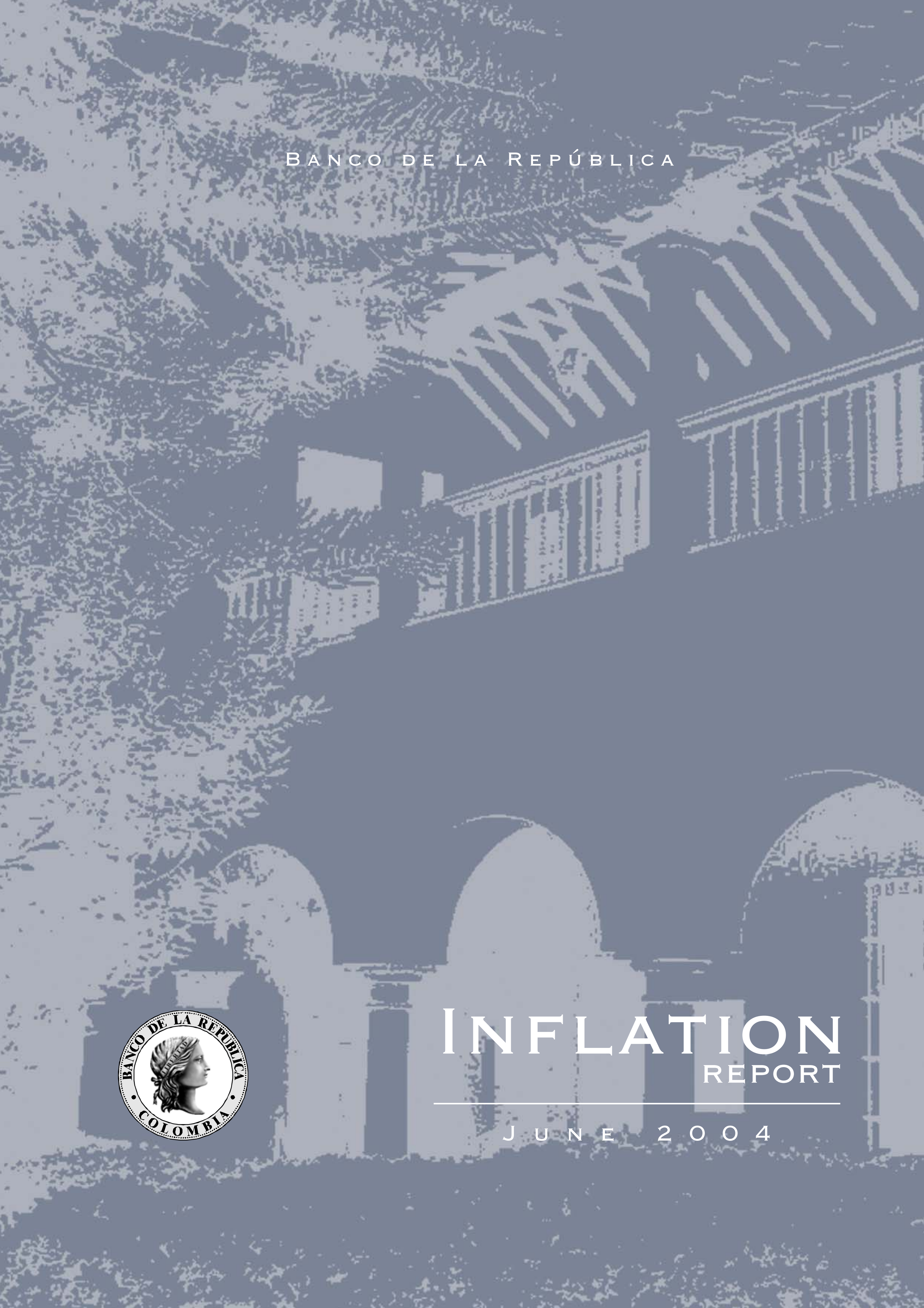

Banco de la República

Inflation
Report

June 2004

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Banco de la República

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The inflation Situation and the outlook

- The external context continues to stimulate growth in Colombia through stronger external demand and favorable terms of trade. World economic activity maintained its strong growth led by the United States and, to a lesser extent, Japan and China. In the case of Venezuela and Ecuador, Colombia's main trading partners in the region, growth continued to accelerate thanks to high oil prices. For the next few months, and in the medium term, the world economy can be expected to maintain a good rate of expansion.

- In some countries this situation has been accompanied by an upsurge of inflationary pressures, which increased the probability that central banks raise their interest rates. So far, all the signs are that interest rates will be raised gradually in the United States, with no significant effect on its growth rate, and without sharp rises in the financing costs of emerging countries.

- The growth of the world economy and the favorable trends in the terms of trade have had beneficial effects for Colombia, especially in relation to exports. The growth of traditional exports has speeded up, especially the recovery of coffee, ferronickel and coal. Non-traditional exports also grew strongly thanks to the recovery of demand in Venezuela, and the good performance of industrial exports to the United States, despite the trend of the real exchange rate in the first half of 2004. This trend in exports and favorable external conditions in general has contributed to the good growth of the tradable sectors, which grew 4% in the first quarter of the year.

- Domestically, increased consumer and investor confidence and better employment conditions are stimulating recovery of private demand, especially consumption. The growth of this variable in the first quarter of this year (4.6%) was the highest since 1995. This is accompanied by low real interest rates and the growth of disposable income at even higher rates than GDP. In these conditions, domestic demand in the last three quarters grew at an average annual rate of 4.8%, which is above the average for the last 10 years and above the growth rate of the economy since 1990 (about 3.5%).

- In this context, consumer inflation has fluctuated around 6.0%, with some temporary jumps generated by supply shocks and prices of regulated goods and services. After excluding the supply shocks, inflation was largely unchanged, which confirms the forecasts made in the last report. Core inflation remained at levels slightly under 6.0% during the second quarter of the year, continuing two opposing trends: on the one hand, the fall in tradables inflation thanks to the accumulated appreciation of the exchange rate; and on the other hand, the slow rise in non-tradables inflation, explained mainly by higher rental inflation.

- The available indicators show that the economy still has spare capacity and that this will probably remain for the rest of the year. In this respect, demand-pressure inflation was contained in the first half of 2004. However, given that the output gap will continue closing, these pressures are likely to increase. Since estimates of the output gap are usually accompanied by a high degree of uncertainty, they must be periodically re-estimated as more recent information becomes available.

- Although no cost pressures were observed at global level, cost-pressure inflation is present in some sectors such as construction, where it has gained strength in recent months. With regard to wages, the unit labor costs indicator for industry does not seem to signal wage-pressure inflation.

- In general terms there are no strong indications of an upsurge in inflation expectations during the first half of 2004, but the downward trend after the important rise in 2002 and 2003 seems to have moderated or even halted.

- The appreciation of the currency this year is explained by the improvement in the terms of trade, the upturn in external demand and increased flows of public and private capital. These factors will probably be present in the next few quarters and could possibly result in a moderate depreciation in 2005. In this context, the Board of Directors of Banco de la República decided to strengthen the country's external liquidity position through intervention in the exchange market by means of foreign-exchange accumulation auctions for US$850 million between April and July this year, of which US$600 million were exercised. This intervention was consistent with the Bank's monetary policy stance and has not resulted in undesirable changes in its interest rates.

- Based on these considerations, the current situation and the macroeconomic outlook do not differ substantially from the diagnosis presented in the last quarterly report. The main differences relate to the existence of more severe supply shocks than expected, and the projection of a lower exchange rate in 2004 and 2005. The inflation forecast does not vary significantly from the last report because the effects of these two innovations are offset in 2005. However, inflation this year could end very close to the upper limit of the targeted inflation range.

- The last report stated that the inflation outlook for the medium and long term depended on two fundamental factors: the trend in the exchange rate and the speed of the closure of the output gap. Although this report suggests that these two factors are still important, the presence of stronger than expected shocks from regulated prices and food suggests that special attention should be paid to the future trend in inflation expectations.

- The higher inflation forecasts for December this year due to upward adjustments in food and regulated prices could keep inflation expectations at levels close to 6.0% even during part of

2005, in addition to a predicted contraction of spare capacity in the next few quarters and possible increases in production costs stemming from the higher prices of imported raw materials.

- In this context, the central prediction model maintains the requirements of an increase in interest rates in the future to prevent inflation overtaking 6.0% and to facilitate convergence with long-term targets. The break in the trends of domestic rates would be in accord with the new international conditions and the process of normalization of productive activity. Based on this trend in interest rates, the Bank's central model projects declining inflation in 2005 and 2006. These long-term forecasts assume that food inflation converges with non-food inflation at the end of next year, and do not include the effect of a possible change in the VAT regime in 2005.

- As usual, considerable risks surround these forecasts: in 2004 appreciation could exceed the forecast in the central scenario, contributing to lower inflation this year, while in 2005 the bias could be toward greater depreciation, given the risks that weigh on world inflation and external rates. The gap could close more rapidly than expected as the latest data on productive activity suggest. Although the estimate of the current level of the output gap is uncertain, this report assigns the same probability to under or over estimation. Also, some price increases in the rest of 2004 could be higher than expected, especially food and fuel. Finally, production costs could increase more than expected due to higher international prices and the possible appearance of bottlenecks in some sectors.

- Based on this balance of risks, inflation this year has less possibility of being below 6.0% than in the last quarter. However, the probability of inflation below 5.5% in 2005 increased slightly in relation to the previous results.

- Based on these considerations, the Board of Directors of Banco de la República maintained its intervention interest rates unchanged in the second quarter of 2004. Although the Board is confident about meeting the inflation target this year and next, it will continue to watch closely the trend in prices in the coming months in order to adopt the necessary measures. Likewise, it will ensure that its monetary policy stance is consistent with the new international situation and the normalization process of productive activity.

Board of Directors of Banco de la República

INFLATION
REPORT

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I. The Current Economic Situation

Economic growth in Colombia continued to strengthen in the first half of 2004 thanks to external and internal factors. Externally, the expansion of the world economy continued, leading to higher than expected growth in terms of trade and demand from the country's main trading partners. Although world growth and the high raw material prices have produced a surge in inflation in the US and other economies, generating expectations of higher interest rates, the circumstances have not yet adversely affected capital flows. The nominal exchange rate has appreciated, reflecting a large accumulated supply of foreign exchange from the productive sector. This supply, originating from factors associated with the current account and increased net capital operations by the private sector, has been largely acquired by the Bank through accumulation options.

Economic growth in Colombia continued to strengthen in the first half of 2004 thanks to external and internal factors..

Domestically, the improved consumer and business confidence, greater labor stability and the increase in disposable income continue to spur the recovery of private investment and more recently household consumption. In this context, consumer inflation has fluctuated around 6.0%, with some transitory jumps generated by supply shocks and regulated prices. Spare capacity maintains inflation of and non-tradable goods services under control, and the appreciation has contributed to reducing tradables inflation. These two trends point to a further reduction in core inflation in the second quarter to below 6.0%. The available indicators show that the economy still has spare capacity and this situation will probably remain for the rest of the year. Demand-push inflation was contained in the first half of the year; however, given a gap will continue to close, these pressures are likely to increase.

The strong demand have led to a surprising surge in inflation in several developed economies which has caused markets to revise upward their expectations of international interest rates.

A. External Context, Exchange Rate and Tradables Production

As forecast in the March report, during the second quarter of the year world economic activity continued to strengthen led by growth in the United States and to a lesser extent in Japan and China. The upturn in economic growth has continued to exert pressure on international prices for most raw materials, pushing them to higher levels than those reported previously, especially in the case of fuel.

This situation and the strong demand have led to a surprising surge in inflation in several developed economies which has caused markets to revise upward their expectations of international interest rates for the rest of year and for 2005. Confirming these trends, the US monetary authorities made a moderate rise in their reference interest rates after several years of cuts, suggesting the need for additional rises in the near future. This decision ends a period of ample international liquidity and historically low interest rates.

