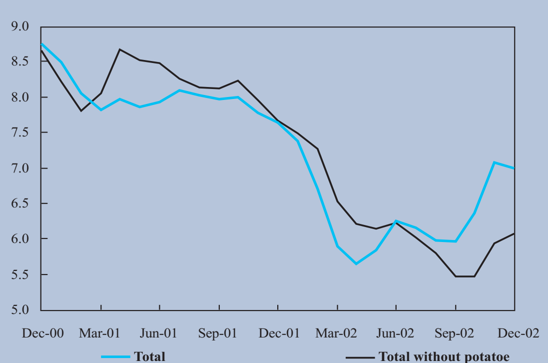
I

Recent Inflation Trends

At the close of the fourth quarter of 2002, annual inflation to consumers was 6.99%, 0.99 percentage points above the inflation target established by the Board of Directors of the Banco de la República (BDBR) for 2002. In statistical terms, deviation from the target was almost entirely due to a strong increase in the price of potatoes during the last trimester of the year (Figure 1). Likewise, in December the average of the three basic inflation measurements calculated by the Banco de la República was 5.6%. This figure is 0.5 percentage points higher than that recorded a quarter before. Due to the fact that the Colombian economy has been working below its potential capacity for several years, recent acceleration in basic inflation suggests inflationary pressures associated with costs, principally the effects of devaluation (25% in the year) and a rise in the international prices of inputs.

Recent acceleration in basic inflation and failure to completely fulfill the target for 2002 can lead to an increase in inflation expectations. This fact, added to the inflationary pressures originating from devaluation and the temporary effect on the price level of extensions of the added value tax (IVA), compromises fulfillment of future inflation targets. All of this suggests the need for a change in the government's position with respect to monetary policy, a conclusion that is reinforced by the analysis given in other chapters of this report (for example, Chapter IV, Inflation Forecasts).

Figure 1
Total annual inflation without the price of the potatoe
(Percentage)



Source: Departamento Administrativo Nacional de Estadística (DANE), Banco de la República calculations

A. Temporary inflation

One of the most outstanding phenomena related to inflation in the last quarter of 2002 was the acceleration of inflation in food prices. In December, measured by the CPI, it was 10.9%, that is 2.4 percentage points higher than the value recorded in September (8.6%), and 1.5 percentage points above the Banco de la República forecast presented in the last inflation report. The latter can be explained, principally by the intensity in the increase in potato prices (89.8% in December), a transitory situation difficult to foresee in its magnitude, because of its association with performance in product supply.

For the coming months better performance is expected for food prices. The main reasons are the following:

- Following a strong increase in potato prices, planting has increased and prices will drop again. There is already recent evidence to sustain this: annual variation in the potato price dropped from over 120% in November to 89.8% one month later. This tendency will continue in coming months[1].

- According to Fedegan criteria, in 2003 Colombian cattle raising should enter a phase of liquidation. This is a period when real meat prices drop.

- The U.S. National Oceanographic and Atmospheric Agency (NOAA), has confirmed the expected presence of El Niño for May, 2003, but the forecast is for moderate intensity. Negative effects for agricultural productivity are lesser then and very possibly will not exert great pressure on food price inflation.

- The opinion survey of agricultural business carried out by the Center for Cattle and Agricultural Studies (CEGA) foresees recovery for agricultural investment in general, and for production other than coffee and the livestock sector. The foregoing factors should bring about positive levels of food supplies in early 2003.

On the other hand, transitory inflation could be adversely affected by the increase in international prices of oil and the IVA reform. This high price scenario for crude oil will be maintained throughout a good part of 2003 for reasons to be explained in detail in Chapter III. With respect to the IVA reform, increases in inflation resulting from a rise in indirect taxes should be an entirely temporary phenomenon with greater effects during the first three months of 2003.

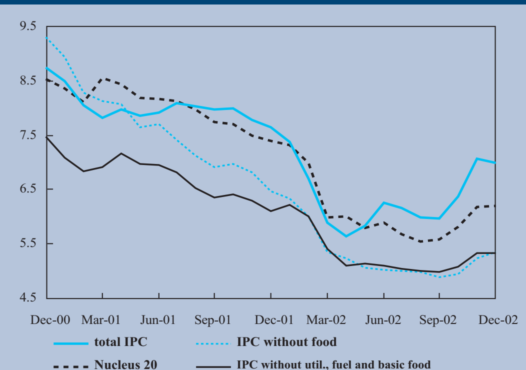
B. Basic inflation

Studies are being done on inflation trends over longer periods of time in terms of so-called «basic» or underlying inflation», that is, the inflation rate remaining after excluding occasional and transitory price shocks. In the fourth quarter of 2002, all basic inflation indicators that the Banco de la República calculated showed significant acceleration. The indicator that most grew was «the inflationary nucleus», rising from 5.6% in September to 6.2% in December. At the same time, the CPI without food, and the latter without primary food, fuel and public utilities increased by 0.5 and 0.3 percentage points respectively (Figure 2 and Table 1). As a consequence of the foregoing, the average of the three basic inflation indicators rose from 5.1% in the month of September to 5.6% by the end of 2002.

For several years, the Colombian economy has been functioning below its potential production capacity. This has not changed in the last quarter. Therefore, recent acceleration of basic inflation cannot be explained by aggregate demand factors. The explanation is principally due to the effect of strong peso devaluation with respect to the dollar, on the price of internationally tradable goods and services. The following data are illustrative:

- The goods that most contributed to increases in inflation to the consumer in the quarter were medicine, electricity and fuel, jewelry and cleaning and personal care items.

Figure 2
Evolution of Annual Inflation, Total and Basic
(percentage)



Source: DANE, Banco de la República calculations.

[1] Acording to price informationsystems for the agricultural sector (SIPSA), by the third week in January, the price potatoes had dropped 13% with respect to the price observed in December

Table 1
Inflation Indicators
(Annual Percentage variations)

	Dec-01	Mar-02	Jun-02	Sep-02	Dec-02
I. CPI	7,6	5,9	6,2	6,0	7,0
Food	10,5	7,2	9,2	8,6	10,9
Food without meals outside the home	11,7	7,5	10,1	9,4	12,2
Meals outside the home	6,5	6,1	5,7	5,4	6,1
Housing	4,3	3,8	4,2	3,8	4,1
Housing occupation expenses **1/**	2,0	2,4	2,9	2,8	2,9
Public utilities and others	10,0	7,0	7,1	6,1	6,7
Clothing	2,6	2,2	1,1	0,9	0,7
Healt	10,9	9,3	9,7	8,9	9,2
Medicines and others	13,4	11,3	13,0	12,3	13,3
Proffesional healt services	8,4	7,3	6,6	5,6	5,3
Education	10,2	9,3	6,7	6,4	6,5
Culture and entretainment	7,1	7,0	5,9	4,7	5,3
Transportation	8,9	5,8	5,0	5,1	5,9
Miscellaneous expenses	7,6	6,7	6,8	7,7	9,0
II. Basic Inflation 2/	6,7	5,6	5,3	5,1	5,6
CPI without food	6,5	5,3	5,0	4,9	5,4
Nucleus **3/**	7,4	6,0	5,8	5,6	6,2
CPI without primary food, fuel and public utilities	6,1	5,4	5,1	5,0	5,3
III. IPP	6,9	3,6	2,9	6,8	9,3
According to use of economic destination					
Intermediate consumption	5,8	2,9	1,2	6,2	9,9
End consumption	8,5	4,3	4,6	6,3	7,3
Capital goods	5,7	2,4	2,8	10,8	15,6
Construction materials	7,4	5,0	5,0	6,4	7,8
According to origin					
Produced and consumed	7,7	4,4	3,4	5,5	7,1
Imported	4,6	0,8	1,6	10,7	16,0
Exported **4/**	(7,9)	(7,1)	(2,4)	15,5	28,5
According to industrial origin (CIIU)					
Agric., Forestry and Fishing	7,6	2,4	2,1	6,8	9,2
Mining	(1,3)	1,7	2,1	22,4	33,3
Manufacturing industry	7,0	3,9	3,2	6,3	8,6

1/ Housing occupations expenses are basically rent.
2/ Corresponds to the average of the three basic inflation indicators calculated by the Bank of the Republic.
3/ Excludes from the CPI the 20% weight of those items that showed the greatest price volatility between January, 1990 and April,1999.
4/ The total does not include exported goods. Calculation is done with the weighted sum of produced, consumed and imported goods.

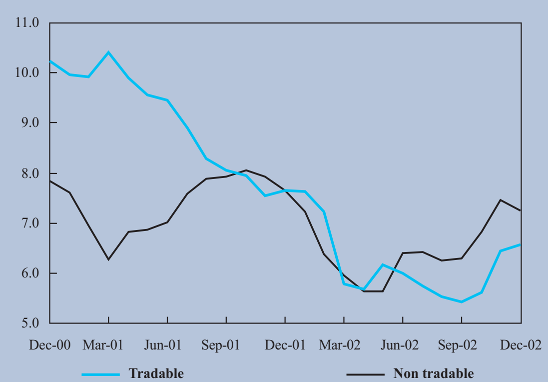
Source: Banco de la República, Subgerencia de Estudios Económicos (SGEE). Tabulated from IPP, IPC y DANE.

- The latter, as well as automobiles and accessories, are intensive in imported inputs, or with a significant import component in the consumption.

- Upon breaking down the consumer basket into tradable and non-tradable goods, acceleration in the annual variation of 1.2 percentage points for the former can be observed in the quarter, with an increase from 5.4% to 6.6% (Figure 3).

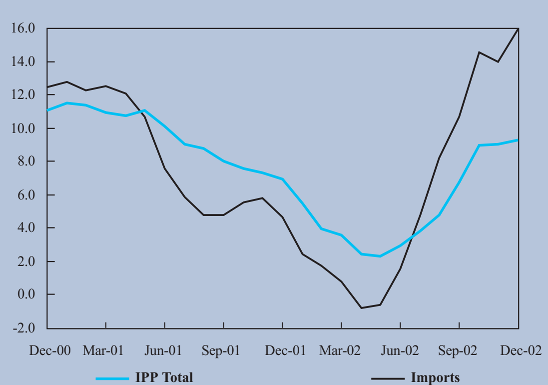
- In the producer price index (IPP) inflation for imported goods increased by 5.3 percentage points in the fourth quarter of 2002, ending at 16.0%. Although increases in the international prices of some were observed, the main explanation for this acceleration was the greater devaluation of the peso with respect to the dollar (Figure 4).

FIGURE 3
ANNUAL INFLATION OF TRADABLE AND NON-TRADABLE GOODS
(PERCENTAGE)



Source: Banco de la República, SGEE.

FIGURE 4
PRODUCER PRICE INDEX
(ANNUAL PERCENTAGE VARIATION)



Source: DANE, Banco de la República calculations.

Acceleration in basic inflation was not foreseen in the projection models calculated by the Banco de la República[2]. In the September report, for example, it was calculated for December that there would be 4.8% inflation without food. The result observed was 5.2%. This underestimation was the result, mainly, of the rhythm of devaluation and its effect on the prices of internationally traded goods. The former is especially difficult in an economy like Colombia's where the exchange rate floats freely. Meanwhile, the degree of transference of devaluation to prices, and the moment at which it occurs depend on other factors, on the perceptions of agents as to the duration of devaluation, costs of changing prices and evolution of demand with respect to potential capacity. Furthermore, some readjustments in energy prices and telephone services had already been programmed for 2003. Lastly, the intensity of the increase in the price of banking services was not correctly foreseen either.

C. THE EFFECT OF IVA ON INFLATION

In the tax reform approved by the Congress of the Republic at the end of 2002, a 7.0% value added tax was introduced to take effect January 1, 2003, on certain goods that make up part of the family basket (Table 2). This constitutes a single time adjustment in prices that will temporarily affect inflation.

The final effect on inflation occurs directly through readjustments in the prices of final goods that have been affected by the reform, and indirectly through adjustment in the costs of intermediate goods and taxed raw materials.

[2] Inflation forecasts presented in this report for each quarter, are recorded in terms of geometric averages. Thus, when reference is made to a quarter average, this corresponds to the geometric average of the monthly values.

Preliminary estimates by the National Directorate of Taxes and Customs (DIAN) suggest that the reform might generate an increase in annual inflation to the consumer on the order of 0.4 percentage points. These calculations are still highly uncertain, since the methodologies used cannot easily take into account the substitution effects that result from price increases and that tend to modify them. Finally, it must be pointed out that historically the readjustments in IVA and the broadening of the taxable base has had a very small impact on permanent inflation in Colombia and on that of other countries.

TABLE 2
REFORM IN THE ADDED VALUE TAX (IVA)

Goods in the consumer basket with a 7.0% rate as of January 1, 2003

- Corn flour and other flours
- Dry pasta
- Prepared cereals
- Other bakery products
- Meat and sausages
- Canned sea and river fish
- Sugar
- Coffee
- Chocolate
- Matches

Additionally, the tax on beer increased from 8% to 11.0%, while rates on automobiles were also modified.

Services in the consumer basket with a rate of 7.0% as of January 1, 2003.

- Pre-paid medical programs and medical insurance
- Tourism
- Games of chance (5.0%)

Additionally, the tax on cellular telephony was increased from 16.0% to 20.0%.

Source: Law 778 of the Tax Reform, December 27, 2002.

II

Determinants of inflation

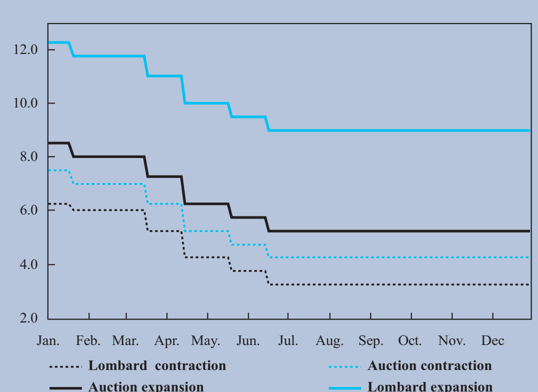
A. Monetary and credit aggregates

1. Monetary Policy Guidelines

The Board of the Banco de la República maintained its position on interest rates throughout the fourth quarter, as it did during the third quarter of 2002. The last modification in intervention interest rates made by the Bank was on June 17th, with intervention rates that reached historical minimums, in order to promote economic growth without compromising achievement of the inflation goal. In this way, upon finalizing the month of December, the rates in force were: 9.0% Lombard expansion, 5.25% auction expansion, 4.25% auction contraction and 3.25% Lombard contraction (Figure 5).

During the third quarter, conditions for undertaking the auction of call[3] options occurred twice and was activated to control volatility in the exchange rate, due to acceleration of devaluation beginning last May[4]. Strong peso depreciation with respect to the dollar continued at the end of September, bringing about a new activation of the auction on October 2 to control volatility by means of the auction of US$180 million (m). Of this amount, US$124.5 m were sold, enough to assuage the exchange market, which readjusted downward in the following weeks. Nevertheless, by the end of November, the exchange rate had begun to rise again, without, however, fulfilling the conditions to convoke another auction for the sale of dollars (Table 3).

Figure 5
Intervention rates of the Banco de la RepúblicaT, 2002
(Percentage)



Source: Banco de la República, SGEE.

Once the condition for control of exchange rate volatility was underway on October 2, the pressure on the price of the dollar dropped, and it began to revaluate in the following days, due to an increase in confidence throughout the region. This led to the situation at the end of the month that conditions to activate put[5] options on the accumulation of international reserves would be fulfilled. Thus on October 21, US$50 million were auctioned, the entire amount of which was purchased by market agents (Table 3).

The demand for liquidity in the fourth quarter was satisfactory, in part, through the expansion Repos for 1, 30 and 90 days[6]. The quota for one day Repos

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[3] Options for the sale of internacional reserves.

[4] The auction of call options to control volatility is activated when the representative market rate (TRM) increases by more than 4% over the 20 order mobile average for said rate.

[5] Options for the parchase of internacional reserves.

[6] The 30 and 90 Repos were auctioned between November 15th and December 20th, within the Banco de la República's program for supplying liquidity for the end of the year.

Table 3
OPTIONS TRADED
PURCHASE AND SALE OF INTERNATIONAL RESERVES

Date	Limit Auctioned	Amount traded in US$m	TRM	Amount traded in $mm
		Put options traded		
02-Jan		27,5	2.291,2	63,0
15-Jan		22,5	2.297,3	51,7
January Total	50,0	50,0		114,7
05-Feb		1,5	2.266,6	3,4
February Total	50,0	1,5		3,4
08-Mar		50,0	2.289,8	114,5
March Total	50,0	50,0		114,5
I trimester Total	150,0	101,5		232,6
02-Apr		68,0	2.264,6	154,0
05-Apr		32,0	2.269,4	72,6
April Total	100,0	100,0		226,6
May Total	100,0	0,0		0,0
June Total	100,0	0,0		0,0
II trimester Total	300,0	100,0		226,6
July Total	100,0	0,0		0,0
August Total	50,0	0,0		0,0
September Total	50,0	0,0		0,0
III trimester Total	200,0	0,0		0,0
21-Oct		50,0	2.836,3	141,8
October Total	50,0	50,0		141,8
November Total	0,0	0,0		0,0
December Total	0,0	0,0		0,0
IV trimester Total	50,0	50,0		141,8
		Call options traded to control volatilly (sale)		
29-Jul		117,0	2.596,3	303,8
31-Jul		63,0	2.625,1	165,4
July Total	180,0	180,0		469,1
01-Ago		69,0	2.636,3	181,9
02-Ago		17,0	2.640,4	44,9
06-Ago		23,5	2.663,8	62,6
August Total	180,0	109,5		289,5
02-Oct	180,0	124,5	2.885,5	359,2
October Total	180,0	124,5	2.885,5	359,2

Source: Banco de la República.

was used to a large degree in the month of October (70.8%), as a reflection of the high demand for money within the economy. This proportion fell in the following two months, from 42.5% to 31.2% respectively, being thus coherent with the Repos set for 90 days in November and for 30 days. Meanwhile, it was observed that there was greater average use of quotas for contraction Repos for the fourth quarter (60.5%), as compared to the third quarter (40.9%). Another important source of liquidity provided by the Banco de la República was the final gross purchases of Treasury papers (TES) in the secondary market. Between the months of October and December, the Bank purchased $139.8 billion (mm) of the $1,208.4 billion purchased during the year 2002 (Table 4).

During 2002, the indicator of monetary conditions (ICM) for aggregate demand remained below the base period (1998:01). The ICM position suggests that

TABLE 4
Final purchases of TES B in the secondary Market
(Billion of pesos)

	SEN	Auction (•)	Total (SEN + Auctions)
January	0,0	0,0	0,0
February	0,0	0,0	0,0
March	0,0	0,0	0,0
April	26,6	0,0	11,5
May	117,0	0,0	132,2
June	96,3	0,0	96,3
July	148,1	0,0	139,2
August	416,5	130,0	546,5
September	143,1	0,0	143,1
October	90,6	0,0	90,7
November	49,1	0,0	49,1
December	0,0	0,0	0,0
Total	**1.087,3**	**130,0**	**1.208,4**

(•) The Bank of the Republic undertook an auction for purchase of TES in the amount of $130 billion on August 21 for financial intermediaries that do not belong to SEN, including stock market commissioned firms and trusts.

the Bank Board keeps a loose rein on monetary policy as compared to that applied at the beginning of 1998. The ICM level for December of the year analyzed can be explained by the combined effect of a reduction in interest rates and the depreciation in the real exchange rate observed in the fourth quarter of 2002 (Figure 6).

2. Monetary Aggregates

a. Monetary base

The low levels of inflation and the interest rate together with the three per thousand tax on financial transactions stimulated the holding of very liquid assets during a good deal of the third quarter and beginnings of October.

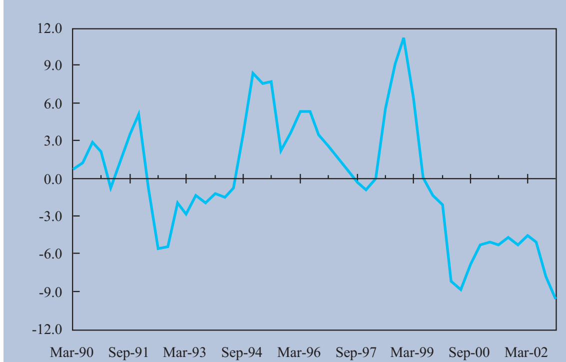
The foregoing made the Bank Board adopt a new line of reference at the beginning of the fourth quarter (October 18), with average annual growth of the monetary base of 28.3% and of cash of 29.8%, while in the whole year growth of 20.3% and 22.9% respectively had been expected.

In the following months the various indicators of monetary supply decelerated, a behavior which is in accord with lower demand for liquidity observed in the third quarter of the year. The balance for the monetary base was kept below the reference line during the entire fourth quarter, both for the order 20 mobile average and the order 45. In this way the annual growth rate of the monetary base fell from 26.0% in September to 20.3% in December. This deceleration in the growth of the base is a consequence of the lower growth of cash (20.9% in December) compared to that observed three months ago (30.7%). On the other hand, the reserves component adjusted its growth upward from 15.8% in September to 18.6% in December (Figure 7).

b. M3

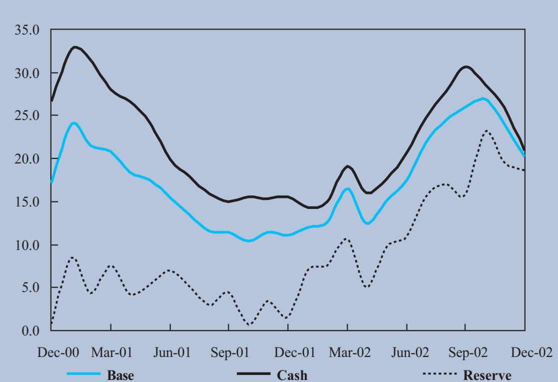
In the fourth quarter almost all of the components of the broader monetary aggregate (M3) decelerated their growth rhythm as compared to the levels observed in September, with which the growth of M3 descended from 8.8% in September to 7.4% in December (Figure 8). In spite of the fact that this behavior of M3 is explained by the lower dynamism of the more liquid assets (cash, savings and checking accounts), recomposition of M3 is still toward this type of assets, as shown by the strong contraction of time deposit certificates (CDT), Repos with the Treasury and bonds. This recomposition can be explained because the private sector has had an inclination toward liquidating CDTs, in exchange for having greater cash balances in their savings and checking accounts, and due to the significant fall in interest rates, which has allowed them to reduce the opportunity cost of keeping liquid assets.

Figure 6
Indicator of monetary conditions (ICM) for aggregate demand
(Percentage)



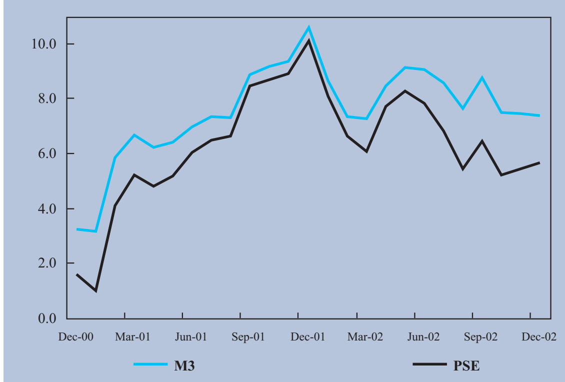
Source: Banco de la República, SGEE.

Figure 7
Monetary base and its uses
(Annual percentage variation from monthly average)



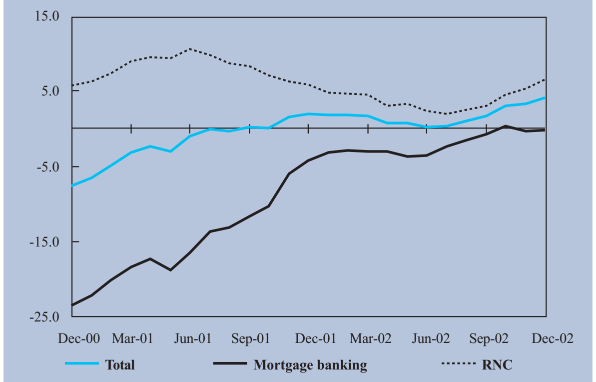
Source: Banco de le República, SGEE.

Figure 8
M3 and liabilities subject to reserves (PSE)
(Annual percentage variation of the monthly average)



Source: Banco de la República, SGEE.

Figure 9
Nominal gross portofolio of the financial system in national currency without FEN
(Annual percentage variation of the monthly average)



Source: Banco de la República y Superintendencia Bancaria.

Lastly, the expectations survey done by the Bank of the Republic in October indicates that the perception of liquidity remained stable. Some 66.7% of the individuals surveyed perceived a high level of liquidity, a level that is only 0.3 percentage points above the figure the July survey yielded. With respect to expectations for liquidity conditions in the following six months, 56.8% of those surveyed considered that the current liquidity situation will not change, that is, a lower percentage than the 61.7% of the July survey.

c. Credit and portfolio

At the end of the fourth quarter, the nominal gross portfolio of the financial system without the Financiera Electrica Nacional (FEN) accelerated its annual growth (4.1%), with respect to the last quarter (1.6%). This portfolio expansion indicates a break in the trend, as was anticipated in September's report (Figure 9). The analysis, by type of institution, shows mortgage banking with negative growth in its portfolio, rising from -0.8% in September to -0.3% in December. On the other hand, the portfolio of the rest of the financial system recovered significantly by growing 6.6% in December with respect to 3.0% in September (Figure 9). All types of institutions improved their performance, including financial corporations, the only ones with negative annual growth.

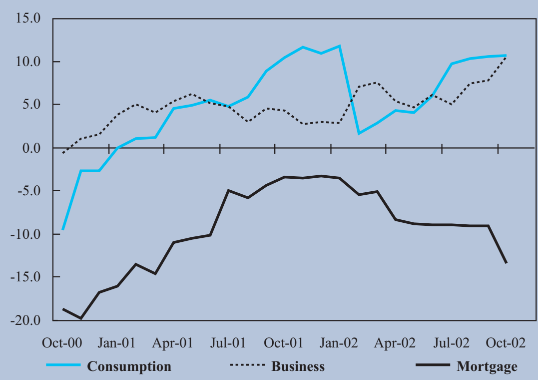
According to some analysts, this improvement in portfolio results responds not only to recovery in consumption and investment, but also to the crisis in the internal public debt market which took place at the end of September and beginnings of October, the immediate consequences of which was a lower preference for TES purchases in favor of greater credit expansion.

Portfolio behavior by type of credit, with information for November, shows an important recovery for credit aimed at consumption and commerce and confirms the low level of dynamism in the mortgage portfolio. On the whole, consumption and commerce portfolio grew 10.5%, accelerating with respect to this figure for September (8.0%), while mortgage portfolio dropped from -9.0% in September to -13.4% in November (Figure 10). This improvement in the performance of portfolio is confirmed by the expectations survey done by the Banco de la República which showed results indicating greater credit availability (55.6%) with respect to expectations expressed by agents in the July survey (53.8%).

3. Interest Rates

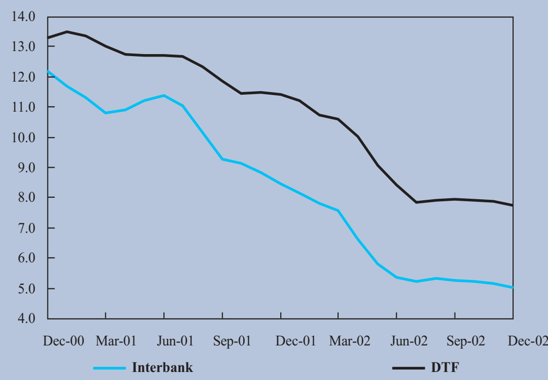
During the fourth quarter, all of the nominal interest rates of the financial system dropped continually and

Figure 10
Nominal gross portofolio in national currency by type of credit
(Annual percentage variation)



Source: Banco de la República, SGEE.