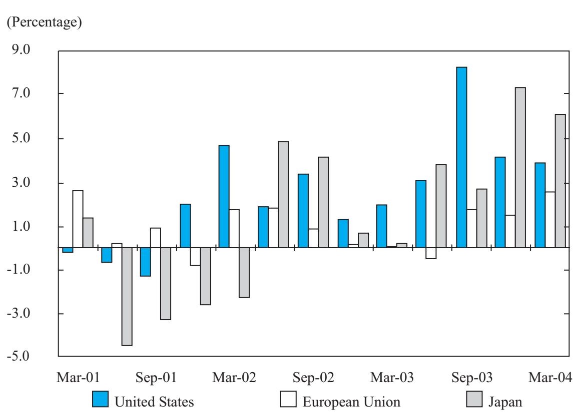
In relation to world growth, in the last six months the pickup in the US economy has been striking. For the first quarter of 2004 in particular, US economy grew strongly in real terms by 3.9% (quarterly annualized), stimulated by the upturn in domestic demand, including the improvement in private investment. More recent information, such as the fall in the industrial production index by 0.3% (annual) from May and in installed capacity utilization between May and June (from 77.6% to 77.2%), suggest a slightly lower growth rate than expected three months ago, partly due to the increased costs stemming from high fuel prices. However, performance this year has been good, decreasing the possibility of a relapse, and taking the economy into a new expansionary phase (Chart 1).

The strength of US economy is accompanied by Japan, whose continuing vigorous growth has surprised markets in a positive way. Real growth in the first quarter was 6.1% (annualized quarterly), stimulated by the external demand generated in United States and China, and by stronger domestic demand.

In relation to the developed economies, the euro area continues to have weaker growth and a more gradual recovery than United States and Japan. For the first quarter of 2004, growth (annualized quarterly) was 2.5%, based on the increase in private consumption and exports. According to the European Central Bank (ECB), industrial activity grew more vigorously in the first quarter, creating confidence in future growth,

Chart 1

Quarterly annualized growth of GDP, United States, Euro Area and Japan



Source: Datastream.

although more moderate, in the next quarters. The critical aspects continue to be weak investment and the high unemployment rate (9% in May and unchanged from the month before).

The ongoing expansion of the developed economies favors the growth of the emerging economies, especially in Asia. In this region, the Chinese economy continued to report robust growth and play a leading role despite the measures taken by the economic authorities to brake rising inflation. The latest indicators for this Asian economy show growth of 9.6% for the second quarter of 2004, while the stability policy is expected to have less impact on growth for the full year.

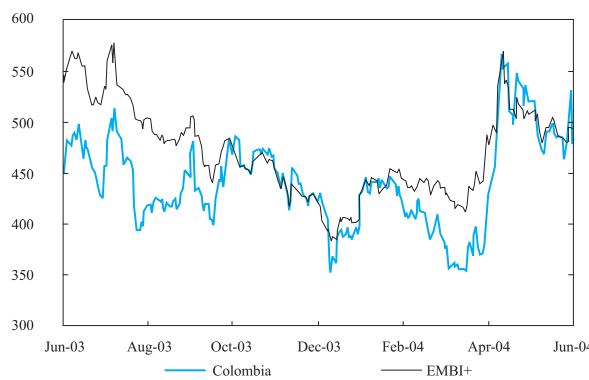
Latin America has not been affected by the good news about growth. The regional economy maintained its recovery thanks to higher external demand and improved international prices. Also, the low level of external interest rates continues to stimulate the inflow of foreign capital and the financing of the emerging economies.

Although at the end of April and May the emerging market spreads widened following the announcements by the US Federal Reserve (Fed) of higher interest rates, there were downward corrections in the following weeks. Overall, the EMBI+ of the region's economies grew strongly in the quarter, with the exception of Chile (Chart 2 and Table 1).

The behavior of the exchange rate in most Latin American countries during the quarter was closely associated with the trend in spreads, a correlation that was especially evident in the last week of April and

Chart 2

Country-risk premium
EMBI+ Latin American countries



Source: Bloomberg.

Table 1

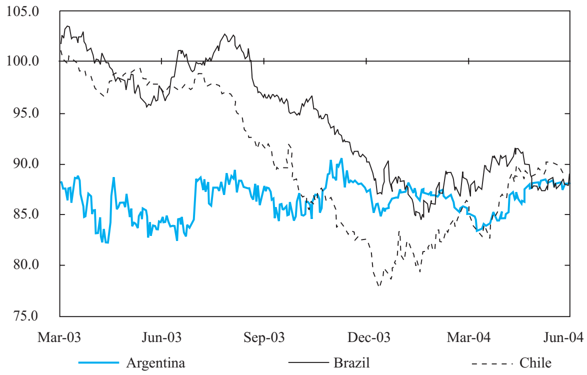
Quarterly and monthly change in EMBI+ in period
(basis points)

	Colombia	Brazil	Mexico	Argentina	Chile (*)
II Quarter 2004	107	89	32	358	(8)
April	52	105	17	(211)	1
May	90	36	6	332	0
June	(35)	(52)	9	237	(9)

(*) Chile has no EMBI+ so the global EMBI is used.
Fuente: Bloomberg.

Chart 3

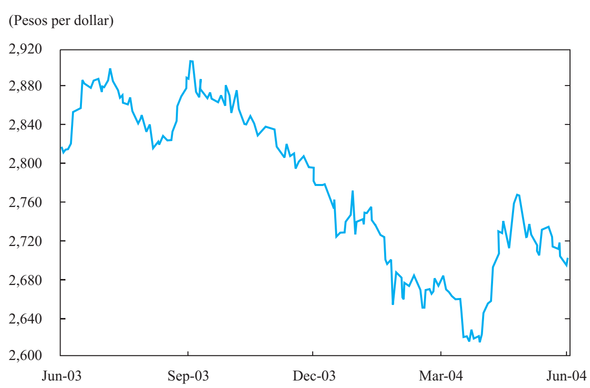
Nominal Exchange Rate Index
Argentina, Brazil and Chile
(January 1, 2003 = 100)



Source: Datastream.

Chart 4

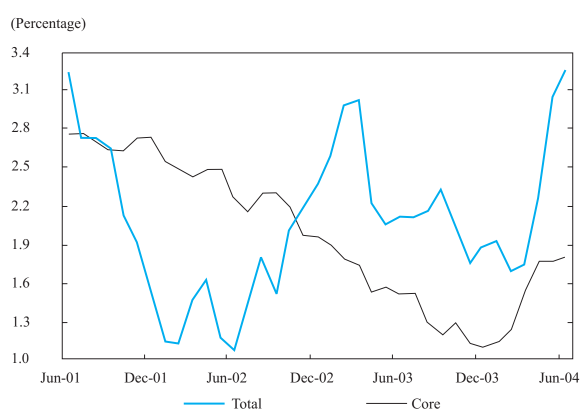
Representative Market Rate



Source: Banco de la República.

Chart 5

Annual Inflation in United States
(Last 12 months)



Source: Datastream.

most of May. After depreciating in April and May, regional currencies resumed their path to appreciation, especially in Brazil, Chile, Colombia and Argentina (Chart 3 and 4).

In the case of Venezuela and Ecuador, Colombia's main trading partners in the region, growth continued to improve favored by high oil prices. Particularly important is the case of Venezuela, whose economy grew 8.6% in the first quarter of this year, higher than expected. Despite this, in the first half of the year political uncertainty persisted, especially the outcome of the presidential recall referendum. In Ecuador in the first half of the year, growth continued to be satisfactory (5.9% in the first quarter), although a high level of uncertainty prevails associated in this case with fiscal stability, given the procedure that various bills have followed in the Congress of the Republic (increase in pensions already passed and the freezing of the debate on the hydrocarbon bill).

The most important external event in recent months has been the appearance of inflationary signs in the US economy. The March *Report on Inflation* considered that if the economic recovery and high oil prices continued, they would eventually affect inflation; however, this would be very gradual since until March inflation had stabilized at very low levels, and signs of deflation had not completely disappeared.

However, the events of the second quarter represent a sharp break in market expectations. In the three months, total inflation for 12 months in the United States rose 160 basis points (bp), overtaking all forecasts. The increase was much higher in the total inflation indicator given the weight of fuel prices, but it has also been apparent in core inflation which excludes them (Chart 5).

As already mentioned, behind the increase in inflation is the strength of world demand and the US economy, although accompanied by the rising prices of raw materials and fuel, stimulated partly by the expansion of the Chinese economy. At the end of the second quarter, international commodity prices remained at higher levels than those expected three months ago, especially coal, coffee and oil, all very important to the Colombian economy (Chart 6, 7 and 8).

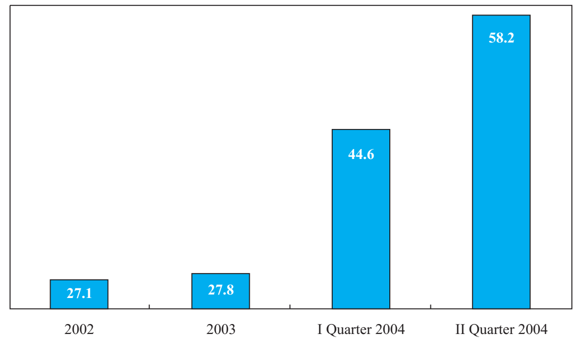
In particular, the oil price continued above the US$40 per barrel barrier in July despite the increase in the production of the members of the Organization of Petroleum Exporting Countries (OPEC), including Iraq at 28.8 million barrels per day. The reason why prices have remained at higher levels is partly due to the low level of stocks (which, although they have grown, are still less than expected), and also to the existing low level of spare capacity. These circumstances generate uncertainty about the capacity of supply to react to any shock.

Higher inflation has led to a change in the Fed's monetary policy stance, generating uncertainty about the speed and size of possible rises in the US reference rate. In fact, US Treasury bond rates overreacted initially to the probability of strong adjustments. However, recently a certain reduction has taken place especially in the longer terms (Chart 9). At present the medium- and long-term rates of US Treasury bonds are between 50 bp and 75 bp above the March level, similar to the expected increase in Fed rates this year.

The growth of the world economy and the favorable trend in the terms of trade have been beneficial for Colombia, especially in relation to exports. Traditional exports have grown more strongly and in April were close to 13.5% for the accumulated 12 months (Chart 10). Specially important was the recovery of coffee exports which grew 19.3% this year to April, while oil exports grew 4.9%, and coal was at historically high levels.

CHART 6

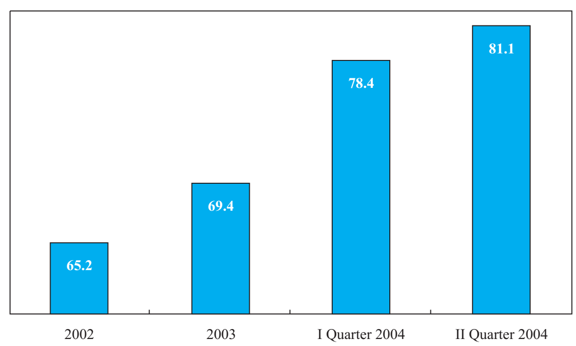
INTERNATIONAL COAL PRICES
(DOLLARS / METRIC TON)



Source: World Bank (Pinksheet).

CHART 7

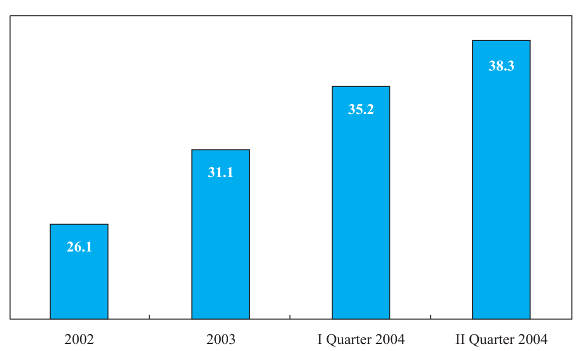
INTERNATIONAL COFFEE PRICES
(US CENTS / POUND)



Source: Datastream.