Figure 11
Interbank rate and DTF monthly average
(Percentage)



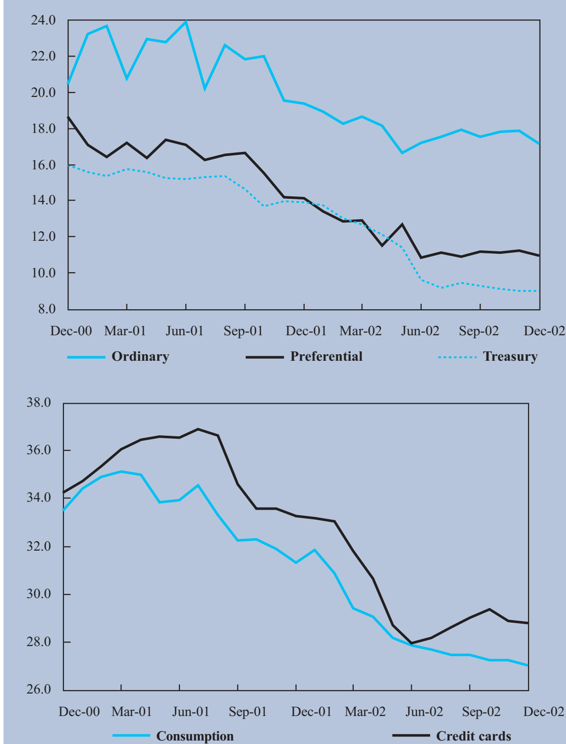
Source: Banco de la República.

significantly. The nominal interbank rate continued its decreasing tendency observed throughout the year, ending in December at a level of (5.02%), which was lower than the months of November (5.17%) and September (5.3%). With the reduction in the nominal rates and acceleration of inflation, the real interbank rate dropped throughout the quarter from -0.68% in September to -1.84% in December. This last record is the lowest observed since March of 1995.

In line with the still low growth of credit, maintenance of the monetary position by the Bank Board and a fall in the interbank rate, the average capture rate, measured by the DTF experienced a drop of 20 basic points (bp) in the fourth quarter, falling from 7.9% in September to 7.7% in December (Figure 11).

Following the descending trend for liability rates, the rate for placement, measured by the asset rate calculated by the Bank of the Republic, closed in December at 14.9%, a half percentage point lower than the rate observed in September, while the asset rate excluding treasury credits was situated at 16.0%, that is, 0.5 percentage points lower than that recorded for September. At the same time, nominal active rates, by type of placement, with respect to the levels observed in September dropped between 0.2 (preferential and card) and 0.5 (consumption) percentage points (Figure 12).

Figure 12
Nominal interest rates on credit by type of placement
(Percentage)



Source: Banco de la República.

The real asset and liability rates decreased in the fourth quarter not only due to lower nominal rates, but also as a result of the comeback in inflation. In this way, the real interest rate for DTF capture dropped from

1.9% in September to a historical minimum of 0.7% in December, while all the real placement rates dropped 1.2 percentage points or more for the same period.

As a consequence of the announcements about a greater fiscal deficit than that initially foreseen, and the uncertainty about the government's financing capacity, in an atmosphere of tight international markets, by the end of September and beginning of October a strong increase in the TES interest rates at different terms was observed (Figure 13). These tendencies began to recede later as a result of the presentation in Congress, and later approval of the structural reforms of the public sector; financial backing and support from multilateral banking, including the commitment to a standby agreement with the International Monetary Fund (IMF) signed early in 2003, and the opening of international capital markets following the political definition in Brazil.

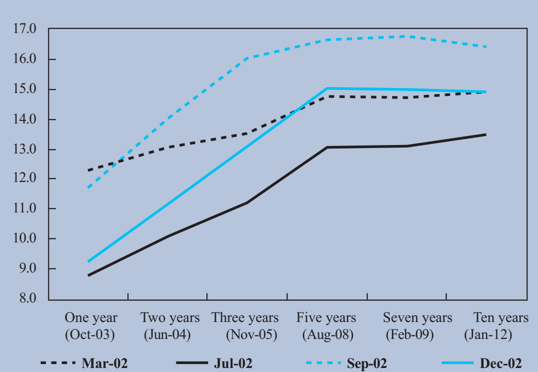
As a reflection of the improved economic and financial panorama of the last few months, interest rates on TES securities in the secondary market showed a significant drop all along the yield curve. Between September and December, the yield on bonds at one, five and ten years dropped 3.1, 2.0 and 1.5 percentage points respectively. Thus, the slope of the yield curve for TES, measured as the difference between the yield on a 10-year bond and the same for a one-year bond, peaked by rising from 276 bp in September to 431 basic points in December. Some of this shift in the slope was due to increases in the expectations of greater inflation in November and December.

4. Exchange rate

The nominal exchange rate in the fourth quarter of 2002 recorded a temporary revaluation in the months of October and November, and then again curved upward in a rising tendency observed since the end of the second quarter of the year (Figure 14). At the end of 2002 the exchange rate was $2,864.8 per dollar, which gave a nominal devaluation for the year of 25.0% and average devaluation of 9.1%.

During the majority of 2002, the performance of the nominal exchange rate closely followed the evolution of the public debt spreads (Figure 15). Initially, with the political uncertainty in Brazil and other economies in the region, markets exhibited doubts as to the government's capacity to finance its growing public sector deficit abroad. The nominal exchange rate, therefore, devaluated sharply. Then, starting in October, with the results of the elections in Brazil and the package of fiscal reforms presented by the government to Congress, and their later approval, the rate temporarily revaluated. Lastly, in December a strong devaluation I the exchange rate began to be

FIGURE 13
CURVE OF EARNINGS ON TES (*)
(PERCENTAGE)

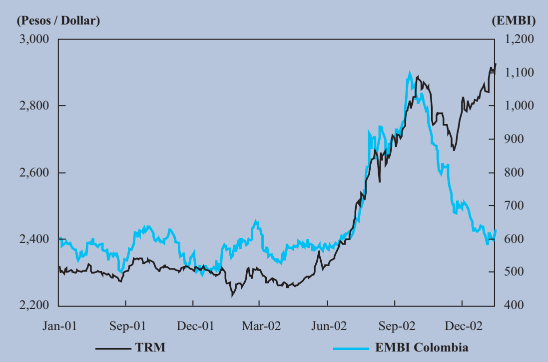


(*) Information according to SEN.
Source: Banco de la República.

FIGURE 14
REPRESENTATIVE MARKET RATE, 2002
(PESOS PER DOLLAR)

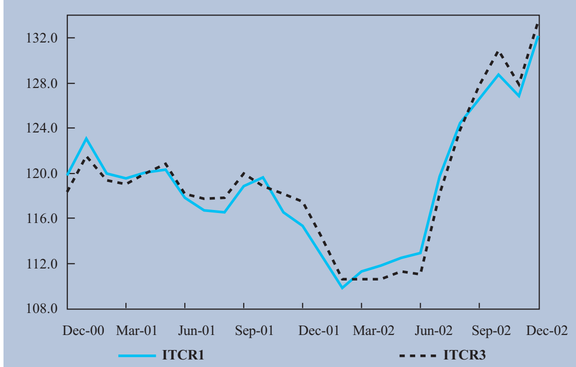
Source: Banco de la República.

Figure 15
EMBI* Colombia vs TRM



*EMBI: *Emergin Markets Bond Index.*
Source: Banco de la República y Bloomberg.

Figure 16
Index of real exchange rate
ITCR1 and ITCR3, (1994 = 100)



Source: Banco de la República.

noticed, in spite of the important drop recorded in the spreads and the opening of international capital markets for the country.

This can be partially explained by the acute deterioration in the economic, social and political situation in Venezuela and its negative effect on Colombian exports and investments in that country, and also in part by the lack of monetization of exchange by the General Treasury of the Nation expected by markets at year's end.

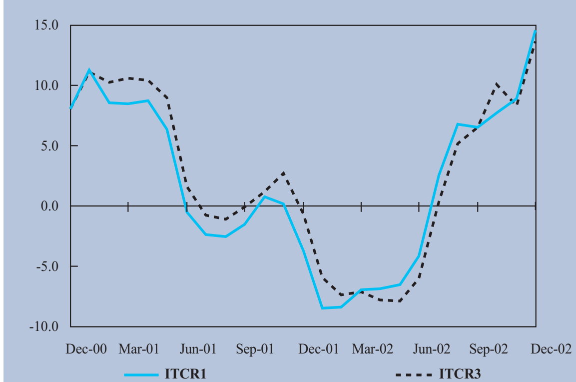
With the nominal devaluation of 2002, the real exchange rate, measured by the ITCR1[7] calculated by the Banco de la República ended up at 132.2. This is the historically highest level registered in the country (Figure 16). Compared with t he value of the same index in December of the foregoing year, real devaluation of 14.6% can be seen in 2002, of which 4.4 percentage points were recorded in the last quarter. For the year's average, preliminary calculations indicate real devaluation of 0.4% (Figure 17).

5. Asset Prices

Two indicators that illustrate recent evolution of some asset prices in Colombia are given below. The first of these is the general index of the Colombian Stock

[7] The ITCR1 uses the IPP of the country and its 20 trade partners.

Figure 17
Real annual devaluation
ITCR1 and ITCR3, (1994 = 100)
(Percentage)



Source: Banco de la República.

Market (IGBC), which gives an aggregate measurement of price evolution of the most representative shares in the market, by means of a basket or selection of shares chosen by their rotation and frequency. The second indicator is the price index of new housing.

a. Stock market

The IGBC grew constantly in the fourth quarter of the year, with an annual variation by December of 50.2%, a higher level than the one observed in September of 36.4% and with higher yield than that offered by other financial assets (Figure 18). This rising activity of stocks has been present since early

2001, but in spite of the significant rise in IGBC, only now are 1997 prices again being reached. According to some stock market analysts, it is possible that stock valorization will continue at least in the near future, due to the current low price of money, financial restructuring of many firms, rationalization of costs and expenses and technological updating of companies, new opportunities with ATPA (Andean Customs Preferences Law) and the free Trade Area of the Americas (FTAA), devaluation in the year 2002, greater perception of national security, decrease in the size of the state, and the slight, but sustained recovery of demand.

b. Housing prices

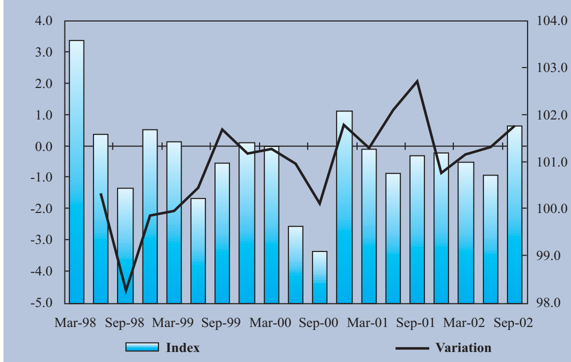
This index is constructed by the DANE for the seven principal metropolitan areas that cover 23 municipalities of the country. This index has a quarterly periodicity and is calculated based on information from the building census for houses and apartments since 1997. The calculation formula weights the price of new housing, according to square meters, the socio-economic strata and the city where building takes place.

New housing prices in Colombia recovered in the third quarter of 2002 as compared to the previous quarter, and its annual variation did likewise since the first quarter of 2002. As of the second quarter of this year, there has been positive annual growth in new housing prices, climbing from -0.3% in March to 0.0% in June and 0.6% in September. This evolution can be explained by new housing, the prices of which have recovered since early 2002, which has allowed an acceleration in annual growth of its index from -1.8% in march to 3.7% in October. On the other hand, although new apartment prices rose from the second quarter on, annual variation in the third quarter continued to be negative (-0.7%) (Figure 19).

FIGURE 18
GENERAL INDEX OF THE STOCK MARKET IN COLOMBIA

Source: Stock Market of Colombia.

FIGURE 19
EVOLUTION OF NEW HOUSING PRICES



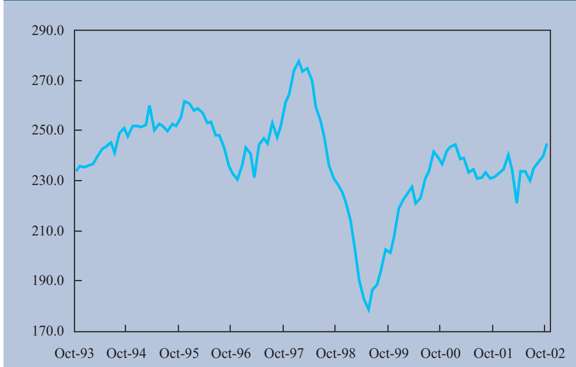
Source: DANE.

B. SUPPLY AND DEMAND

1. General Considerations

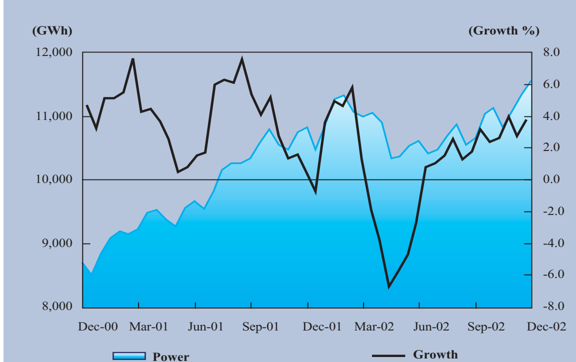
GDP growth in the third quarter was 1.9%, higher than that observed in the first semester of the year (1.4%). Private domestic demand expansion allowed for compensation of the weakening of external demand, affected by lower traditional exports and the crisis in Venezuela. Household consumption and investment equally contributed to expansion, with especially notable dynamism of investment in the last quarter. For the fourth quarter, several sectoral indicators show that the growth trend was sustained (Figures 20 and 21), with which GDP growth for the year 2002 will possibly exceed government forecasts (1.6%). Along with internal demand reactivation, industry, commerce and building have been the sectors showing the greatest recovery. For the year 2003 it is expected that private internal demand will continue to be the principal source of economic growth. This is suggested by the greater consumer and producer confidence, and recent evolution of household consumption and investment in real estate. This confidence will be strengthened by the structural reform program in the public sector and the effects of the government's democratic security strategy. In contrast, recent events in Venezuela lead us to expect even fewer Colombian exports to that country than foreseen in the month of September. Furthermore, this drop will only be partially compensated by greater dynamism in exports to the United States, in spite of the stimulus derived from broadening of the ATPA. Therefore, external demand will continue to represent a source of output

Figure 20
Indicator of economic activity



Source: Banco de la República, SGEE.