CHART 8

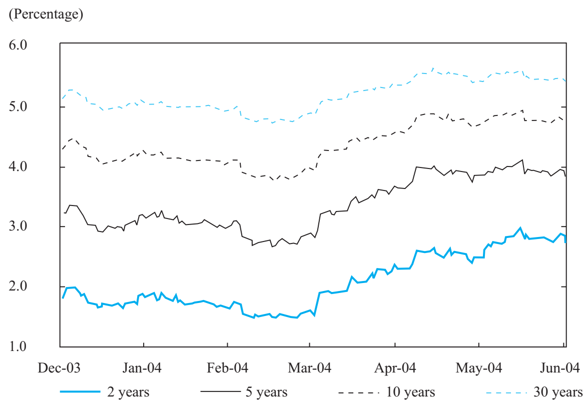
INTERNATIONAL OIL PRICES WTI
(DOLLARS / BARREL)



Source: Bloomberg.

Chart 9

US Bond Interest Rate

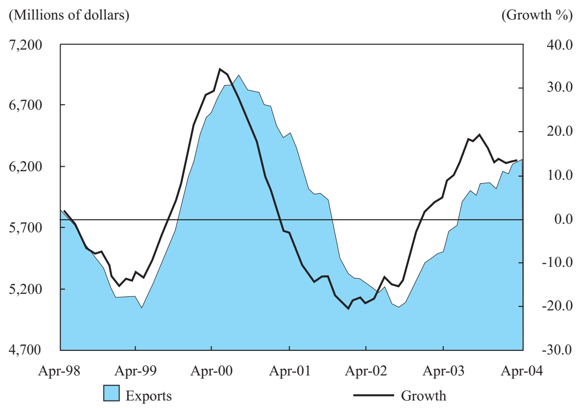


Source: Datastream.

Non-traditional exports also increased sharply thanks to the recovery of Venezuelan demand and the good performance of industrial exports to the United States despite the trend in the real exchange rate in the first half of 2004 (Charts 11 and 12.). This trend in exports and the favorable external conditions in general have contributed to the good performance of the tradable sectors which grew 3.9% in the first quarter of the year (Chart 13).

Chart 10

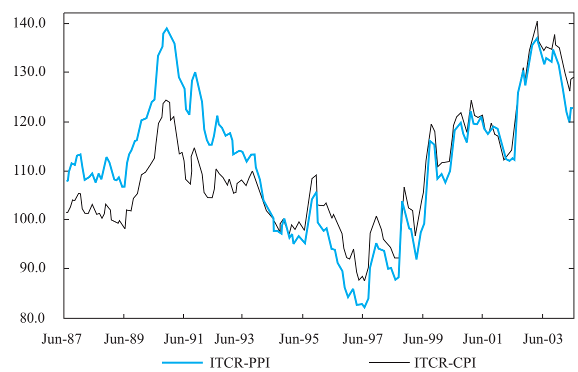
Traditional exports (last 12 months)



Source: National Statistical Department (DANE).

Chart 12

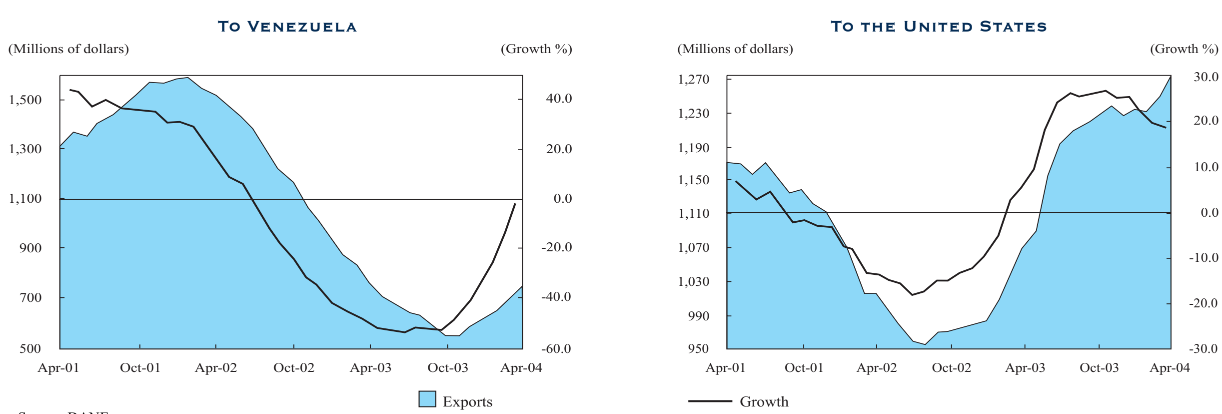
Real exchange rate index (1994 = 100)



Source: Banco de la República.

Chart 11

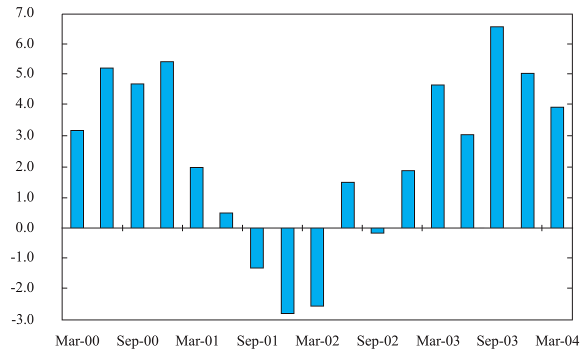
Non-traditional industrial exports (last 12 months)



Source: DANE.

Chart 13

Annual growth of tradables GDP



Source: DANE.

B. Domestic Demand and Non-Tradables Production

Domestic demand continued to gain strength, growing in the last three quarters (to March) at an average annual rate of 4.8%, above the average for the last 10 years (2.4%) and above economic growth since 1990 (3.5%). The first quarter of 2004 (the latest figures published by the National Administrative Statistics Department (DANE) showed no change in this trend (Table 2).

The strengthening of domestic demand in recent quarters was possible thanks to the good trend in private investment destined for private construction, and machinery and equipment. Recently, household consumption has also began to play an important role. Growth in the first quarter (4.6%) was the highest since 1995 (Table 2), which is consistent with higher levels of consumer confidence, as reported by the Fededesarrollo survey (Chart 14).

Table 2

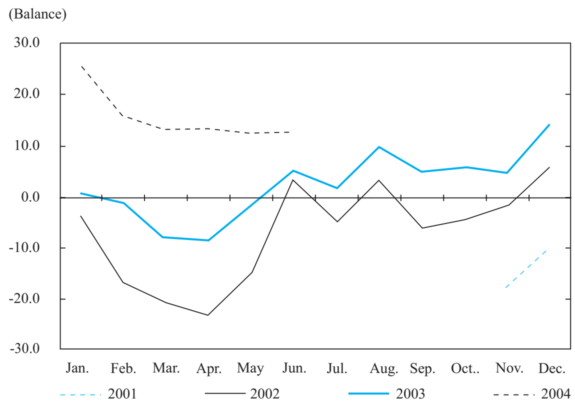
Demand-side GDP
(real annual percentage change)

	2001	2002 (pr)	2003 (pr)	I Quarter 2004 (pr)
Gross domestic product	1.5	1.8	3.9	4.1
Total imports	6.8	0.3	9.7	5.3
Total final supply	2.2	1.5	4.8	4.3
Final consumption	2.3	1.7	2.1	4.0
Household **(*)**	2.7	2.0	2.3	4.6
Government	1.1	0.6	1.2	2.2
Gross capital formation	1.9	9.4	19.4	9.0
Gross fixed capital formation	8.5	9.2	13.7	10.8
Subtotal: final domestic demand	2.2	2.8	4.7	4.8
Total exports	2.4	(4.6)	5.6	1.1
Total final demand	2.2	1.5	4.8	4.3

(*)Includes purchases of goods abroad by residents and excludes purchases by non-residents in Colombia.
(pr) Preliminary.
Source: DANE and Banco de la República.

CHART 14

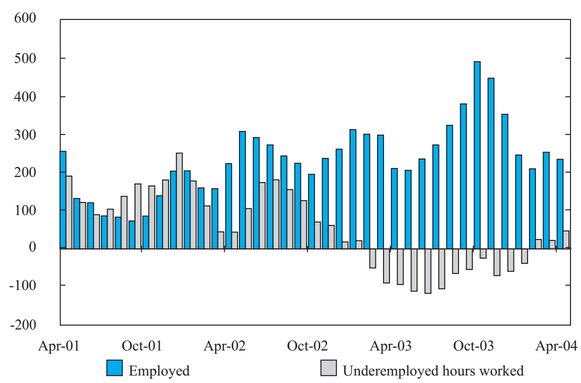
CONSUMER CONFIDENCE INDEX



Source: Fedesarrollo.

CHART 15

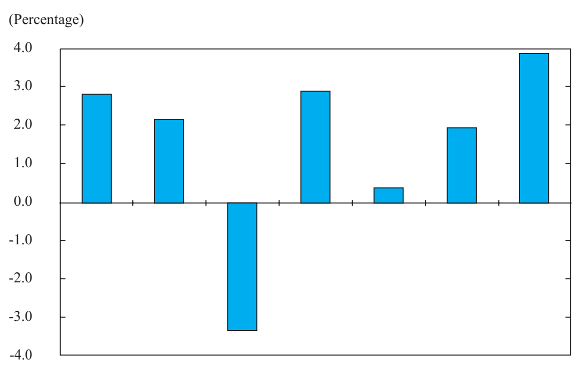
CREATION OF EMPLOYMENT
(1,000S OF PEOPLE IN 13 CITIES – MOVING AVERAGE OF ORDER 3)



Source: DANE.

CHART 16

GROWTH OF REAL DISPOSABLE INCOME



Source: National Tax and Customs Office (DIAN) and DANE. Bank's own calculations, Economic Studies Unit (SGEE).

The ongoing improvement of employment conditions (number and quality) partly explains the upturn in domestic demand. In the first five months, employment grew 2.6% annually, represented almost entirely by the generation of formal employment (Chart 15). Employment conditions have been favorable for about two years with no substantial changes, leading to the recovery of household income and facilitating lower levels of indebtedness.

Other factors are the improvement in terms of trade and remittances received from Colombians resident abroad which led to the recovery of disposable income. Preliminary calculations show that this grew faster in 2003 than gross domestic product (GDP) despite the greater tax effort (Chart 16).

Lastly, the ample liquidity afforded by the monetary authority has also contributed to the growth of domestic demand. First, it has maintained low real interest rates. Second, the economy has enjoyed easy credit, evidenced by the significant growth of lending. So far this year, disbursements of commercial, consumer and mortgage loans have been growing at rates over 23.0%. Although late in the first quarter and early in the second growth of total loans slowed, this phenomenon was due to special circumstances that do not contradict the perception of rising demand (for more details see Box 1).

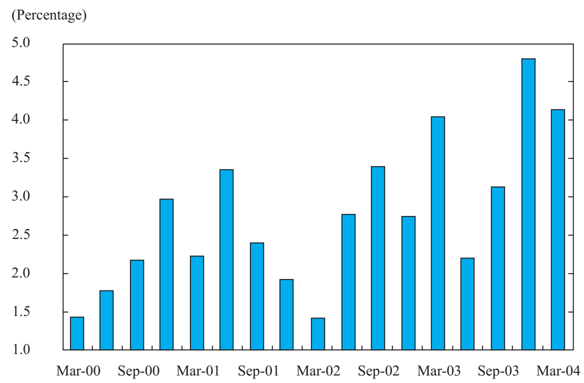
As expected, stronger domestic demand continues to be linked to the good performance of the non-tradables sectors. Examples of this are the expansion of building construction, commerce, financial services and transport. For the first quarter of 2004 these sectors together grew at a rate of 4.2% (Chart 17).