Figure 21
Quarterly demand for power
(Annual growth)



Source: ISA.

contraction, and GDP growth for 2003 will continue to depend on the strength of recovery in private domestic expenditure.

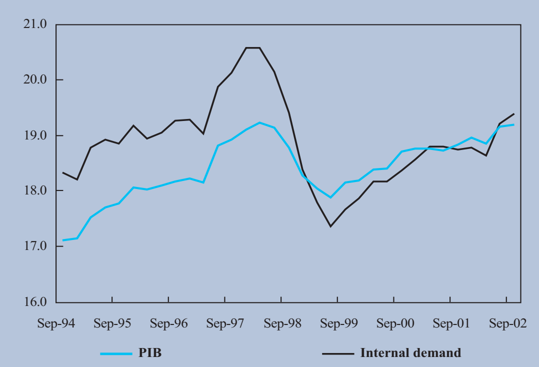
Dynamism of private domestic expenditure in 2003 will, in part, depend on fiscal policy. On the one hand, higher taxes and contributions to social security will reduce disposable income and business profits. This will negatively affect the consumption capacity of households and incentives to investment. On the other hand, by reducing the risk of future insolvency in the public sector, it will facilitate access to international capital markets and strengthen confidence. This, together with the effects of the government's domestic security strategy, promotes private investment and household consumption. According to the experience of countries with vulnerable public finances, the latter effect surpasses the former, with which, contrary to the expectations of some analysts, the net effect of fiscal adjustment would be expansive, when compared to the alternative of not implementing it. The foregoing, together with the increase in employment and expected evolution in the terms of trade for the country, suggest that GDP growth in 2003 should be above 2002 (e.g. 2,0% -2.5%), in spite of less dynamism in foreign demand.

Among the principal risks in the foregoing prediction is the performance of the exchange rate. An excessive increase in devaluation expectations provokes the flight of capital abroad, increases the value of the foreign debt in local currency and provides a negative stimulus to foreign investment. This drains productive capacity and depresses domestic spending, raises internal interest rates, increases the possibilities of bankruptcy for companies with debts in foreign currency and compromises the sustainability of public sector finances (nearly half of its debt is in foreign currency). Furthermore, as analyzed in other sections of this report, it compromises the achievement of inflation goals. Thus the costs of devaluation may exceed the positive effect that it can have on the degree of competitiveness of national producers of traded goods. Moreover, on some occasions there must be an economic policy response.

2. Demand and the foreign balance

In the third quarter of 2002, the balance of payments deficit on current account expanded when compared to that recorded in the same period of the previous year (Table 5). In macroeconomic terms, it indicates growth in domestic absorption greater than the growth of national income (Figure 22). Dynamism of exports declined and imports showed a slight increase, especially in intermediate goods for the industrial sector. For the entire year 2002, a deficit on current account is foreseen in the proportion of 2% of GDP, a similar figure to that expected for 2003. This last forecast is compatible with an economic growth scenario of 2.0%, less private capital outflow[8], and a stable nominal exchange rate, given that the government has almost entirely completed the foreign financing program for the year[9].

Figure 22
PIB Vs internal demand, series corrcted for seasonal change
(Billions of pesos de 1994)



Source: DANE.

8 Without including direct foreign investment.
9 At the time this report is being written, the government had made two bond issues abroad for US$1,000 million, with which it fulfilled its foreign financing needs, according to announcements by Public Credit.

Table 5
Current account in Colombia - summary
(Millions of dollars)

	July-September		Variation	
	2001 (p)	2002 (p)	Absolute	(%)
Current account (A + B + C)	(133)	(493)	(360)	
Income	4.720	4.392	(328)	(6,9)
Expenditure	4.853	4.886	32	0,7
A. Non-factor goods and services	(37)	(401)	(364)	
Income	3.914	3.587	(327)	(8,4)
Expediture	3.951	3.988	37	0,9
1. Goods	321	(3)	(324)	
Income	3.360	3.116	(244)	(7,3)
Expediture	3.038	3.119	81	2,7
2. Non-factor services	(358)	(398)	(40)	
Income	554	471	(84)	(15,1)
Expediture	913	869	(44)	(4,8)
B. Income on factors	(625)	(680)	(55)	
Income	200	157	(44)	(21,8)
Expediture	825	837	12	1,4
C. Transfers	528	588	60	
Income	606	649	43	7,1
Expediture	78	61	(17)	(21,3)

(p) Provisional.
Source: Banco de la República.

a. Consumption

During the third quarter of 2002 household consumption was more dynamic with respect to the preceding quarters, just as predicted in the previous report. On the other hand, government consumption reduced its growth rhythm (Table 6).

The growth acceleration observed in household consumption can be explained by the greater dynamism of non-durable and semi-durable goods, added to the high rate of growth in consumption of durable goods. The tendency shown by household consumption is associated with a reduction in interest rates on consumption credit, greater consumer confidence by (Figure 23), replacement of durable goods stock and an increase in employment, above all the non-skilled, due to improved performance in the construction and commerce sectors.

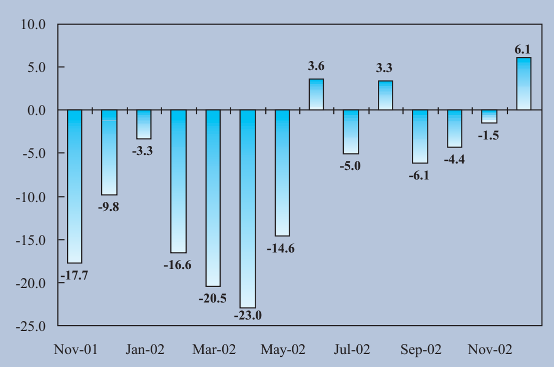
For the fourth quarter, available indicators, such as credit card sales, the Fenalco sales survey, new vehicle sales and consumption goods imports suggest that growth dynamics could have been maintained or even accelerated. This positive result can be associated, in part, with the noticeable increase in perceptions of security, thereby significantly improving indicators dealing with tourism.

TABLE 6
ANNUAL GDP GROWTH ON THE DEMAND SIDE
(PERCENTAGE VARIATION)

	2001 (p)					2002 (p)		
	I	II	III	IV	Anual	I	II	III
Gross domestic product	2,05	1,76	0,72	1,09	1,40	0,47	2,31	1,91
Total imports	12,24	15,45	12,00	3,64	10,74	(8,34)	(1,59)	3,21
Total final supply	3,57	3,77	2,36	1,48	2,79	(0,96)	1,68	2,11
Final consumption	1,90	1,13	0,62	1,41	1,26	1,74	2,26	2,17
Households **1/**	2,44	1,30	0,04	1,16	1,23	2,19	2,02	2,51
Final domestic household consumption **2/**	2,85	1,61	0,20	1,40	1,51	1,71	1,46	2,17
Non-durable good **2/**	1,46	(0,35)	(2,56)	(0,26)	(0,44)	0,19	0,55	1,18
Semi-durable goods **2/**	10,56	6,29	0,35	(1,13)	3,83	2,22	(2,39)	3,49
Services **2/**	2,32	2,20	2,46	2,93	2,48	2,28	1,86	2,09
Durable goods **2/**	3,74	3,31	3,56	7,97	4,67	8,87	15,34	8,66
Goverment	0,37	0,65	2,32	2,13	1,37	0,45	2,95	1,18
Gross capital formation	12,72	18,23	10,87	(0,43)	10,13	(15,17)	1,60	10,55
Variation in inventories **3/**	60,25	101,01	(16,20)	(87,93)	(2,00)	(101,26)	(11,60)	70,84
Groos formation of fixed capital	7,73	12,47	13,39	11,94	11,37	(1,76)	3,24	6,42
Agriculture, livestock, forestry, hunting and fishing	7,04	(1,19)	9,56	5,72	5,12	7,45	7,84	10,09
Machinery and equipment	17,73	32,41	21,45	9,62	19,96	(3,96)	(5,24)	3,59
Transportation equipment	43,80	28,66	44,87	33,02	37,46	(18,14)	6,75	16,31
Buildings	7,04	10,51	8,41	18,01	11,04	23,69	21,74	19,89
Civil works	(12,19)	(8,86)	1,73	5,75	(3,63)	(17,10)	(3,77)	(6,83)
Subtotal: Final domestic demand	3,43	3,46	2,03	1,14	2,51	(0,87)	2,16	3,42
Total exports	4,30	5,43	4,10	3,23	4,25	(1,41)	(0,83)	(4,56)
Total final demand	3,57	3,77	2,36	1,48	2,79	(0,96)	1,68	2,11

(p) Provisional.
1/ Includes purchases of goods by residents, made abroad and excludes those of non-residents made within the national territory.
2/ Corresponds to final consumption of resident households performed within the national territory.
Source: DANE.

Figure 23
Consumer confidence index
(Balances)



Source: Fedesarrollo, EOE.

For 2003, the performance of household consumption is uncertain. On the one hand, it is hoped that the atmosphere of confidence can be maintained, thanks to the effect of reforms and continuation of the democratic security strategy. At the same time, the tax reform (especially extension of the VAT, the surtax on income and reduction in exemptions for payment of this tax), and the increased contributions to Social Security, imply a reduction in disposable income for households in the short run, and can have a negative effect on economic activity.

Concerning government consumption, given the backlog on payments that occurred during the first months of 2002, it is not strange that it shows an important annual growth rate in the first quarter of 2003. This result is coherent given the fiscal adjustment program and in line with the financial plan for the year.

b. Investment

Growth during the third quarter of 2002 (Table 6), was noticeably greater than predictions made in the previous report. Favorable performance observed in the machinery and equipment investment group and in transportation equipment explains this result. The previous report expressed the belief that the industrial sector showed excesses of installed capacity, given its low level of utilization and scarce production growth. Nevertheless, in the third quarter, the balances for firms improved and the sector experienced an important recovery in its sales. The foregoing added to the good news from ATPA and optimism shown by businessmen might have improved the atmosphere with regard to investment decisions.

For the fourth quarter, investment will continue to grow as a result of the dynamism in building expenditure. Sector indicators (the building census, loans granted to builders and buyers of housing and approved building licenses) suggest that this category kept up its growth rhythm at the end of the year and support the positive expectations for good performance in the early months of 2003.

On the other hand, it is expected that for 2003, investment in civil works will receive important contributions from local government. This is the case of Bogota, where new roadway infrastructure and massive transportation construction are planned. Other cities, such as Cali and Medellin, also plan to begin construction and to extend their massive transportation systems. Finally, for the first quarter in 2003, a significant recovery is foreseen in Central Government investment, due to the statistical effect indicated above.

In addition to the foregoing, a customs exemption on imports of capital goods took effect in October, 2002 for items not produced in the Andean region. This measure can notably stimulate fixed capital formation during 2003.

In spite of this, it is still premature to foretell whether total investment in the third quarter represents a breakpoint in growth trends for this aggregate. Its evolution in the immediate future will continue to depend on the climate of confidence and the expectations of businessmen as to the economy's growth capacity, as well as expected behavior of foreign sales. Given the international environment (except for ATPA) and still incipient domestic growth, it is difficult to expect a sustained recovery of this variable in 2003.

c. Exports

In November, 2002, total exports continued to contract. This behavior can be explained mainly by the noticeable decrease in non-traditional industrial exports to Venezuela. The greater sales dynamics to other regions, particularly toward Central American countries, the growth of exports to Ecuador and the initiation of ATPA were not able to compensate for Venezuela.

For 2003, it is expected that traditional exports will drop in volume due to the decline in oil production and unfavorable expectations with respect to the coffee harvest. This circumstance should have a negative effect on real growth. However, the fall in volume can be compensated by improved perspectives for the evolution of international prices, which would allow growth of the export value.

For non-traditional exports a mixed result is foreseen. In the case of sales aimed at the United States, it is to be expected that they recover and toward the end of the year present a similar or greater level than that observed in 2001, due to the initiation of ATPA, in addition to a possible improvement in the economic situation of that country.

As for exports to Ecuador, there will probably be a significant reduction in the rate of growth, although it will continue to be positive. The dynamics here will be restricted by the slow growth shown by the Ecuadorian economy and possibly by restrictions in commerce given the high rate of penetration by Colombian exports in that market. In any case, a favorable factor that increases the competitiveness of sales toward Ecuador is the Colombian peso devaluation with respect to currencies such as the Chilean peso and the new Peruvian sol, which are our strongest competitors in that market.

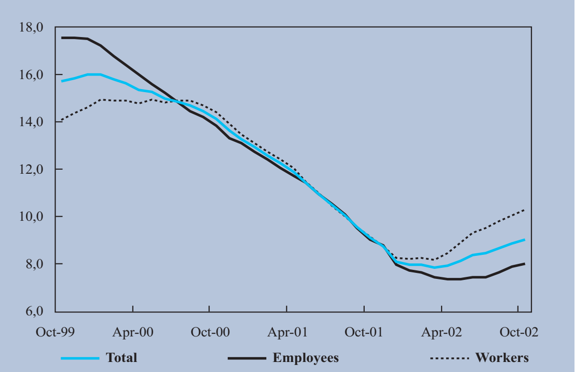
Finally, sales to Venezuela do not present a favorable outlook. The general strike begun in December, the political conflicts and crisis in the confidence of agents has exacerbated expectations of low economic growth this year. Some analysts estimate a contraction of the product similar to or greater than that occurring in 2002. Likewise, the recent announcement of the closing of the exchange market[10] (capital control) could hinder the payment of exports made in previous months, which would deteriorate even more the commercial portfolio with that country (Figure 24).

C. Salaries employments and salary agreements

1. Industrial salaries

According to figures in the new monthly manufacturing sample, in the last 12 months ending in October, 2002, nominal salaries in the industrial sector adjusted to an annual rate of 9.0%. This rate is no higher than the rate observed one year ago, but it does exceed that recorded in April, 2002, by 1.1 percentage points, which could indicate the beginning of a change in the trend for nominal salaries in this sector (Figure 25). Since 1993, and along with a reduction in inflation, nominal salaries in industry had been adjusted to the ever lower rates, except for a short period of exception during 1997. The change

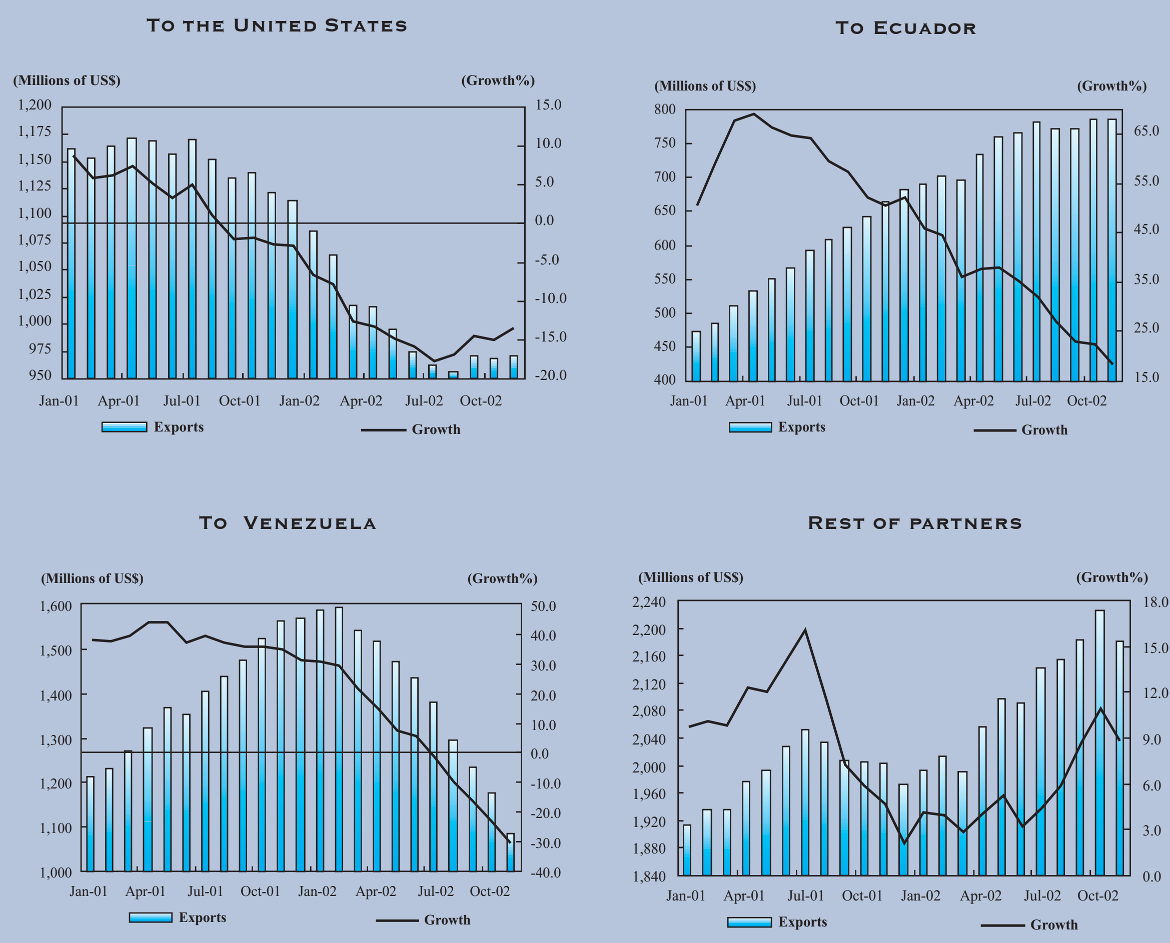
Figure 25
Annual growth of nominal industrial salary last 12 months
(Percentage)



Source: DANE.

[10] This measure took place January 21, 2003, the date on which this report was prepared.

Figure 24
Non-traditional industrial exports
last 12 months, data up to November, 2002



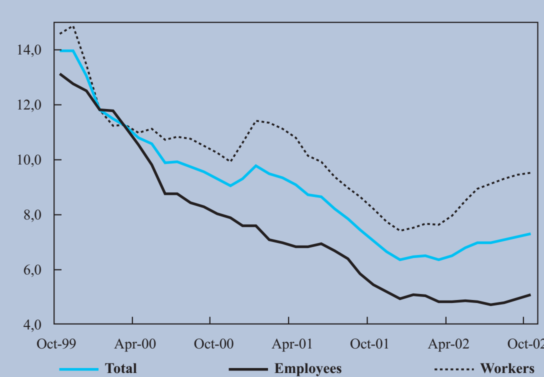
Source: DANE.

in this tendency is being pushed by the greater rhythm of adjustment exhibited by workers' salaries, although a break in the tendency for employees' salaries has also been observed.

On the other hand, real industrial salaries grew 1.4% during the first 10 months of 2002 and 2.7% between July and October of the same year (compared to the same period of the previous year).

Benefits paid to workers in the sector also showed accelerated growth from March, 2002 onward. By October, the annual rate of readjustment in benefits was 7.3% (Figure 26).

Figure 26
Annual growth in nominal labor benefits in industry last 12 months
(Percentage)



Source: DANE.

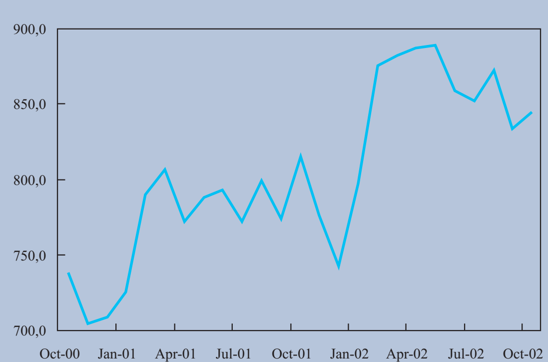
The increase in nominal salaries was reflected in an increase of the unit labor cost (ULC) until May, 2002 (Figure 27). Since then the growth of productivity has allowed a reduction of 5% in the ULC with respect to the level reached in May, but is still 3.6% greater than it was in October, 2001.

The labor reform approved is aimed at reducing the costs of firing employees and at increasing the work day. The pension reform will at the same time allow a reduction in the costs of labor stability.

There are two elements that strongly influence labor costs of formal employment in Colombia: the minimum wage and the high level of extra costs to the payroll.

The minimum salary determines the labor earnings of the majority of the workers with lower levels of education. For example, 40% of the workers, with less than five years of education, receive a minimum wage or very close to it. Although the coverage of minimum wage is the highest in all of Latin America, the impact of greater coverage tends to be critical in the rate of unemployment, because it takes the people who are willing to work for a lower salary much longer to find employment. Typically, an unemployed individual in Colombia spends nine months looking for work, when the average for Latin America is four months.

FIGURE 27
NOMINAL UNIT LABOR COST FOR WORKERS IN THE INDUSTRIAL SECTOR



Source: DANE.

2. Salary increase agreements

Table 7 shows the percentage of workers benefited by ranges from a salary increase agreed upon for a year ahead in the collective bargaining agreements reported to the Ministry of Labor and Social Security. The greatest percentage of beneficiaries, 48.7% was located in the range between 8% and 10%. This proportion is slightly greater than that observed last September (46.4%). Furthermore, another important proportion of benefited workers, 23.9% were able to reach agreements on salary increases in the range from 10% to 12%.

TABLE 7
PERCENTAGE OF BENEFICIARIES BY LEVEL OF AGREED SALARY INCREASES

Negociaciones a un año			
<5,5	**[5,5-8,0]**	**[8,0-10,0]**	**[10,0-12,0]**
8,6	24,0	48,7	18,6

SML = Minimum Legal Wage

Source: Ministerio de Trabajo y Seguridad Social.

3. Employment

The rate of unemployment in the 13 principal urban areas continues its declining trend, and in December, it was 15.7%, or 0.6 percentage points lower than that observed in the same month of 2001 (Figure 28). The lower unemployment rate in the 13 cities can be explained by greater activity in the creation of jobs.

Within the national total, however, the unemployment rate increased from 13.5% to 15.6%. The explanation for this increase was the loss of 485 thousand jobs. Given that employed persons in the 13 principal cities increased by 230 thousand, the employment in the rest of the country (municipalities and «the rest») must have dropped by 715 thousand, which is equal to a decrease of 7.5% in the employed population, excluding the 13 principal cities.

It is difficult to understand the magnitude of this contraction in employment, if it is taken into account that the agricultural and livestock sector, the principal economic activity in rural areas, grew by 2.64% between January and November, 2002, while the agricultural component of GDP grew by 3.23% in the same period. On the other hand, industrial employment continues shrinking. Annual variation in total employment was -4.32%. This reduction in industrial employment occurred principally in permanent jobs (-6.36%), although it has also begun to affect temporary jobs (-0.14%).

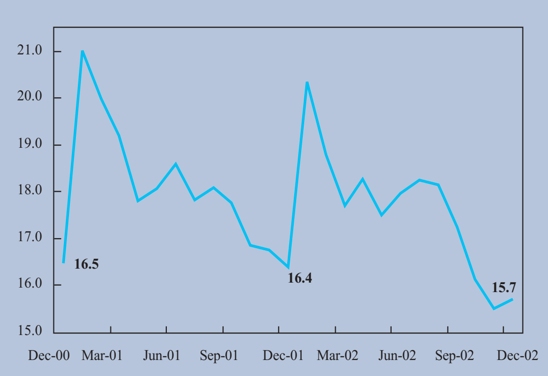
D. Utilization of installed capacity and the product gap

Analysis of installed capacity use and the product gap has not changed with respect to the previous report. In November, indicators on use of installed capacity for industry continued to show levels that are lower than the historical average.

According to the last entrepreneurial opinion survey done by Fedesarrollo, use of installed capacity for the period between September and November, 2002 was 68.9%, which was 5.8 percentage points lower than the average registered in those same months over the last 21 years (Figure 29). Likewise, the ANDI indicator for October was lower than the recorded average for the same month over the last 11 years.

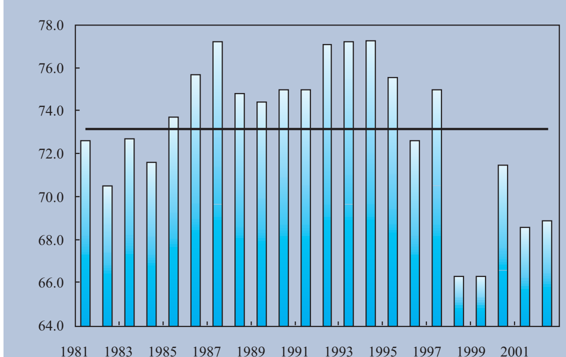
The different indicators for product gap, estimated by the SGEE, confirm the existence of a substantial amount of unused installed capacity for the economy as a whole. At the third quarter of 2002, the gap was equal to 3.5% of GDP and it is expected to remain at this level. Furthermore, the positive growth of investment in machinery and equipment during 2001 and its new recovery in the third quarter of 2002 will extend the economy's productive capacity for 2003. Due to the foregoing, there should not be inflationary pressure with respect to demand during the coming quarters.

Figure 28
Rate of unemployement in 13 cities
new methodology
(Percenteges)



Soure: DANE, continual household survey (ECH).

Figure 29
Use of installed capacity in indusry,
according to Fedesarrollo
(For the third quarter)



Note: The horizontal line represents the average.
Source: Fedesarrollo.

III

International context

Current perspectives for world growth in 2003 are less favorable than those presented in the Inflation Report for last September. Although we can expect some acceleration in this growth compared to 2002, it is very likely that it will be less than the figure initially predicted (Table 8). In the United States, confidence has not been fully restored and there is a lot of uncertainty about the conflict with Iraq and oil price behavior. In Europe external demand is weak and the possibility of using a anti-cyclical fiscal policy is limited due to relatively high fiscal deficits. In Japan, the weakness of the financial system and weakening of external demand have not allowed internal deflationary pressures to be counteracted, in spite of the recent strong monetary expansion. All of this means that growth in industrialized countries will create a stimulus to growth in the emerging countries that is lower than that previously predicted.

On the other hand, the forecasts available for Latin America, suggest that in the three major economies of the region (Brazil, Mexico and Argentina) growth for 2003 will be higher than that recorded for 2002, but lower than that expected one quarter ago. This new forecast is mainly due to the lower growth in industrialized countries (particularly in the U.S.) and intensification of inflationary pressures. For Venezuela, there is no agreement on the growth forecast

Table 8
Annual growth rate and predictions for the principal economies of Colombia's trading partners

	2001	January 13th 2003		September	
		2002	2003	2002	2003
Developed countries					
United States	0,3	2,4	2,7	2,4	3,1
Euro zone	1,5	0,8	1,8	1,3	2,9
Japan	(0,3)	(0,3)	0,4	(0,8)	1,0
Latin America					
Argentina	(4,4)	(11,6)	2,0	(14,7)	1,1
Brazil	1,5	1,1	1,7	1,2	2,6
Chile	2,8	1,9	3,3	2,0	3,6
Mexico	(0,3)	1,2	3,2	1,6	4,0
Peru	0,2	4,4	3,4	3,4	3,2
Ecuador	5,6	3,2	3,0	2,4	3,3
Venezuela	2,8	(6,7)	0,1	(5,7)	0,3

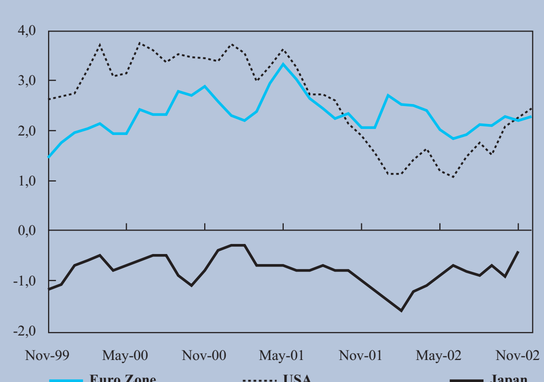
Source: Datastream.

for 2003; however, the latest projections point toward a new fall in output that the most pessimistic analysts calculate at more than 7%.