C. Determining Factors of Inflation

In Colombia, the trend in external and internal variables analyzed in the previous sections affects inflation through various channels, particularly: 1. output gap; 2. costs; 3. inflation expectations; and 4. nominal exchange rate.

Chart 17

Annual growth of GDP of non-tradable sectors



Source: DANE.

1. Output gap

Medium- and long-term inflation is closely linked to demand-pull pressures, which usually intensify when the economy begins to operate above its productive capacity or beyond the level that is compatible with price stability.

To determine at what point growth of production begins to be incompatible with the economy's productive potential, and therefore when demand pressures could be emerging, is not an easy task because there are no broad indicators that measure this phenomenon. Also, these processes have to be captured early to allow monetary policy to act, given the lags proper to its transition mechanisms.

For this report, as in previous ones, three types of variable were used to give an idea of the current volume of spare capacity. These are: a) industrial installed capacity utilization (ICU); b) percentage of businesses that consider lack of demand a problem for expansion of production; and c) output gap.

With figures to May 2004, the two indicators available on industrial ICU – Fededesarrollo and the Asociación Nacional de Industriales (ANDI, National Industries Association) – are relatively stable at levels very close to their historical averages. During most of 2003 the tendency had been growing, although significantly less than their averages, suggesting high levels of spare capacity and therefore limited demand-pull inflation.

Growth continued in the first two months of the year. If it continues at the same rate, the spare capacity in the industrial sector will probably be used up in the second half of 2004, with perhaps a surge of inflationary pressures. However, with the stability of the indicators (adjusted for seasonality) between March and May, industry will very likely continue to operate below its productive capacity and existing demand-pull inflation will remain under control.

Both indicators are still within the confidence intervals estimated from the historical averages for different time periods (Chart 18). As explained in the

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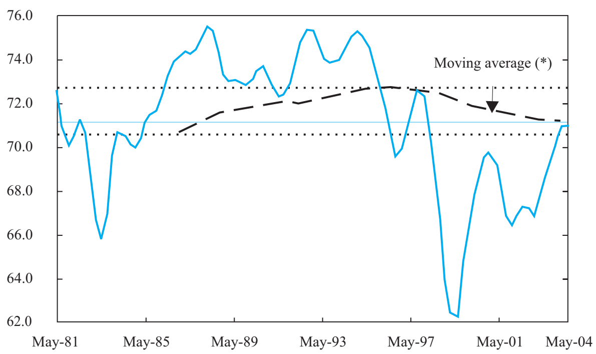
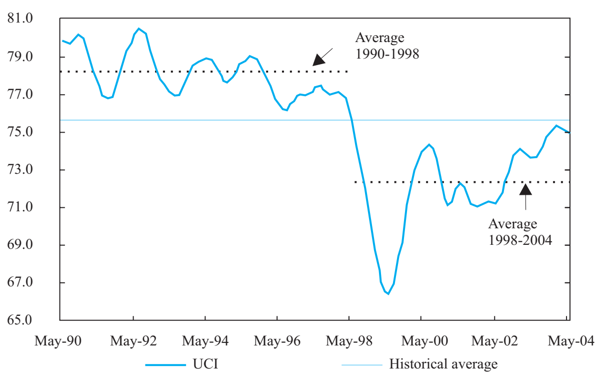
Chart 18

Installed capacity utilization (ICU) Trend component

Fedesarrollo



ANDI



(*) Calculated as: $\sum_{1981}^{n} UCI / \#\ of\ observations$ where n is 1986, 1987, … 2004, with quaterly frecuency.
Source: Fedesarrollo and ANDI, bank´s own calculations.

March report, these intervals were used in an attempt to correct possible biases in the estimate of the historical averages caused by the brevity of the series and extremely low figures in 1999 and 2000.

The stability of the indicators around their historical average in the first two quarters of this year is significant, given the good growth rate of industry, which also occurs after an expansion, although moderate, in 2003. It seems the reason lies in the strong pickup in sectoral investment, as suggested by the figures for production and capital goods imports, which have led to the expansion of the productive capital of industry at a rate similar to demand, postponing inflationary pressures.

Although industry as a whole does not seem to have spare capacity, when sub-sectors are examined individually, the result is not so clear. These figures to May show that the ICU for several industries has been significantly above their historical average for some months. With the information to May, the number of sectors that have a higher ICU than their historical average increased against February and November (Table 3). A rapid inspection suggests that the indicator tends to move to higher levels in export sectors, while remaining at low levels in sectors oriented to the domestic market.

Overall, these results show that spare capacity has been running down, as expected, and that bottlenecks could be building up in specific sectors, which could eventually generate demand-pull inflation if the installed capacity does not expand through increased investment in line with the growth of demand. These pressures have probably not been reflected in consumer inflation because the most important sectors of consumer goods production (such as food) still tend to have a low ICU compared with their historical averages.

The stability of the indicators around their historical average in the first two quarters of this year is significant, given the good growth rate of industry.

This interpretation is supported by the indicator of insufficient demand measured as the percentage of industries that consider that demand is a problem for the expansion production in their firms, according to the ANDI surveys. As Chart 19 shows, this percentage continued to fall during the second quarter of the year to levels not seen since the mid-1990s when industry grew strongly with buoyant domestic demand.

All these items relate exclusively to industry and, as such, offer only a partial view of spare capacity. The output gap is a broader indicator, measured as the

Table 3

Installed capacity utilization (ICU)
(Percentage)

Sectors	November		February		May	
	2003	Average 1991-2004	2004	Average 1991-2004	2004	Average 1991-2004
Beverages	40.0	68.1	**70.0**	59.6	**75.0**	64.8
Base metals	**75.0**	71.5	64.5	69.4	**79.3**	70.8
Mach. except electric	63.3	64.9	**66.9**	64.2	**69.4**	63.5
Industrial chemical substances	**79.6**	75.2	**76.8**	71.9	**79.7**	74.2
Metallics product. except machinery	**71.1**	64.9	**70.8**	63.8	**66.4**	62.1
Leather and manufactures, footwear	67.1	74.1	**68.9**	65.0	**71.7**	68.1
Glass, porcelain, china, clay	68.0	77.0	70.0	74.6	**80.0**	76.6
Electrical and electronic equipment	61.7	65.3	**67.3**	64.7	**67.5**	64.8
Textiles	77.4	79.0	72.6	76.9	**75.6**	74.2
Paper and carton	**80.0**	74.7	71.4	72.8	**77.5**	76.2
Other chemical products	71.4	74.2	68.7	71.4	**72.1**	71.2
Tobacco	**65.0**	51.7	**60.0**	53.7	55.0	55.1
Plastic products	71.6	73.8	**79.4**	73.8	71.9	72.1
Cement and other non-metallics	58.9	67.2	62.5	66.7	65.4	66.3
Rubber products	65.0	68.5	67.1	69.9	62.9	64.0
Transport equipment and material	73.2	69.6	65.7	67.6	65.3	66.7
Wood and manufactures, furniture	62.9	69.8	68.5	68.7	64.4	66.5
Other manufactures	60.0	70.2	58.3	62.9	66.0	69.1
Food	73.2	75.7	**73.8**	73.2	71.0	74.5
Printing and publishing	**72.9**	72.2	67.2	67.4	65.0	68.6
Oil and products	**80.0**	79.9	80.0	80.5	80.0	83.7
Clothing	65.4	76.0	64.2	66.4	62.5	67.6
Total	**71.2**	**72.5**	**70.4**	**69.6**	**70.3**	**69.8**

(*) The figures in bold type show the sectors that have a higher than average ICU.
Source: Fedesarrollo, bank´s own calculations.

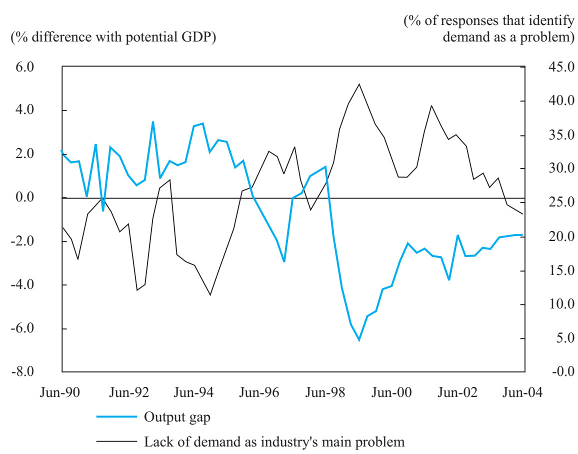
difference between observed or expected output and potential output. The latter, in turn, depends on the availability of productive factors (capital and labor in the simplest case), the degree of utilization of the factors, and growth of multi-factorial productivity.

Past reports gave the output gap as negative at the end of 2003 (that is, potential GDP exceeded observed GDP) at around -1.8%. In the first half of the year the gap can be expected to remain negative, although gradually closing as a result of a higher level of economic activity.

The Bank's new estimates using the latest information maintain these forecasts, showing that the gap was still negative but closing gradually in the first half of 2004, and could be situated at -1.7% of potential GDP in the half year. The projections

Chart 19

Indicator of insufficient demand measured by ANDI (*) and output gap



(*) Percentage of industrial firms that consider that lack of demand is the main problem for expansion of production.
Source: ANDI, , bank´s own calculations.

Past reports gave the output gap as negative at the end of 2003 (that is, potential GDP exceeded observed GDP) at around -1.8%.

for the rest of the year show that, if current growth rate is maintained, the gap will continue to narrow, although remaining in negative values. This trend is inversely correlated with the trend in the percentage of businesses that see demand as a problem for the expansion of their production (Chart 19).

Previous results for the gap take into account the high growth of investment in 2003 and assume, as will be seen in the next chapter, equally important growth this year. It is precisely this upturn in investment, together with a recovery in the growth rate of multi-factorial productivity, which keeps the gap in the negative for the rest of the year, despite the expected good rate of growth.

Various statistical methodologies such as the Hodrick-Prescott (HP) multi-variant and the HP with priors produce similar results, predicting a negative gap for 2004 similar to that used in this report, but which has been gradually closing. However, whatever the methodology used, estimates of the output gap are usually accompanied by a high degree of uncertainty that requires regular re-estimation to include more recent information.

The gap was still negative but closing gradually in the first half of 2004, and could be situated at -1.7% of potential GDP in the half year.

Given these elements, the available indicators show that the economy still has spare capacity and that this will very probably remain for the rest of the year if the economy grows at similar rates to the first quarter. In this respect, demand-pull inflation has been contained in the first half; however since the gap will continue closing, the probability that these pressures emerge could increase.

The available indicators show that the economy still has spare capacity and that this will very probably remain for the rest of the year .

2. Cost-pressure inflation

To evaluate cost-push inflation, this report estimates cost indicators that take account the productive structure of several sectors of activity in Colombia.

This was done using the technical coefficients of production from a social accounting matrix constructed by the Ministry of Finance and Public Credit, and the price and wage indicators (producer price index (PPI), industrial wages, among others) available in Colombia.

The cost indicator for the overall economy has not shown any increase in inflationary pressures so far in 2004. In the first six months, total costs increased at an annual rate of about 6.0%, consistent with the targeted inflation range for 2004 (Chart 20).