Inflation in the advanced economies remained at low levels during 2002. This is especially true of Japan and the United States (Figure 30). However, in the Euro zone, consumer inflation has exceeded 2.0%, the upper limit of the range considered price stability by the Council of Governors of the European Central Bank. Nevertheless, analysts do not expect a change in the expansionist position of monetary policy in those countries, at least during the first six months of the year. In Latin America, the devaluation shown during a goodly part of 2002 has been transferred (in some countries) to the prices with greater intensity than that originally foreseen. In Brazil, for example, devaluation carried the inflation rate to a higher level than that initially established by the Central Bank as its target. Therefore it is expected that the region apply a more restrictive monetary policy than that observed in 2002.

The world economy today is strongly vulnerable to negative future shocks. Trust in a rapid recovery is very low. Companies and families can, then, postpone their consumption and investment decisions. Recovery of investment can, furthermore, be affected as a result of the conflict between the United States and Iraq and its effect on petroleum prices. The national strike in Venezuela increases the possibilities that the oil price will continue high, negatively affecting a significant number of the developed economies. The positive effect of higher petroleum prices on the producers can be counteracted by the deceleration of the world's principal economies. Additionally, the deficit in the U.S. current account is historically high and very probably will have to be reduced in the future. Unless, this reduction is gradual, it can have strong negative consequences for the world economy due to a fall in demand in the principal economy and a brusque devaluation of the dollar. Lastly, the U.S. government intends to give new impetus to its economy by tax cuts and increases in military spending. Although in the short run these measures can contribute some additional impetus to economic growth, in the long run it can also lead to serious fiscal problems.

Figure 30
Inflation rate in industrialized economies
(Percentage)



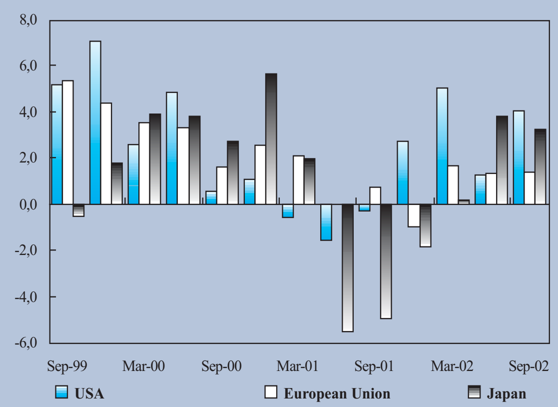
Source: Datastream.

A. Developed economies

Recent performance by the U.S. economy is characterized by a contrary evolution of family consumption and investment. Family consumption has continued to be dynamic throughout the cycle of the economy as a result of lower interest rates, the increase in available income due to tax cuts, and a continual increase in housing prices. On the other hand, productive investment has not been too dynamic. With the drop in share prices, the high level of business debt and accounting scandals involving some corporations, the capacity of businesses to finance new investment with debt or shares has decreased, and the desire to invest has been weakened in spite of a recent increase in the earnings of some companies.

Recent estimations suggest growth in the United States of 2.4% in 2002 and 2.7% in 2003 (Figure 31). It is expected that internal demand records a moderate recovery in spite of low interest rates and the fiscal stimuli of the past (family consumption is not likely to record important acceleration). It is

Figure 31
Annualized quarterly GDP growth United States, euro zone and Japan
(Percentage)

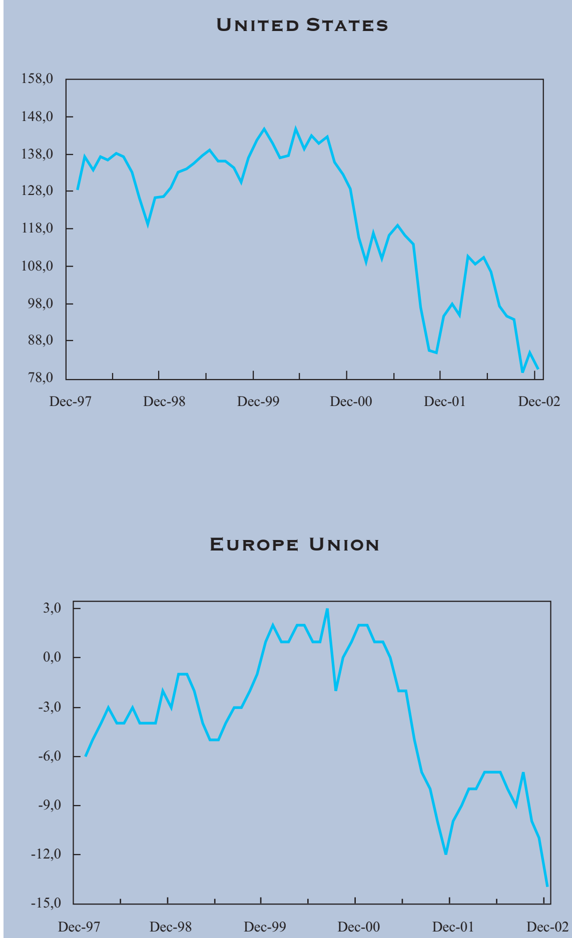


Source: Datastream.

considered that the effect of tax stimuli on consumption will be declining, andalso there could be a certain degree of demand saturation in some durable goods due to strong consumption in the recent past. More importantly still, employment perspectives continue unaltered, uncertainty about financial markets continues and there are still fears about the effects of an eventual armed conflict with Iraq (Figure 32). At the same time, recovery of earnings and improvement in cash flow for companies points toward a gradual recovery in investment. Nonetheless, this phenomenon has not yet occurred.

Since the end of 2001, monetary policy in the United States has shown an expansive tendency. The last reduction in interest rates (to 1.25%) took place in November, 2002. In spite of this, the inflation rate has remained at around 2.0% and there is no indication of any important acceleration in the rhythm of growth in consumer prices. Inflation control can be explained principally by the high level of idle capacity in firms, increases in unemployment and increased competition. Nevertheless, service prices have been increasing at a much higher rate than the consumer basket and in the last months strong devaluation of the dollar with respect to other currencies has been recorded.

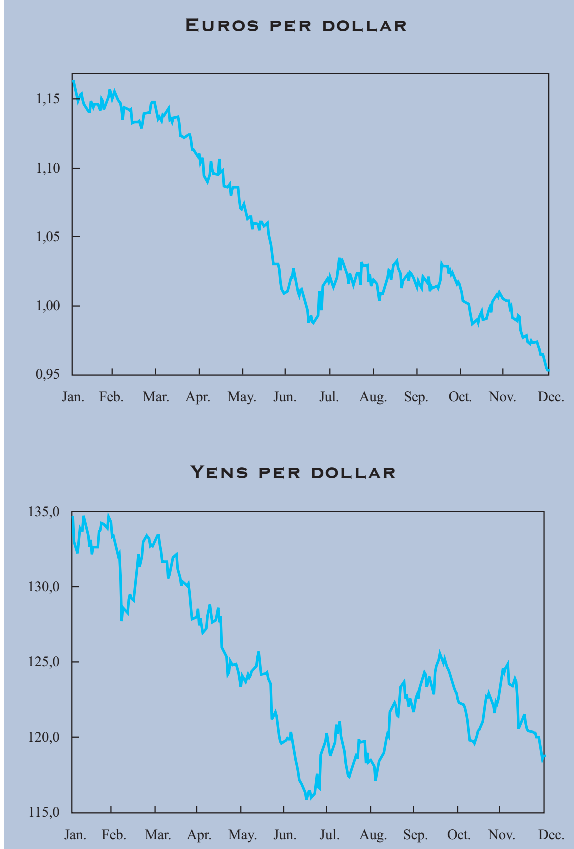
Figure 32
Index and confidence indicator for consumers



Source: Datastream.

With respect to the Euro zone, growth during the first half of 2002 was pulled mainly by net exports and accumulation of inventory, with low level of activity for household consumption. In the second semester, however, the tendencies for these variables changed. Net exports weakened due to the combination of slight world growth and strong appreciation of the euro with respect to the dollar (Figure 33). Perspectives for investment also deteriorated. On the other hand, indicators for household spending improved and the consumption showed a certain recovery, in spite of the low level of the consumer confidence indicator (Figure 32).

Figure 33
Exchange rates
euro zone and Japan, 2002
(Daily series)



Source: Datastream.

Some countries reduced taxes and/or increased public expenditure, which, at a time when the economy is growing at a slow rhythm, has created a strong deterioration in the fiscal situation (for example, in Germany, France, Italy and Portugal).

Recent estimations suggest an increase in the GDP in the euro zone of 0.8% in 2002, a figure that is lower than the 1.3% forecast one quarter ago. For 2003, growth in the region of 1.8% is predicted, a lower rate than the 2.9% expected three months before. This correction downward in the prediction can be largely explained by Germany. This country faces a high fiscal disequilibrium - which exceeds the reference value located at 3% of GDP -, and a loss of dynamism in the economy. Currently, the German government plans a restrictive fiscal policy based on an increase in taxes, cutbacks in public expenditure, and postponement of tax cuts that had been previously planned. The effect in the short run of this policy will probably be recessive. Taking into account that Germany is an important market within the European Union, the weak tendency of its economy will affect the zone significantly.

Inflation in the euro zone, as previously described, has exceeded the high limit of the range considered as price stability by the Council of Governors of the European Central Bank (2%), although there is a big difference in the inflation rates of the countries: in Germany and its neighbors inflation has remained at levels lower than 2%, while in the south of Europe, Ireland and some others, the increase in prices has been much faster. Services prices have been the main source of increased inflation. This phenomenon can be explained, largely, by the performance of real salaries, which have accelerated their growth over the last years in the majority of the countries in the area. Cost pressures are greater in the services sector than in the industrial area, due to the fact that productivity in the former has traditionally grown less than the latter. Some analysts also have attributed part of the price increase for some services to the circulation of euro bills and coins, creating the need to round up prices of hotel and food services outside the home.

The most recent predictions for 2003 suggest a slight reduction in inflation that could continue into the future.

B. Latin America

In Latin America, economic growth in 2002 was less than the expected, due to both external and internal factors. Among the external factors we can see the performance of international markets and a fall in world demand. Scarce capital flows made investment financing difficult and pressured toward a rise in exchange rates and interest. The fall in world demand explains a good part of the weak activity in exports and the international prices of some of the principal export products of the region. Among the internal factors are political uncertainty due to coming presidential elections in some countries, and the difficulty of applying anti-cyclical fiscal policies due to the high levels of public debt that the majority of the countries in the region register. Nevertheless, in the fourth quarter of the year, following elections in Brazil, access to external resources opened up again in some countries and the spreads for debt and volatility of exchange rates dropped (Figure 34 and Table 9). In spite of the recent opening of international capital markets for some of the Latin American economies, for 2003 we expect only a slight increase in said resources with respect to the levels observed in the previous year (Table 10).

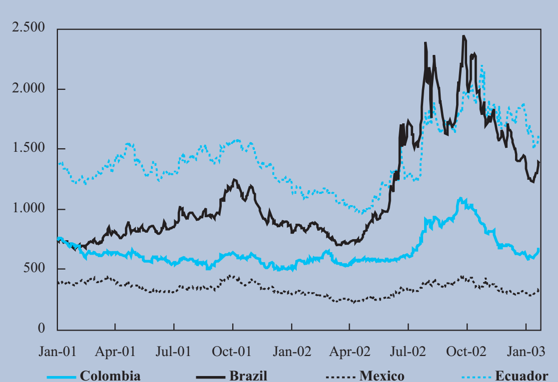
Contrary to what happened in the majority of Latin American countries, the situation in Venezuela deteriorated in the last quarter of the year, especially in December, when the «National Civic Strike», also joined by the state petroleum company PDVSA started. In that month the production and exportation of petroleum, the main source of income for the country, dropped by about 75%, while the spread and exchange rate increased systematically[11] (Figure 35). Thus at the end of 2002, Venezuela recorded a devaluation of 83.1%, inflation of 31.2% and estimated growth of -6.7%[12]. The economic outlook for Venezuela for this year is for continued political and economic crisis. Even if the former is solved in the short run, the negative economic effects will persist, in part, due to the difficulty of rapidly restoring the normal volumes of petroleum production and due to the distrust of investors. As stated above, the latest forecasts for GDP growth for 2003 show that the Venezuelan economy might register a decline similar to that shown in the previous year.

In 2002 the Ecuadorian economy registered one of the highest output growths in Latin America (3.2%), and analysts hope for a similar rate in 2003 (Table 8). However, this growth could be less if the new government is not successful in approving and rapidly carrying out strong structural reforms in the public sector. Likewise, economic performance will depend on the support that it can get from multilateral banking and the IMF.

[11] On January 22, 2003 the exchange and the spread were at about 38.6% and 33.4% above the level observed at the end of 2002.

[12] Forecast by *Consensos Economics,* Datastream.

Figure 34
EMBI PLUS
Latin America countries
(Percentage)



Source: Bloomberg.

Table 9
Devaluation of Latin American currencies with respect to th U.S dollar

	Quarterly (*)	Annual
Argentina	(10,0)	237,2
Brazil	(5,9)	53,2
Colombia	1,3	25,0
Chile	(3,9)	8,9
Mexico	1,7	13,4
Peru	(3,6)	1,9
Venezuela	(6,0)	83,1
Uruguay	(1,1)	84,2

(*)Corresponds to the devaluation of December Vs. September (end of period).

Table 10
Capital flows to embeging economies by region (NET)
(Billions of dollars)

	1999	2000	2001	2002 (e)	2003 (Fore.)
Private funds	148,2	185,6	125,7	112,5	137,1
Latin America	69,7	62,6	47,8	25,2	35,5
Europe	38,3	42,2	17,0	21,7	31,0
África / Middle East	10,2	4,7	9,3	3,8	8,1
Asia / Pacific	30,1	76,2	51,6	61,8	62,5
Five Asian economies (*)	(5,8)	17,2	7,1	2,9	5,7
Official funds	12,4	(3,0)	14,7	12,2	10,4
Latin America	7,9	(6,7)	22,4	14,0	17,7
Europe	0,2	2,0	1,4	5,0	(0,1)
África / Middle east	(1,7)	(0,5)	(4,0)	(2,0)	(2,0)
Asia / Pacific	6,0	2,3	(5,0)	(4,8)	(5,2)
Five Asian economies (*)	1,9	2,9	(4,6)	(3,9)	(4,9)

(e) Estimated.
(Fore.) Forecast
(*) South Korea, Indonesia, Malaysia, Thailandia, Phillippines.
Source: Institute of International Finance. *Capital Flows to Emerging Market Economies*, January 16, 2003.

Figure 35
EMBI Venezuela Vs Exchange rate

Source: Datastream y Bloomberg.

C. PRICES OF BASIC PRODUCTS

The prices of the principal basic products increased throughout 2002, especially during the second semester of the year. In this way, the average price index for the set of basic products listed in The Economist increased by 4.8% with respect to the average index for 2001 (Figure 36).

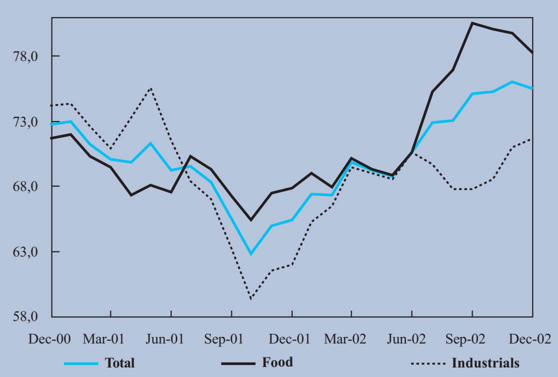
This increase in basic product prices was the result, for the most part, of an increase in the price index for food. The index of average prices for foodstuffs increased by 7.8% in the year 2002, according to the magazine The Economist, principally due to a reduction in inventories motivated by climatic factors. Likewise, in 2002, the price index for industrial goods was at 0.7% above the level observed one year before.

Given that a very tentative recovery of the world economy is expected in the year 2003, there is no expectation of demand pressures on the basic product prices, particularly of those industrial goods, with the exception of the oil price.

1. Petroleum

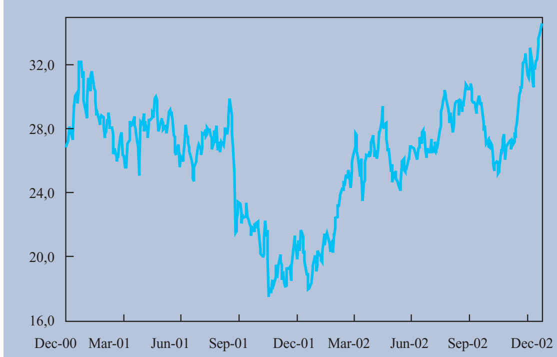
During 2002, the international price of petroleum registered a rising tendency as a result of diminishing

FIGURE 36
MONTHLY INDEX OF PRICES OF
PRINCIPAL BASIC PRODUCTS
(1995 = 100)



Source: *The Economist.*

FIGURE 37
WTI PETROLEUM PRICE
NEW YORK EXCHANGE
(DOLLARS PER BARREL)



Suente: Bloomberg.

inventories of crude oil in the world, especially in the U.S. and due to the uncertainty created by the conflict in the Middle East. In spite of sustained price rises, the Organization of Petroleum Exporting Countries (OPEC) kept its quotas for production unchanged throughout the entire year. Thus, the quotation on WTI petroleum in 2002 was, on the average, US$26.2 per barrel, that is 0.8% higher than that registered in 2001 (figure 37).

From the end of November a sharp increase in the oil price was observed mainly as a result of the political crisis in Venezuela and the greater probability of a war between the United States and Iraq, as well as the low levels of inventories. In fact, daily production in Venezuela in December dropped, approximately, two million barrels, creating a strong reduction in the petroleum stock worldwide and great uncertainty in the market about future supplies. As a consequence, at the end of December, the international price for petroleum reached the highest levels in the last two years, situated at 16% above the level of the previous month.

The behavior of petroleum prices during 2003 is dubious and depends, basically, on two factors: first, the effectiveness of an increase of 1.5 million barrels per day (MBD) in OPEC production quotas, which should take effect as of February 1. Second, it will depend on the outcome of the conflict between the United States and Iraq and the political situation in Venezuela. If the war with Iraq becomes a fact and there is no short term solution to the paralysis of oil production in Venezuela, oil stock will drop even further, creating pressure on the price of crude, especially if the world economy begins to show signs of solid recovery. Given the foregoing situation, and taking into account that several months are needed to reestablish levels of production in Venezuela to those prior to the national strike, it is estimated that the price of petroleum WTI will settle on the average between US$28 and $US30 per barrel in 2003.

2. Coffee

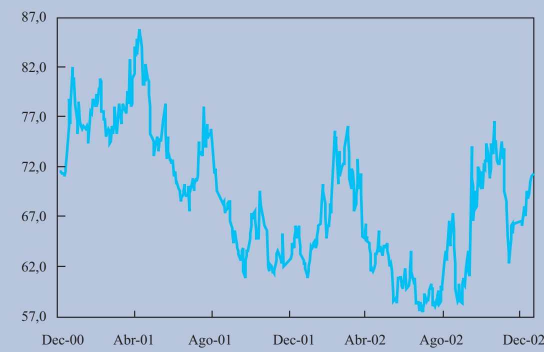
In the last quarter of 2002, a sustained increase was seen in the international price of coffee. In this way, the average price of this period exceeded the level for the same period last year by 7.7%, reaching U$69 cents/pound. Nevertheless, this increase did not prevent the average price for the year (US$65.1 cents/ pound) from dropping by 10.1% from the price of the previous year (Figure 38).

The increase in the price of the bean in the last quarter is attributed mainly to a climatic shock that affected the Brazilian harvest, with high temperatures and scarce rains. This situation created uncertainty as to a possible decrease in the 2003 harvest. Future performance of coffee prices will continue to be influenced, largely by the factors linked to product supply. According to the International Coffee Organization (ICO)[13], it is possible that during 2003 a reduction in Brazilian production may be seen as a consequence of the two year production cycle and the drought[14]. It is, therefore, expected that the average price in 2003 will be above the price observed in 2002.

[13] Report on the coffee market, November, 2002.

[14] The two-year cycle of production gives a plentiful harvest one year followed by a lesser harvest the next year.

Figure 38
Prices for colombian arabic coffee
New York Exchange
(US$ Cents/Pound)



Source: Bloomberg.

IV

Inflation forecasts

As indicated in Chapter I (Recent Evolution of Inflation), in the last three months, there has been an increase in the rate of inflation, which exceeded the target established by the Board of the Banco de la República for 2002 by 0.99 percentage points. The main explanation for this is the marked increase in the price of potato, due to temporary supply factors. Nonetheless, the acceleration of inflation also derived from an increase in basic inflation.

Due to the fact that the Colombian economy has functioned for some years now below its potential capacity, the recent acceleration of basic inflation suggests there are inflationary pressures from associated costs, principally, the effects of devaluation on the prices of tradable goods.

Recent acceleration in basic inflation and failure to meet the 2002 target with precision, can lead to increases in inflation expectations. This added to the inflationary pressures originating from devaluation and the transitory effect on the price level of an extension of IVA (added value tax), compromises the achievement of future inflation goals.

Forecasts for inflation show that it is necessary to control inflationary expectations in order to achieve fulfillment of the 2003 goal. As indicated above, this suggests the need for a change in monetary policy position.

In the last months there has been a favorable evolution of the Colombian macroeconomic environment that would facilitate the policy of price stabilization in the medium and long terms. On the domestic front, approval of structural reforms and the new adjustment program with the IMF may be highlighted. On the external side, a relative opening of capital markets for bond issues could mean greater exchange rate stability.

However, there are also a number of factors that could create or maintain rising pressure on inflation. This is the case of the effect of VAT reform, the increase in energy rates, the dismantling of fuel subsidies and their high international prices together with rises in the prices of some basic imported products. Furthermore, the high devaluation seen since the second semester last year could continue to be transmitted to prices through greater costs. To the foregoing, we must add the uncertainty with respect to the development of the Venezuelan crisis, and forecasts of lower growth in the world economy in 2003. These factors could maintain or increase expectations of devaluation with negative consequences for inflation.

In this chapter we give the Bank's inflation forecasts, emphasizing the changes made with respect to the assumptions in the September report. Likewise, the principal factors that create uncertainty, both positive and negative accompanying these forecasts, are identified, together with the risk balances.

A. The external enviroment

The most important change on the external side is a significant decrease in risk perception toward Latin America by international financial markets during the fourth quarter. This evolution has allowed a rapid correction of sovereign risk premiums as of October, which was transmitted also, albeit for a short period of time, to the exchange rate.

Presently, there are some indications that suggest that capital flows could be partially returning to Latin America. However, there is no indication that improvement in capital flows will be growing. The markets are still adverse to risk, due to the delicate international situation, and the lack of solidity in Latin American economic growth.

For this report it is supposed that during 2003, there will continue to be partial opening of financial markets for Latin America. In the case of Colombia this means that the government will not be able to access programmed external resources. Likewise, it supposes that net private capital flows will not be reduced with respect to the levels observed last year. These factors would ease exchange rate pressures somewhat.

Nevertheless, inflationary pressures due to devaluation will not disappear. First, devaluation in the last six months has been considerable, so that it is probable that its effect will continue to be transmitted to inflation to the degree that other economic sectors update their prices.

Secondly, not all changes in external conditions favor exchange rate stability. In the last months, the perspectives of growth in the world economy for 2003 were reduced with respect to the scenario contemplated in the previous report, pulled by the greater possibility of an armed conflict in the Middle East and by the low levels of confidence that investors and consumers in the U.S. continue to show. For Colombia, lower world growth reduces growth perspectives for the foreign sector, through a lower export volume or lower terms of trade, increasing sovereign risk and devaluation expectations.

In the case of the United States, for example, the forecast for growth dropped from 3.1% to 2.7%, according to the projections made in Consensus Forecast. A reduction in growth prospects in the cast of the euro zone countries is even higher (Chapter III).

Something similar could be said with respect to the current situation in Venezuela. In the last few weeks it has become clear that the political conflict in that country will have even more negative repercussions on economic performance than was expected some months ago. This has obliged Venezuelan growth forecasts to be downscaled in the Bank's balance of payments and inflation models as compared to what was presupposed in the September report (Chapter III).

Lower growth in Venezuela could have important repercussions on the Colombian economy due to the volume of bi-national commerce and the importance of their market for key sectors such as industry and commerce. Neither can the possibility of a significant reduction in exports to that country in 2003 be discarded, taking into account the high elasticity of our sales in response to economic growth in that country.

The foregoing situation could lead to a reduction in the supply of exchange currency of some consideration and a subsequent acceleration in the rhythm of devaluation. The high volatility recorded in the Colombian exchange market during the early weeks of January, 2003 could have its origin in this phenomenon.

On the other hand, as indicated in previous report, lower growth expectations for the world economy and for our principal commercial partners do not necessarily lead to greater inflationary pressures. If scarce world economic growth takes place in a low inflation environment, it is probable that it will be accompanied by a lax monetary policy by central banks in the most important economies, with which we may expect lower international interest rates. Taking into account the fragility of economic recovery, this report believes it more probable to find a low external rate scenario during 2003.

Finally, the external environment will also affect Colombia's inflation tendencies through its effect on demand. In Colombia, however, this effect is not any more important given the low share of exports in the product. Even so, inflation forecasts presented here contemplate lower pressures on inflation for this reason.

In short, for this report it is supposed that the set of external factors that have already been identified could generate lower pressures on the nominal exchange rate than that which was expected in the September report. Nonetheless, it should be taken into account that the channels of transmission for the external variables toward the exchange rate and inflation are particularly complex and difficult to estimate, such that these forecasts are subject to a level of uncertainty.

B. The domestic enviroment

In recent months important advancements have been made in the area of macroeconomic stability thanks to the structural reforms approved by the Congress of the Republic. This situation, together with the improvement in conditions of internal security and the acceleration of growth in the latest quarters, has contributed to increasing the levels of confidence in the economy with respect to the situation prevailing in September, and partially compensating for the effect of lower prospects for external growth.

In terms of inflation, the improved internal conditions have had two effects. First, they tend to reduce the pressures on the exchange rate and in this way on inflation, adding to the favorable effects identified in the foregoing section and that derive from better external conditions.

Secondly, the greater prospects for growth can create pressures on prices in certain circumstances. For this report it is supposed that the greater confidence shown by consumers and investors will allow a slight acceleration in economic growth in 2003, in comparison to that observed in 2002. This growth would be stimulated by private domestic demand, since public expenditure must be reduced to comply with goals set by the IMF. On the other hand, the external demand will have limited growth due to the international situation.

Forecasts by the Bank for inflation suppose a similar growth to that contemplated in the government goal (2%), which is greater than the estimate for 2002 (1.6%). Growth in 2003, meanwhile, will diminish compared to predictions made by the government in September (2.5%), as a consequence of deterioration in external growth. Bank estimates likewise suggest that growth predicted by the government for 2003 is compatible with the availability of external financial resources announced and with a net foreign investment flow similar to that observed in 2002. For the same reasons, it is also compatible with a stable exchange rate scenario.

Growth such as that indicated should not create inflationary pressures from demand, unless it occurs within a context of growing inflationary expectations and low credibility in the Central Bank's inflation goals. By November, the different indicators for utilization of installed capacity continued to mark historically low levels and the estimates made by the Bank for the output gap (measured GDP- potential GDP) continued to be negative by a wide margin. On the other hand, unemployment continues high and no fundamental change in this variable is expected in the coming quarters.

Taking the foregoing elements into account, this report contemplates an output gap slightly more negative than that foreseen in the previous report. Widening of the gap is justified by a slight acceleration in the growth rate of the potential product, in view of more dynamic behavior by investment in 2002 compared to that foreseen in previous reports. Therefore, this time the evaluation made in the previous report will be upheld, since, in principle, there should not be important inflationary pressures from the demand side.

Other aspects of the new domestic environment are not as favorable for the control of inflation. Perhaps the most disturbing and the one monetary authorities have focused a lot of attention on is inflation expectations. This variable continues to be very important in defining inflation tendencies in Colombia, given that indexing mechanisms in private contracts and official standards for salaries and prices remain in force.

At publication of this document, information relative to expectations was limited and data from the Bank's expectations survey was not available. However, indirect information would suggest that inflation expectations could have taken an upward swing, after several years of continual plunging. Some evidence to this effect is the upswing shown in the TES yield curve in answer to the recovery of inflation in November (Chapter II). Something similar could have happened with the readjustment of the minimum wage (7.44%) and with acceleration in the rhythm of adjustment of industrial wages (Chapter II).