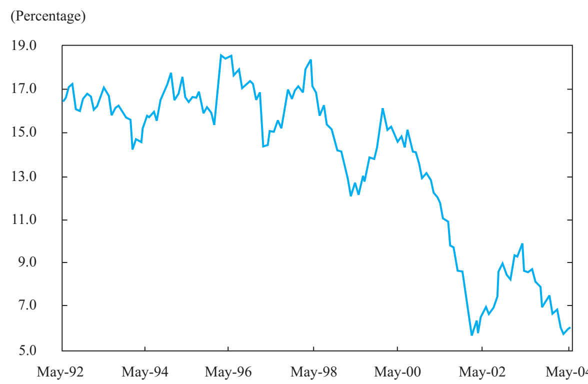
In recent years, the cost indicator has been sensitive to exchange rate fluctuations. In 2002 and early 2003, it grew significantly more than at present, coinciding with the speed up in devaluation during that period. Similarly, the trend toward appreciation this year has reduced the rates at which costs have adjusted. The current trend (with positive inflation) in costs reflects rather the higher international prices of raw materials, fuel and possible wage adjustments.

Although no cost-push inflation is observed at global level, at sector level it does seem to be occurring, mainly in construction, were cost inflation has speeded up in recent years to above 6.0% at present (Chart 21).

This surge could be caused by the high prices of steel and other raw materials, whose rise in the year was associated with higher international prices, and perhaps with the appearance of some bottlenecks, given the rapid expansion of sectoral demand. In industry, cost inflation has accelerated slightly in recent months, which could be the result, among other reasons, of pressure from the higher fuel prices, as well as external factors, and perhaps the adjustments in the prices of some raw materials, as suggested by the cost indicator of the ANDI survey (Chart 22).

FIGURE 20

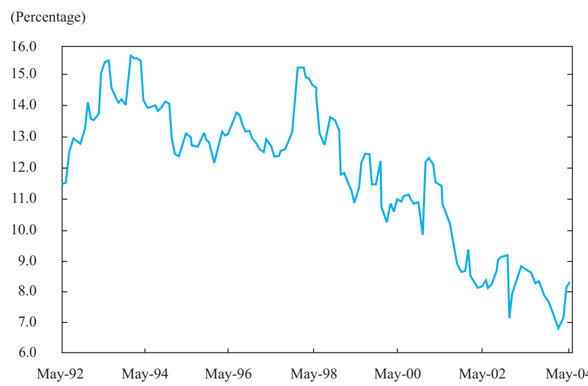
ANNUAL GROWTH. TOTAL COSTS



Source: Banco de la República.

FIGURE 21

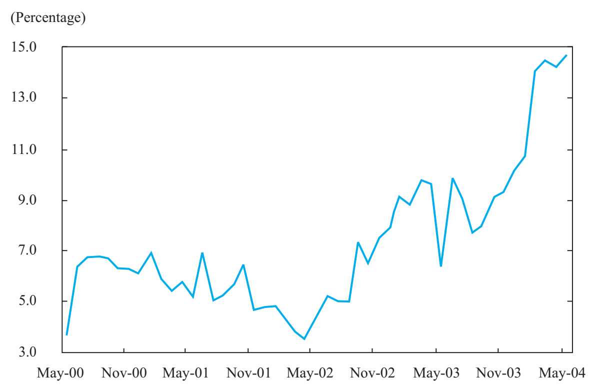
ANNUAL GROWTH. CONSTRUCTION COSTS



Source: Banco de la República.

FIGURE 22

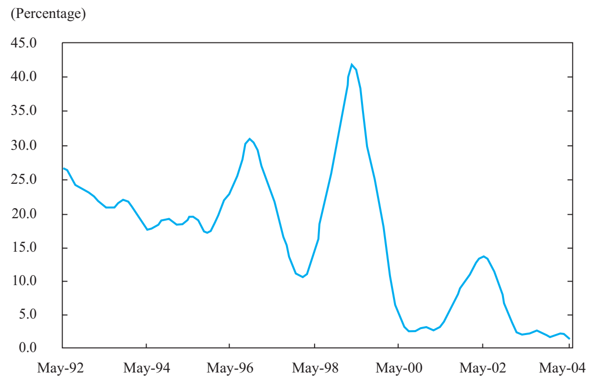
PROBLEMS OF RAW MATERIAL COSTS AND SUPPLIES



Source: ANDI.

CHART 23

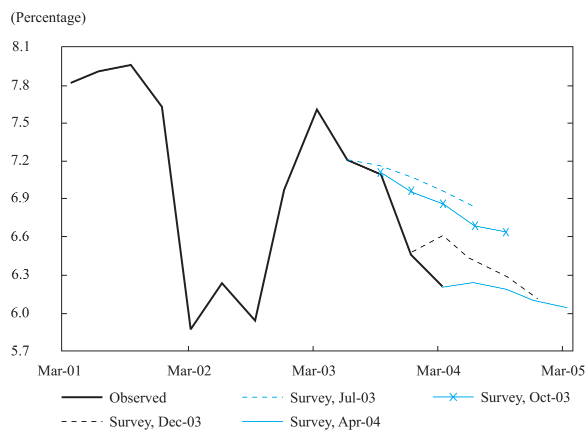
ANNUAL CHANGE IN NOMINAL UNIT LABOR COST OF INDUSTRY



Source: DANE.

CHART 24

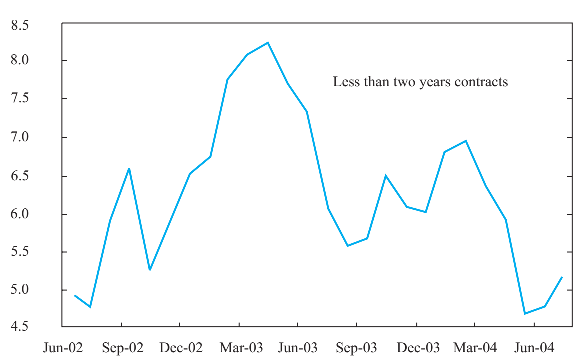
INFLATION EXPECTATIONS



Source: Banco de la República.

CHART 25

INFLATION EXPECTATIONS DERIVED FROM THE TES FIXED AND VARIABLE RATES (WITH INFORMATION TO JULY 16, 2004)



Source: Banco de la República.

On wages, the unit labor cost (ULC) indicator for industry does not indicate wage-push inflation on this front. The latest information available from the monthly manufacturing sample shows that the ULC is increasing at low rates (1.2% in May). Since nominal wages are rising between 6.0% and 7.0%, the low growth of nominal ULC has been possible thanks to the increase in implicit labor productivity (measured as production per man-hour worked) of around 3.0% annually (Chart 23).

3. Expectations

The latest results of the quarterly survey of expectations of business owners, workers and academics taken in April showed that inflation expectations at the end of the year continued to fall gradually during the first quarter, remaining slightly above the 6.0% target (Chart 24). The Bank's June monthly survey exclusively of market analysts is more favorable. These agents forecast inflation of 5.7% at the end of 2004. Finally, the expectations indicator obtained from the differential of rates of TES UVR and fixed-rate TES (for contracts of under two years) increased about 40 bp in May and June, breaking the downward trend of the first quarter (Chart 25).

In general, there are no strong indications of an upturn in inflation expectations in the first half of 2004. Even so, the downward trend after the sharp rise of 2002 and 2003, seems to have moderated and even halted, stabilizing at levels around 6%, the targeted ceiling range. Their role has been neutral in relation to the inflation trend, not inducing inflationary pressures but not contributing to a reduction below 6.0%. The information on the pay rises negotiated in the collective bargaining agreements confirm this appreciation (Table 4).

Percentage of beneficiaries by level of agreed wage rise
(January-May 2004)

Negotations at one year						
<5.0	**[5.6]**	**[6.7]**	**[7.8]**	**[8.9]**	**>9.0**	
1.13	1.41	26.86	43.12	24.35	3.12	
Negotations at two year						
<7	**[7.8]**	**>8**	**[CPI + 0.2]**	**[CPI + 2.3]**	**LMW**	**Others**
1.42	8.87	1.32	67.72	2.83	3.64	14.19

LMW: Legal minimum wage.
Source: Ministry of Social Protection.

4. The exchange rate

The trend of the exchange rate during the second quarter of the year was as forecast in the March inflation report. At that time it was expected that inflationary pressures originating from the exchange front would be minimal, and that exchange stability would even allow inflation of tradable goods and services in the consumer price index (CPI) to fall below the target, offsetting the effects of supply shocks from fuel, transport and public services.

During the first half of the year the representative market rate appreciated 2.8% from 2,778 pesos on December 31, 2003 to 2,700 pesos on June 30 this year. In May, the rate was extremely volatile, gaining 77.9 pesos (2.9%) due, apparently, to a change in investor expectations about the rise in interest rates on the US market. As already mentioned, these factors produced nervousness on emerging markets which exerted upward pressure on exchange rates in the region. From June, the trend toward appreciation returned and the country-risk indicator fell again, following greater calm on international financial markets, despite the rise in US interest rates.

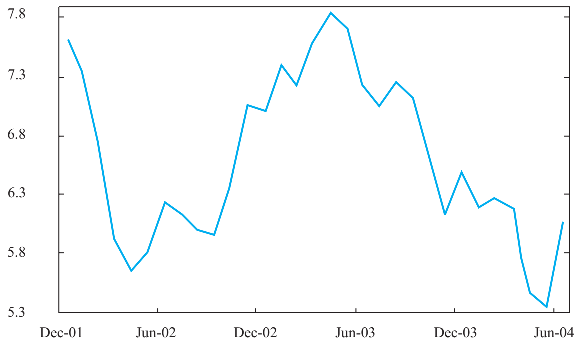
The trend in the exchange rate in 2004 has been associated, among other factors, with stronger external demand due to the recovery of the Venezuelan economy and more rapid growth in the United States, following the improvement in the terms of trade, and the international conditions of low interest rates prevailing in other economies (in particular, the United States and the European Union). All these factors have led to the appreciation of the peso this year, and have been reflected in a large accumulation of US dollars from the productive sector. Most of the supply of foreign exchange, originating from factors associated with the current account and increased net capital operations by the private sector (foreign investment and net indebtedness), haS been acquired by the Bank through accumulation options.

The trend in the exchange rate in 2004 has been associated, among other factors... the improvement in the terms of trade, and the international conditions of low interest rates prevailing in other economies (in particular, the United States and the European Union).

Chart 26

Annual Consumer Inflation

(Percentage)



Source: Banco de la República.

Chart 27

Annual Food Inflation, CPI

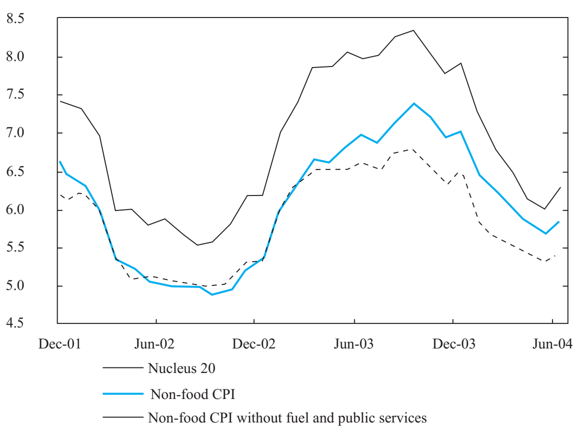
(Percentage)

Source: Banco de la República.

Chart 28

Core Inflation Indicators

(Percentage)



Source: Banco de la República.

D. The Inflation Situation in the Second Quarter

In June, annual inflation was 6.1%, similar to March (6.2%) but higher than in April and May. The increase in the last month was due to the surge in food inflation from 4.7% in May to 6.5% in June (Chart 27). Non-food inflation was more stable, falling slightly to 5.9% in June from the March data (6.1%).

The inflation results were generally higher than the Bank's forecasts in the March report. The largest underestimate was food (0.3 pp) but also non-food inflation (0.9 pp). In the latter case, the Bank did not foresee all the adjustments in the regulated prices, especially in fuel and public transportation.

In the last month, food inflation was affected by a higher than expected rise in the prices of primary food (vegetables and root vegetables except potatoes) probably caused by the recent contraction of supply due to the low prices at the end of last year. So far this year, the items that reported highest inflation (which could contribute to reduce inflation in the second half, given their normal production cycle) are potatoes, fruit, vegetables, and pulses.

Core inflation continued to fall in the second quarter. In April, for the first time since January 2003, the average of the three indicators used by the Bank (non-food inflation; nucleus 20; and inflation excluding primary food, public services and fuel) fell below 6.0% (Chart 28). However in June this average rose slightly mainly due to increases in rental and transport inflation. The average of the three indicators was 5.9% in June against 6.0% in March.

A breakdown of core inflation into tradables, non-tradables and regulated goods and services shows that the trend in the second quarter was mainly due to the effect of the exchange rate appreciation. In recent months, core inflation has returned to levels very close to the historical lows of mid-2002 following the fall in tradables core inflation, which in June was 4.3% against 5.3% in March (Chart 29).

Since the appreciation trend continued in June and early July, further reductions in tradables inflation can be expected for the rest of the year. However, given the seasonality of price adjustments in Colombia (concentrated in the first quarter) and the slowing of the fall in inflation in this group this year (1.0% in the second quarter, 1.7% in the first), the reduction will probably be moderate and could even be delayed until early 2005.

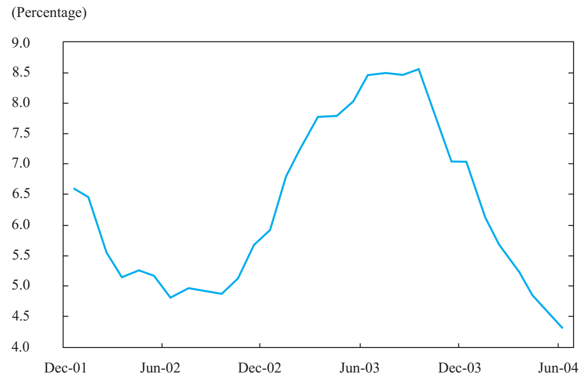
In tradables, the only item that did not move in line with the exchange rate was medicines, whose inflation remained at levels over 11.0%. In the last five years, prices in this group have increased dramatically above inflation, with no relation to the movements in the exchange rate.

Non-tradables core inflation (excluding regulated prices and food) continued to rise in the second quarter. Even so, its level at June (4.9%) was still well below total inflation and the targeted range for this year (Chart 30).

As stated in previous reports, two ongoing trends can be identified in this group. First, rental inflation which, although very low, has a clear upward trend; and second, the rest of goods and services including health and culture and leisure, whose inflation has been very stable, fluctuating between 5.5% and 6.0% (Chart 31). In the last quarter, annual rental inflation rose strongly from 3.6% in March to 4.3% in June. Given its high share of the consumer basket (20.7%), this rise affected the inflation result in June.

Chart 29

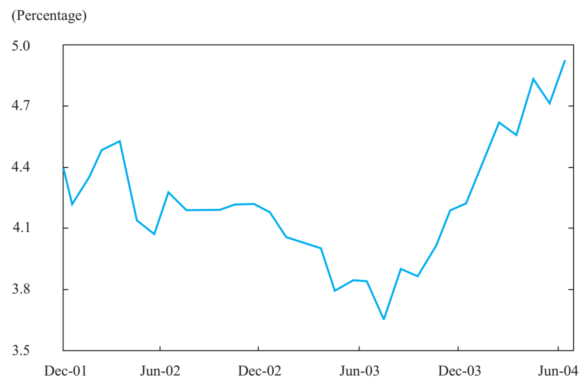
Annual tradables core inflation



Source: Banco de la República.

Chart 30

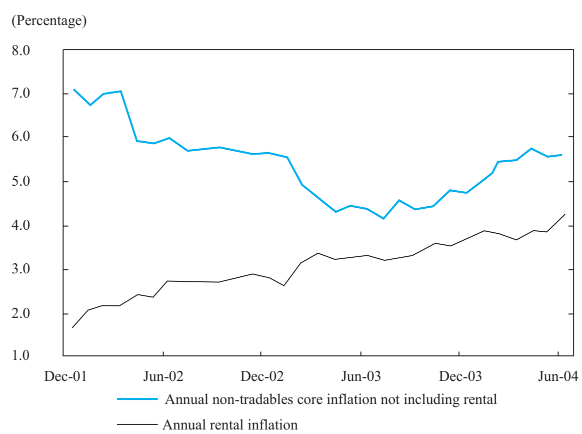
Annual non-tradables core inflation



Source: Banco de la República.

Chart 31

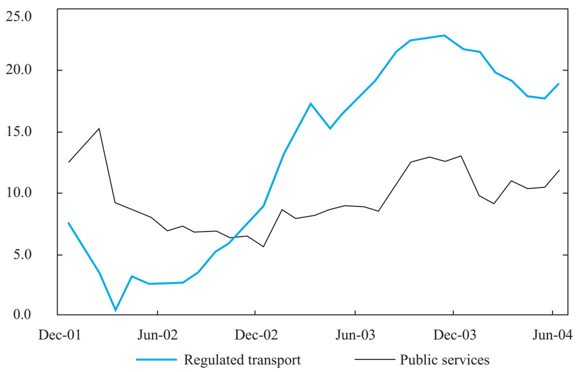
Annual non-tradable core inflation broken down into rental and the rest



Source: Banco de la República.

Chart 32

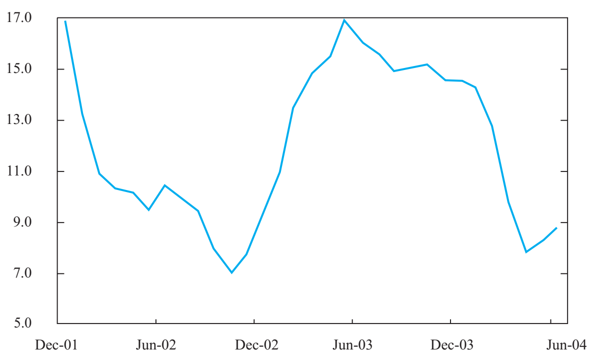
Annual inflation of regulated transport and fuel



Source: Banco de la República.

Chart 33

Annual public services inflation



Source: Banco de la República.

In general, the trend in non-tradables inflation in the last three months does not evidence the presence of demand-pull pressures, which is confirmed by the existence of abundant spare capacity. The persistence of inflation in this group at levels above 5.5% probably reflects the ongoing closure of the output gap amidst inflation expectations that are still relatively high.

What happened with the June result, which was higher than forecast, could portend the presence of inflationary pressures in the medium term, localized in specific goods and services, than can be related to a possible excess of demand in some sectors. Anyway, it is early to state that the June figures imply a change in the inflation trend of non-tradables.

Lastly, one factor that pressured the surge in inflation in June was the adjustment in the prices of certain regulated goods and services for various reasons. First, the rise in fuel prices as a consequence of high external prices and the recent increases, which obliged the Ministry of Mines and Energy to raise the domestic reference price to US$26.4. Second, again due to high fuel prices, public transport fares were adjusted above targets (Chart 32).

Also, continuing the expected trend, public services reported price adjustments above inflation, resulting from changes in the formulas for fixing their prices, among other reasons. In the specific case of gas, increases were higher than expected, probably related to the high fuel prices (Chart 33).

What Explains the Trend in the Credit in Colombia?

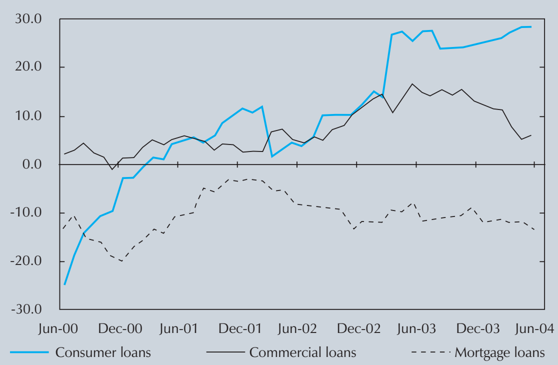
Lending has been slowly recovering since the economic crisis in the late 1990s, reporting real positive growth only since 2003. Toward the middle of last year, the credit was growing at an annual rate close to 2.5% (10% nominal) (Chart B1.1); however, from 2004 growth began to slow despite stronger economic growth.

This downturn is mainly due to the weaker growth of commercial loans (Chart B1.2). In contrast, the balance of consumer lending shows a very favorable trend in line with the recovery of demand. On the other hand, mortgage loans continue to contract, although the accumulated disbursements in the first six months of the year grew strongly (31.5%).

Chart B1.1
Nominal gross lending in national currency not including FEN
(annual percentage growth)

Source: Banco de la República.

Chart B1.2
Nominal gross lending in national currency not including FEN by type of loan
(annual percentage growth)



Source: Banco de la República.

The weaker growth of commercial lending could be attributable to the increase in the sources to finance company investment and spending. As the Table shows, bond issues have grown strongly, probably at a lower financing cost. As a result, the business sector's financial obligations have decreased as a percentage of their liabilities in recent years, while the share of commercial papers and bond placements has increased.

In recent years the profits generated by the productive sector have grown, and have been used to finance spending and investment projects. According to information from the Securities Superintendency, the operating profits of the productive sector rose 21.83% on average in 2002 and 2003, and 27.7% in the first quarter of 2004 against the same period of the previous year. The tax benefit granted in the last tax reform to firms that reinvest their profits in the purchase of productive assets has increased companies' use of their own funds to finance investment.

Although commercial lending grew only 3.3% in the first six months of 2004, disbursements of ordinary and preferential loans grew 29.5%, which suggests that firms are making repayments.

Table
Liabilities of non-financial entities registered with the Securities Superintendency

Description	2001	2002	2003	2004 I Quarter
Levels (millions of pesos)				
Total financial obligations	6,740,455.9	8,587,117.8	7,750,816.6	7,611,346.2
Total bonds and commercial bonds	1,121,001.6	2,315,954.6	3,811,498.1	3,717,677.7
Commercial loans	24,876,784.7	27,816,712.8	31,296,991.1	30,873,708.6
Bonds plus commercial lending	25,997,786.3	30,132,667.5	35,108,489.2	34,591,386.4
As percentage of liability				
Total financial obligations	48.53	49.55	41.51	39.78
Total bonds and commercial paper	8.07	13.36	20.41	19.43
As percentage of commercial lending				
Total bonds and commercial paper	4.5	8.3	12.2	12.0

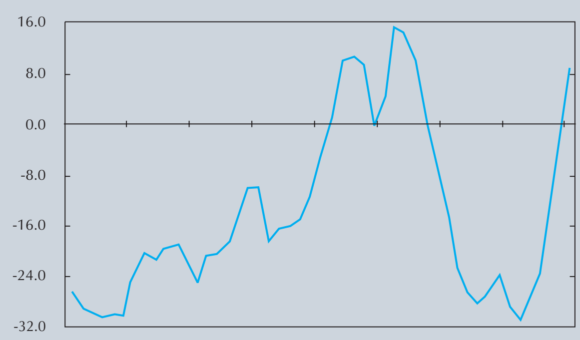
Source: Securities Superintendency.

External borrowing has also expanded recently. Foreign currency loans grew 23.1% in the first half of the year (9.6% annual growth), but their share is still marginal Footnote 1 (Chart B1.3)[1].

The results of the Bank's latest survey expectations (with information up to April) show that 82.6% of those surveyed consider that credit disposible is high, the highly percentage in the history of the series. Similarly, the perception of available liquidity is at its highest levels, and economic agents consider that it will stay this way for some months.

All this shows that, despite the slower growth of commercial lending, there is abundant credit and liquidity in the economy, as confirmed by the stability of lending and deposit rates. What is observed is a diversification of the sources of financing of investment and working capital in the Colombian business sector. Even so, looking to the future, commercial credit can be expected to grow at higher rates given the pickup in economic activity.