Failure to fulfill the inflation goal by nearly a percentage point has surely contributed to increasing expectations in 2003. Although this failure cannot be attributed to a monetary policy that was too lax, it could create doubts as to the commitment of the monetary authority with its policy in the area of price stability in the long run, and particularly with the fulfillment of the 5.5% goal for 2003. The foregoing is particularly valid for a public that is not well informed, that does not recognize the difference between basic inflation (of a monetary origin) and total inflation and which is the one that is responsible for most of the adjustments in prices and salaries. The panorama is complicated if it is taken into account that markets are highly sensitive to price pressures deriving from the IVA reform and the high readjustments announced for prices such as gasoline and power.

The inflation forecasts presented in this report, assume an increase in inflationary pressures originating from greater inflation rates than those predicted in the September report. It is expected that these pressures will be seen during the first quarter of the year principally, a period during which the companies and consumers concentrate the updating of their prices and salaries.

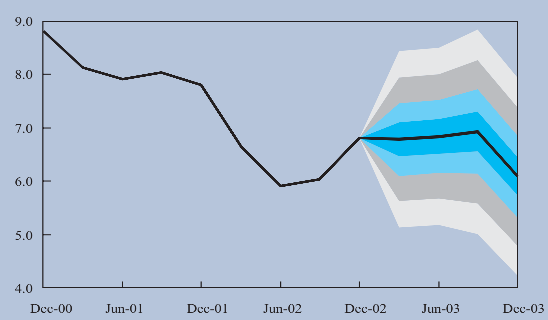
C. Inflation forecasts

With price information for December, the Banco de la República forecasts total inflation for the consumer at 6.1% for the average of the fourth quarter of 2003. This prediction is 0.6 percentage points higher than the forecast presented by the Bank in its September report. Likewise, this forecast is slightly above the 5% to 6% range established by the central bank as the inflation goal for 2003. It is worth mentioning, however, that the forecast in question is not incompatible with inflation for December below 6%. In fact, if one takes into account that the projected path is declining throughout 2003, it is plausible that in December consumer inflation could be even lower than that expected for the fourth quarter (Figure 39).

The increase in the prediction for total consumer inflation in this report has to do mainly with the increase in the forecasts for food inflation. While the September report forecast food inflation of 2.8% for the average of the fourth quarter of 2003, the current forecast has risen to 5.8% (Figure 40). This increase can be explained because currently it is supposed that devaluation can have a greater effect on the price of some processed foods, such as oil, grease and cereals than that foreseen in the previous report. Likewise, it is expected that international prices for these same products and of cacao will pressure domestic prices upwards.

In this respect, it must be pointed out that part of the price rise in foodstuffs during the fourth quarter of 2002 was due to readjustments in the prices of tradable foodstuffs and were associated with the acceleration of devaluation and with the increase in international prices of several associated raw materials (Chapter I).

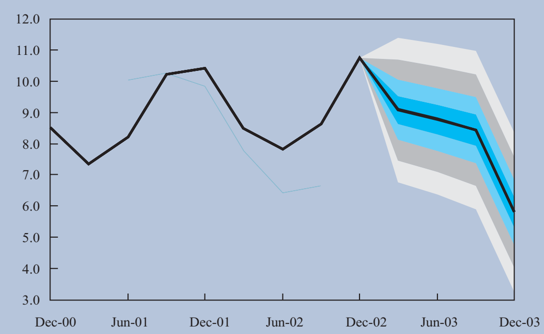
FIGURE 39
FORECAST OF TOTAL INFLATION TO CONSUMERS FOR THE YEAR 2003
(CENTRAL SCENARIO AND RISK BALANCE)



Period	90%	50%	25%	Central	25%	50%	90%
Mar-03	5,1	6,1	6,5	6,8	7,1	7,5	8,4
Jun-03	5,2	6,2	6,5	6,8	7,2	7,5	8,5
Sep-03	5,0	6,1	6,6	6,9	7,3	7,7	8,9
Dec-03	4,2	5,3	5,7	6,1	6,5	6,9	8,0

Source: Banco de la República.

FIGURE 40
FORECAST OF FOOD INFLATION FOR THE YEAR 2003
(CENTRAL SCENARIO AND RISK BALANCE)



Period	90%	50%	25%	Central	25%	50%	90%
Mar-03	6,8	8,1	8,6	9,1	9,5	10,0	11,4
Jun-03	6,4	7,8	8,3	8,8	9,2	9,8	11,2
Sep-03	5,9	7,4	7,9	8,4	8,9	9,5	11,0
Dec-03	3,3	4,7	5,3	5,8	6,3	6,8	8,3

Source: Banco de la República.

In any case, the Bank's models continue to predict a reduction in food inflation as a consequence of a downward correction in potato prices and of some other agricultural products, as well as due to the lower adjustments in the price of meat and its substitutes, in view of the fact that Colombian cattle raising must enter a phase of liquidation during this year. Likewise, by the end of the year there are no expected adjustments in the prices of processed and tradable foodstuffs, which should contribute to a drop in annual inflation for this sub-group given the high increases in their recorded prices during the fourth quarter of 2002.

The food forecast that is presented here supposes the presence of a moderate Niño phenomenon until mid-year, as was stated in the previous report[15]. The effect of this type of phenomenon on rainfall in Colombia is difficult to predict, even though it is usually accompanied by reductions in its intensity in very geographically limited areas. For this same reason, its impact on food prices is usually limited and much less than that observed in situations in which the phenomenon is classified as strong.

With respect to inflation without foodstuffs (basic inflation), in this report the forecast for the average in the fourth quarter is situated at 6.2%, that is a drop from the forecast presented in the September report (6.6%). The Bank's forecast indicates that the annual inflation without foodstuffs may rise until the third quarter and then will begin to descend (Figure 41).

In this report, there are shown for the first time, forecasts of inflation without foodstuffs for 2004. According to these figures, inflation without foodstuffs will continue to drop to a level of 4.7% for the average of the fourth quarter of 2004 (Figure 41).

15 Since July, 2002, the NOAA confirmed the presence of the Niño.

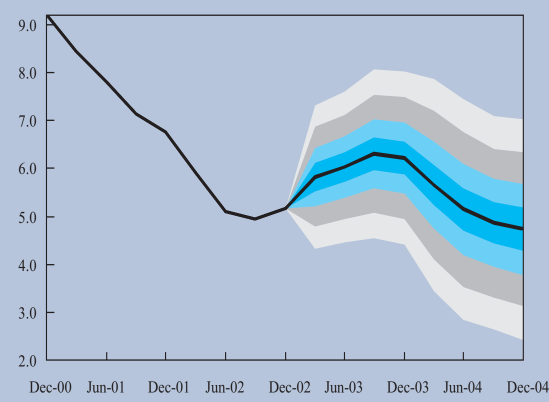
In general terms, the forecasts for inflation without foodstuffs for 2003 and 2004 dropped compared to those obtained three months ago. This was possible due to the lower nominal devaluation and a broader and negative gap in output expected for that period.

D. Uncertainty factors

As usual, the predictions that have already been presented are subject to different sources of uncertainty. The most important of these is devaluation and its effect on inflation. For the most optimistic scenario in the area of devaluation contemplated in this report to become reality, it is necessary for capital markets to continue to be willing to finance Colombia. This, in turn, requires that the perception of risk in the region does not deteriorate, for which it is essential that several of the countries in the region find their way toward greater macroeconomic stability and that the prospects of world growth do not deteriorate much more. Likewise, it assumes that Colombia will fulfill its goals in accordance with the IMF and that it will successfully carry out the structural reforms within the state, some of which should be submitted to the consideration of the public in the referendum. Failure in any of these assumptions could harm the confidence investors show in Colombia and create additional exchange and inflationary pressures not contemplated in the forecasts indicated.

A second source of uncertainty comes from food prices. As explained above, the reduction in total inflation could depend exclusively on an important decline (about 5.0 percentage points) in food inflation. Even though the Bank's models foresee a correction in the prices of perishable foodstuffs, which was already present to a degree in December, the magnitude of this correction is very uncertain and difficult to predict according to experience. Furthermore, for 2003, the adverse effects on food prices of the Niño phenomenon cannot be disregarded, even though it is supposed to be of a moderate nature.

Figure 41
Forecats of inflation without foodstuffs for the years 2003 and 2004
(Central Scenario and risk balance)



Period				90%			
				50%			
				25%			
				Central			
Mar-03	4,3	5,2	5,5	5,8	6,1	6,4	7,3
Jun-03	4,5	5,4	5,7	6,0	6,3	6,7	7,6
Sep-03	4,6	5,6	6,0	6,3	6,6	7,0	8,1
Dec-03	4,4	5,5	5,9	6,2	6,6	7,0	8,0
Mar-04	3,4	4,7	5,2	5,6	6,1	6,6	7,9
Jun-04	2,8	4,2	4,7	5,1	5,6	6,1	7,5
Sep-04	2,6	3,9	4,4	4,9	5,3	5,8	7,1
Dec-04	2,4	3,8	4,3	4,7	5,2	5,7	7,0

Source: Banco de la República.

For 2003 greater increases could also be registered than those foreseen here in the international prices of some imported foods or internationally traded goods (cereals, oils, cacao), depending on climatic variables and the performance of world demand (Chapter III). Were these changes to occur, they would be focused on the first half of the year, but could recede in the second semester, decreasing pressures on domestic prices.

An increase in petroleum prices, above the levels contemplated in this report, cannot be disregarded either under the current circumstances and could be a source of uncertainty with respect to inflation.

Nevertheless, it is believed that the direct effect on prices could be more than compensated by the improved current account situation that this would imply for the country, which would in turn presuppose lower pressures on the exchange rate and inflation.

Also for 2003, increases in the electrical power rates are expected above the target, which could affect total inflation to the consumer, throughout the year. Likewise, it is expected that the VAT reform will exercise a rising pressure on inflation, especially at the beginning of the year, when the companies tend to adjust their prices. To judge by historical evidence, the effect of the VAT on inflation should not be significant and would rather be of a temporary nature. Finally, the magnitude in which inflation expectations are increased and their final effect on prices are another great source of uncertainty, given the scarce information available. Very probably, as soon as readjustments are made early in the year, there will be more clarity with respect to this and forecasts for the end of the year and for 2004 can be refined.

Taking into account that the majority of the uncertainty factors can lead to inflation higher than the predicted, the middle path for all the predictions is accompanied by a middle path inclined upward.

This bias, however, was reduced from the September report to this one in an attempt to incorporate the possibility of lower inflationary pressures from demand in response to the risks growth faces and the favorable effect on devaluation that an additional increase in the international petroleum price could have, among others.

FORECASTS BY LOCAL AND FOREIGN ANALYSTS FOR THE PRINCIPAL MACROECONOMIC VARIABLES

A review of the most recent predictions made by local and foreign analysts for the principal variables in the Colombian economy, are presented below for 2003. It should be taken into account that on the date the forecasts by local analysts were received, the latter already had the official inflation figure for 2002.

FORECASTS FOR 2003

In the Table, forecasts made for the year 2003 are listed. The most important change in the forecasts of the local analysts in the last quarter corresponds to inflation. In general terms, expected inflation increased in relation to the forecast that had been reported in the previous report. Presently, the forecast for inflation made by local analysts is 6.3%, that is, 0.6 percentage points above the rate given in September. This increase in the forecasts for inflation is related with the fact that inflation for 2002 ended at 99 basic points above the target.

Table
Forecast for the principal macroeconomic variables for 2003

	Date of forecast	Real growth of GDP	IPC Inflation	Nominal Exchange rate	Nominal DTF	Deficit (% of GDP)		Rate of unemployment
		%	%	(end of)	%	Fiscal 1/	Cur. Acct.	%
Local analysts								
Revista Dinero	20-Ene-03	2,2	6,8	3.094	10,0	(2,8)	(2,1)	16,0
Suvalor-Corfinsura	20-Nov-02	2,4	6,0	2.950	9,2	n.a.	n.a.	n.a.
Corfivalle	15-Ene-03	2,5	6,0	3.110	9,7	(3,0)	(2,0)	15,0
ANIF	16-Ene-03	2,3	5,5	3.094	10,0	(2,5)	(2,2)	-
Fedesarrollo	16-Ene-03	2,4	7,0	3.111	10,0	(2,6)	(2,4)	16,0
Average		**2,4**	**6,3**	**3.072**	**9,8**	**(2,7)**	**(2,2)**	**15,7**
Foreing analysts 2/								
Goldman Sachs	10-Ene-03	1,5	5,5	2.612		(2,4)	(1,6)	
IDEA global	15-Ene-03	2,8	6,5	2.930		(2,7)	(2,6)	
J. P. Morgan	13-Ene-03	1,7	5,7	n.d		(2,6)	(1,6)	
Deutsche Bank	09-Ene-03	2,2	6,0	3.017		(4,6)	(2,8)	
Average		**2,1**	**5,9**	**2.853**		**(2,6)**	**(2,2)**	

n. a. Not available.
1/ In calculating the average of the fiscal deficit, forecasts by the Deutsche Bank are not included since they refer to the deficit of the Central Government and not the non-financial public sector.
2/ Report How do we look to the outside?, SMT, 23 January 2003.

With respect to the exchange rate for the year 2003, devaluation expected by local analysts continued to be revised upward as compared to the forecast presented in the previous report.

Local analysts expect nominal devaluation equal to 7.6% for 2003, when three months ago it was forecast at 3.8%.

Analysts continue to expect better performance in the economy this year. On this occasion the average of forecasts for GDP growth was 2.4%, similar to that presented in the September report.

Finally, local analysts coincide in that this year the public finance adjustment program will take place. For 2003 the consolidated fiscal deficit expected is 2.7% of GDP, a figure that is very close to that established according to the International Monetary Fund (2.5%).

Foreign analysts share the vision of the local analysts. For 2003 they modified their forecast for inflation upward (although the average is kept within the range of the established goal for this year), as is that of the nominal exchange rate. Likewise, they foresee an important adjustment in public finances, as well as better performance by the economy compared to that observed in 2002.

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