Chart B1.3
Nominal gross lending in foreign currency not including FEN
(annual percentage growth)



Source: Banco de la República.

[1] Foreign currency loans not including Financiera Eléctrica Nacional (FEN) represent slightly under 5% of total loans not including FEN.

II. Macroeconomic Outlook

The macroeconomic outlook do not differ substantially from the diagnosis presented in the last quarterly report. The main differences relate to the existence of more severe supply shocks than expected, and the projection of a lower exchange rate in 2004 and 2005.

At present, the conditions are right for the Colombian economy to keep on growing strongly for the next few quarters. The optimism about the performance of the world economy improves the outlook for Colombia's exports and terms of trade. This favorable external environment is combined with domestic conditions that contribute to the revival of private consumption, such as low interest rates, improved consumer confidence, better quality of employment, and higher private disposable income, even higher than the GDP growth rate.

The greatest risk for economic activity comes from the increase in external interest rates.

Currently, the greatest risk for economic activity comes from the increase in external interest rates, which is already under way. However, this adjustment is expected to be gradual and its impact on capital inflows will be limited, at least in the short term. Thus, rate will be contained in the next few months, and a slower depreciation rate than forecasted in past reports cannot be ruled out for 2005. Although this contributes to control inflation, it will not compensate for the adverse effects of other factors. In particular, the increase in the inflation forecast for December of this year, stemming from higher price adjustments for food and regulated prices, could brake the fall in inflation expectations to below 6.0% for 2005. Other factors are an expected contraction in spare capacity in the next few quarters and increases in production costs following higher prices of imported raw materials. So, the central prediction model maintains the requirement of a future increase in interest rates to prevent inflation rising over 6.0% and to achieve convergence to the Bank's long-term targets. The change in the monetary policy stance would be line with the new international conditions and the normalization process of productive activity.

The central prediction model maintains the requirement of a future increase in interest rates.

A. External Context and Production of Tradables

In the medium term no fundamental changes are predicted in the performance of the world economy. The most recent forecasts are for continuing growth in most of the economies during the rest of 2004 and 2005.

The engine of growth in the next 18 months will continue to be United States.

The engine of growth in the next 18 months will continue to be United States, whose economy will keep expanding at a good rate, buoyed by stronger domestic demand. The improved confidence indexes, the upturn in industrial production and the capacity utilization observed in the last six months are an indication in this direction. According to the consensus of international analysts (*Consensus Forecast*) for 2004 and 2005, growth of 4.7% and 3.8%, is expected, respectively, which is similar to the forecast presented three months ago (Table 5).

In the rest of the developed countries, the outlook for 2004 and 2005 is also favorable, however some differences. Recovery in the euro area will continue, although more gradually than in the other developed economies, and at slightly lower rates than forecasted three months ago (Table 5). Growth will continue to be driven by exports, growing investment and the revival of private consumption. However, the possibility of good results in the longer term still depends on the implementation of reforms in various countries to consolidate public finances.

In Asia the outlook is as usual led by China, although its growth could be slightly reduced as a result of stabilization policies recently adopted by that country. For 2004, of GDP growth is expected to be at 8.7% and 7.7% in 2005 (against 9.0% in previous years).

Finally, in Latin America, the optimistic growth outlook is still linked to the expected improvements in commodity prices, which will favor the region's exports. In Venezuela and Ecuador, the expected high prices for oil during the rest of this year and in 2005 point to a good economic performance, as long as political conditions do not generate an adverse effect. Along these lines,

TABLE 5

GROWTH FORECASTS
(PERCENTAGE)

	Observed 2003	Forecast made on: July 6, 2004		April 5, 2004	
		2004	2005	2004	2005
Developed countries					
United States	3.1	4.7	3.8	4.6	3.7
Euro Zone	0.5	1.6	2.4	1.8	2.5
Japan	2.3	4.1	1.8	2.8	1.6
Latin America					
Argentina	8.7	7.5	4.0	6.7	4.1
Brazil	(0.2)	3.4	3.4	3.4	3.6
Chile	3.3	5.0	5.0	4.7	5.1
Mexico	1.3	3.8	3.6	3.2	3.6
Peru	4.0	4.2	4.1	3.9	3.8
Ecuador	2.8	4.9	3.9	4.7	3.8
Venezuela	(9.2)	8.6	4.1	7.1	4.2
Colombia's main trading partners	1.7	4.3	3.6	4.2	3.5

Source: Observed from IMF, and Datastream forecasts

Consensus Forecast recently adjusted its projections upward for these two countries (Table 5).

The expected growth of Colombia's main trading partners is 4.3% for 2004 and 3.6% in 2005.

On this basis, the expected growth (weighted by the size of trade) of Colombia's main trading partners is 4.3% for 2004 and 3.6% in 2005. These figures show a significant recovery from 2003 (1.7%) and are slightly higher than the forecasts of three months ago (4.2% for 2004 and 3.5% for 2005).

Currently, there are two closely related risks that could hold back the sustained expansion of the world economy. The first is the rising international prices of oil and other raw materials, and the second is the probable increase in external interest rates as a result of the efforts of the monetary authorities of the United States and other countries to cool off recent inflationary outbursts. On a broader horizon, another risk could be the high levels of fiscal and current account deficit in the US economy.

Everything seems to indicate that the current high levels of oil prices are due to a structural imbalance between supply and demand which will not be easy to eliminate in the short term. After the latest rises in June and early July, experts raised their forecasts for the rest of the year, and even for 2005, between US$3 and US$4 per barrel (Table 6). The forecasts for other raw materials and commodities were also increased, including Colombia's exports such as coal, coffee and ferronickel (Table 6).

The higher raw material and fuel prices could have a negative effect on world growth, especially in developed economies.

Although there is still no consensus among analysts about the size of this impact, they believe that the world economy is now less vulnerable to its effects than in the last decade, which has created confidence that the impact on growth in the next two years will be limited and will not interrupt the current phase of economic expansion (see Box 2 for the effects on Colombia).

Table 6

Prices of Colombian export products

	2002	2003	Proyection 2004	
			Before	After
Oil (US$ / barrel)	24,20	29,00	31,20	34,14
Coal (US$ / ton)	30,80	28,10	31,60	38,28
Nickel (US$ / pound)	1,10	1,40	1,90	1,94
Coffee (US$ / pound)	0,70	0,70	0,70	0,79
Gold (US$ / troy ounce)	310,20	362,50	423,80	393,50

Source: Banco de la República.

Over the next 18 months, real external rates should increase close to levels more in line with long-term equilibrium rates.

In relation to external inflation, a deflationary scenario, which was assigned some probability in the March report, can now be completely ruled out. This is confirmed by the increases in the forecasts of international commodity prices and external inflation for the rest of 2004 and for 2005.

In this situation, the stage of low interest rates and very ample international liquidity, which has characterized the world economy in the last three years, has reached its end. Over the next 18 months, real external rates should increase close to levels more in line with long-term equilibrium rates. However, the moderate increase in inflation in June in the United States compared with analysts' expectations and the evidence against an uncontrolled expansion of the US and other economies indicates that that rates will continue to be adjusted gradually for at least the rest of this year.

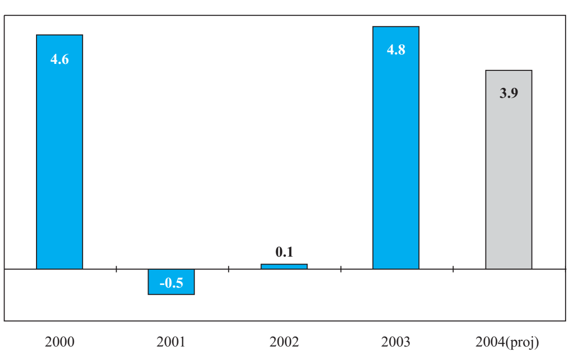
On this basis, this report's forecasts of external interest rates for the next few quarters have been revised upward. The analysis and projections of inflation were made under the assumption of increases of around 100 bp in short-term external rates for all year, with 25 bp observed in June, while in March an increase of only 50 bp was forecasted for all 2004. In 2005, an increase of 150 bp is expected, which would bring nominal short-term rates in the United States to between 3.5% and 4.0% at the end of this year. Historically this rate has fluctuated around 4.5% and 5.0%.

For Colombia, this external context means the possibility of more favorable terms of trade in the next few quarters than were forecasted in the March report. This circumstance, together with the relatively high growth of external demand, especially in Venezuela, creates confidence that our exports will perform well during the year, probably better than expected at the beginning of the year. At the same time, an upturn in exports should result in a more solid growth than initially forecasted in tradable sectors such as industry and agriculture (Chart 34). The improved terms of trade also favor the growth of domestic demand through the effect on national income.

A scenario with rising external rates brings risks for the stability of the local economy and for emerging economies in general. The surge can lead to a sharp contraction in liquidity, which substantially increases the financing costs of emerging economies, especially for the most indebted with greater dependence on external funds. Even so, the positive way in which markets have reacted to the change in the Fed's monetary stance, and the fact that the adjustments are expected to be gradual, reduces the likelihood of difficult situations on this front, at least for the rest of 2004.

CHART 34

GROWTH OF GDP OF TRADABLE GOODS AND SERVICES
(PERCENTAGE)



(proj) Projected.
Source: DANE, Bank's own calculations.

The balance-of-payments projections presented in the *Report of the Board of Directors to the Congress of Republic* at mid-year contained a good part of these considerations. According to these, the deficit on current account for 2004 will be 1.8% of GDP, forecasting 14.5% growth for exports and 11.9% for imports. This deficit would be financed from net inflows of capital equivalent to 2.2% of GDP. The nominal appreciation compatible with these results in 2004 is approximately 6%. For the next two years, the balance-of-payments model predicts a moderate nominal depreciation in line with expected inflation in Colombia. However, the recent improvement in the terms of trade could portend more favorable conditions for exports, which have not been fully included in previous forecasts and which could reduce the current account deficit and strengthen the currency in 2004 and 2005.

The recent improvement in the terms of trade could portend more favorable conditions for exports.

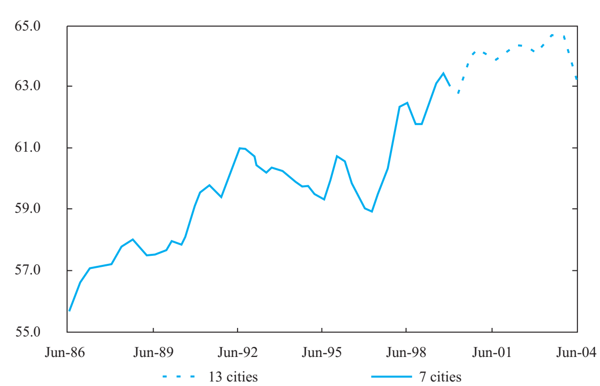
B. Domestic Demand and Economic Growth

This report emphasizes the recent trend in domestic demand and considers that a good growth rate will be maintained during the rest of the year. The factors that favor expansion include increased consumer and investor confidence, better employment conditions, higher disposable income, progressive adjustment of household and company balances, higher company profits so far this year, and low real interest rates consistent with the ample available liquidity. These factors should continue to stimulate household consumption and investment in the rest of 2004.

The trend of the employment indicators confirms this outlook, along with the reduction in the overall participation rate. Significant falls in this indicator are probably associated with improvements in employment conditions and levels of household income, and tend to coincide with expansionary stages of the economic cycle (Chart 35).

Chart 35

Overall participation rate (trend component)

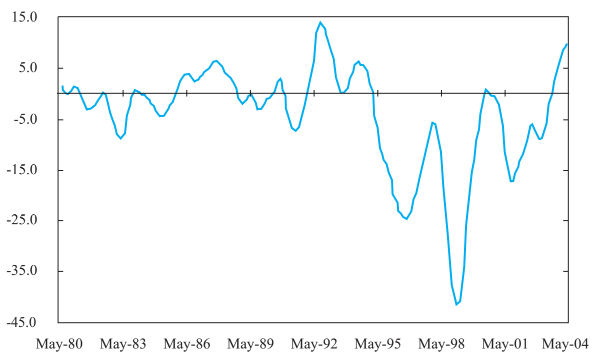


Source: DANE, Bank's own calculations.

As mentioned in previous reports, domestic demand is expected to continue to be favored by relatively low levels of the country risk coefficient (although higher than in the first quarter of 2004), by the trend in share prices (this year the Colombian Stock Exchange General Index (IGBC) gained 26.5%), and the recovery of the value of non-tradable assets, especially real estate.

Chart 36

Industry confidence indicator (trend component)



Source: Fedesarrollo, Bank´s own calculations.

Table 7

Growth projection, 2004 (Percentage)

Gross domestic product	4.0
Total imports	6.7
Total final supply	4.5
Final consumption	3.3
Households **(*)**	3.7
Government	2.1
Gross capital formation	11.6
Gross fixed capital formation	9.0
Subtotal: Final domestic demand	4.7
Total exports	3.0
Total final demand	4.5

(*) Includes purchases of goods abroad by residents and excludes purchases by non-residents in Colombia.
Source: Banco de la República.

In the rest of 2004, the strongest component of domestic demand will probably be private investment, whose growth will be largely stimulated by home and commercial buildings, and also by investment in other sectors such as industry. In addition, the confidence indicator reported by the Fededesarrollo survey remains for high levels, only surpassed by the best years of the 1990s (Chart 36).

There is also a broad space for the continuing recovery of household consumption which, in per capita terms, remains at levels similar to ten years ago. The good performance of this variable in the first quarter creates confidence in higher growth in 2004 compared with the forecast in the last quarterly report.

The 4% growth forecast for total GDP presented in the March report is unchanged (Table 7). However, there is a possibility for higher growth given the good trend in consumption and investment in the first quarter, and the recent increase in exports.

This report considers that economic performance will be affected during the rest of the year by supply shocks; in particular, the third quarter will have two working days less than the same period of 2003, which reduces the growth of some sectors. Also, the mining sector is expected to contract in the second half, given the strong levels of growth observed a year ago (of coal and gold).

Economic growth will continue to be stimulated mainly by the private component of product, which has shown a significant upturn in recent quarters. The outlook suggests that this trend will be maintained despite a weakening of the rest of the economy (Chart

37)[1] . The expected slowing of the "rest" of the GDP (related to government services, civil works and mining) in 2004 with respect to 2003 is mainly explained by the moderate growth of the civil works component of the construction sector, although this sector is expected to correct the steep fall in the first quarter (-42%) during the rest of the year, which may grow only 1% for the full year.

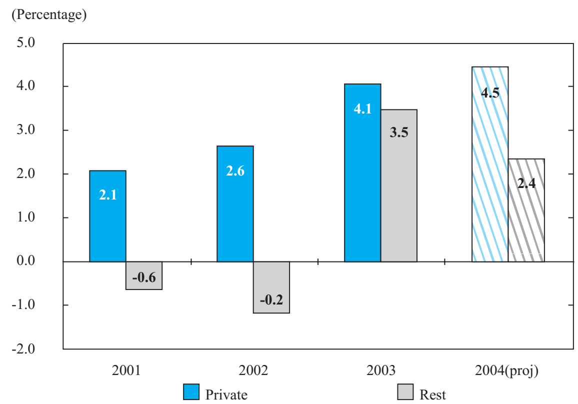
The "rest" sector will also be influenced by the low growth of oil GDP (due to the normal exhaustion of the country's oil reserves), and by a more moderate increase in coal production than in the previous year. Lastly a 2.0% growth is the forecast for 2004 in government services.

Sectoral GDP will grow in line with the domestic and external demand of the Colombian economy (Table 8). In the agricultural sector, growth is expected to be bigger than in 2003, explained mainly by the start of a cycle of cattle slaughter which will

[1] Private GDP is composed of the sectors: agriculture; electricity, gas and water; industry; building construction; commerce; transport, and financial services. The other sectors are grouped in the so-called «rest».

CHART 37

Growth of "private" and "rest" GDP



Proj: Projected.
Source: DANE, bank´s own calculations.

TABLE 8

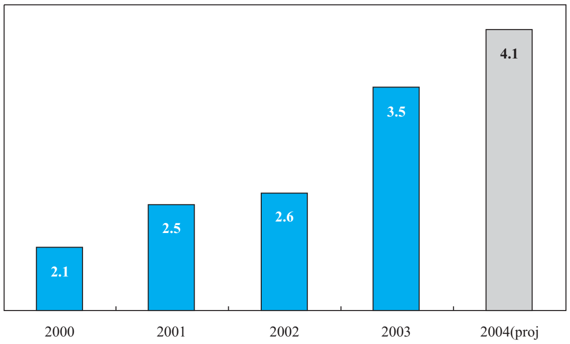
Annual growth of GDP by sector
(annual percentage changes)

Sectors	2002 (pr)	2003 (pr)	2004 (proj)
Agriculture. forestry. hunting and fisheries	0.6	3.1	3.2
Mining and quarrying	(4.3)	12.1	4.4
Electricity. gas and water	3.0	3.3	2.5
Manufacturing industry	1.1	4.2	4.5
Construction	12.7	12.4	14.4
Buildings	35.2	19.7	22.9
Civil works	(7.9)	2.6	1.0
Commerce. repairs. restaurants and hotels	1.4	5.1	5.0
Transport. storage and communications	3.0	4.5	5.5
Financial institutions. insurance and real estate	2.4	4.6	6.7
Social. community and personal services	0.9	1.2	1.9
Intermediation services Financial measured indirectly	(0.0)	13.9	20.8
Subtotal value added	1.8	3.9	4.0
Gross domestic product	1.8	3.9	4.0

(pr) Preliminary.
(proj) Bank´s projection.
Source: DANE and Banco de la República.

Chart 38

Growth of GDP of non-tradable goods and services
(Percentage)



Source: DANE, Bank's own calculations.

stimulate the sector, despite bad data from the first quarter for crops such as bananas and flowers.

For the mining sector, the 4.4% expansion will be partly explained by growth in the construction sector which strongly influences the production of non-metallics. The manufacturing industry will grow faster in 2004, although its quarterly trend is influenced by the number of working days which will mark greater expansion for seasonal reasons than the first half.

Lastly, commerce and other services will grow faster than GDP, with the exception of government services, which confirms the strength of domestic demand, particularly household consumption.

Consistent with the strengthening of domestic demand, the GDP of non-tradable goods and services for 2004 is expected to grow faster (Chart 38), stimulated by trade and services, but particularly by the strong expansion of the construction sector where a 14.4% real growth rate is expected.

C. Inflation Forecasts

As in previous reports, the Bank's forecasts were made in two stages. First, short-term forecasts were produced(horizons of one and two quarters) for variables such as inflation, growth, output gap and devaluation, among others. Sectoral models were used which have demonstrated a high prediction power short horizons. The second stage relates to the production of long-term forecasts based on the over Bank's central model (transmission mechanisms model - TMM). In this case simultaneous forecasts were made for the main macroeconomic variables, including inflation, for horizons longer than two quarters. The short-term forecasts obtained in the first stage are used as an input in the second.

Consistent with the strengthening of domestic demand, the GDP of non-tradable goods and services for 2004 is expected to grow faster

1. The forecasts for 2004

In this report, the short-term forecasts (STF) for inflation cover the third and fourth quarters of 2004. Inflations STF increased from the projections of previous months for both the food and non-food CPI.

In the case of non-food inflation, the short-term models predict 5.9% and 6.1% in the third and fourth quarters, respectively. These values are higher than the forecasts presented in the March report by 30 bp and 40 bp, respectively

For the second quarter, the Bank's inflation forecast was 30 bp lower than the actual figure (Table 9). The underestimate of inflation in June and the higher forecasts for the next two quarters are related to the high level (observed and expected) of international oil prices. This circumstance, which led to higher than expected increases in the domestic prices of fuels and public transport in the second quarter, has raised the forecasts for the rest of the year.

On food inflation, the mismatch between the Bank's forecast and the figure observed in June was significant (5.6% projected vs. 6.5% observed) fundamentally because of the strong rebound of prices of perishable food (vegetables). For the next two quarters, the short-term models predict on annual inflation of 7.1% and 5.9% in this group, higher than the forecast obtained three months ago.

Table 9

Trend of short-term inflation forecasts
(Percentage)

	December	March	June
Total			
Mar-04	5.7	6.3	6.3
Jun-04	5.4	5.6	6.1
Sep-04		5.8	6.2
Dec-04			6.0
Non-food			
Mar-04	6.0	6.1	6.1
Jun-04	5.6	5.6	5.9
Sep-04		5.6	5.9
Dec-04			6.1
Food			
Mar-04	5.0	6.7	6.7
Jun-04	5.0	5.6	6.5
Sep-04		6.2	7.1
Dec-04			5.9

Source: Banco de la República.

In the second half of the year, once again the volatility of annual food inflation will be linked to the trend in the price of perishable food in general, and the price of root vegetables, particulary of potatoes. The second semester is normally a period with a good supply of this type of products so their prices usually fall. This year, however, the models predict a slower reduction until September relative to a year ago. This would lead to a rise in annual inflation, although inflation in this group in the second half of 2003 could be considered atypically low. For the fourth quarter the opposite could occur, with a fall in annual inflation.

End-of-year forecasts for food inflation have been subject to a considerable margin of error, as shown in Table 9. The difference between food inflation in June and the forecast at the beginning of the year was 150 bp, while the difference for non-food inflation is only 30 bp. For this reason, the forecasts for food inflation must be viewed with caution. However, experience also shows that the models used in the STF have normally captured the trend of food inflation, so the annual figures can be expected to fall by the end of the year.

In general terms, according to the STF, total inflation will remain around 6.0% for the rest of the year, with isolated variations that will depend on the trend in perishable food inflation. After discounting the volatility transmitted by food prices and the increases in regulated prices, the resulting inflation path for the rest of the year does not differ much from the forecast of the March report.

In the case of non-food inflation, the short-term models predict 5.9% and 6.1% in the third and fourth quarters.

Besides inflation, the STF used in the Bank's central model considers an average annual appreciation of 6.7% for 2004, similar to the assumptions used in the balance-of-payments central scenario discussed earlier, and the March *Inflation Report*. The STF of 4.0% growth did not change in relation to the previous report. In terms of quarterly GDP, the STF assumes a growth of over 4.0%for GDP for the second quarter, but slightly less in the third and fourth. The slowdown could be due to transitory supply shocks (two working days less in the third quarter of 2004 than in 2003), and to the comparison with a high statistical base because of the pickup in mining GDP in the second half of 2003.

2. Long-term forecasts

The results assume that the short-term interest rate is adjusted to guarantee the long-term convergence of inflation to 3.0%, in line with the Board's target.

The results of the central model (TMM) model are presented for the case of the endogenous determination of the interest rate. That is, the results assume that the short-term interest rate is adjusted to guarantee the long-term convergence of inflation to 3.0%, in line with the Board's target. The path for the rate also takes into account the announcements of inflation targets for 2004 and 2005 (targeted range between 5% and 6% for 2004 and fixing the rate for 2005 between 3.5% and 5.5%).

The last report stated that the inflation outlook for the medium and long term depended on two fundamental factors: the trend in the exchange rate and the speed of closure of the output gap. Although the preceding sections suggest that these two factors continue to be important, the emphasis on the exchange rate has declined in favor of greater weight for expectations and the gap.

The future trend of the exchange rate will continue to be closely linked to external conditions. Currently, these tend to favor greater exchange rate stability in the medium term compared with the revaluation expectations three months ago. The relatively high growth rate of the US economy suggests that it has entered a new expansionary phase, although doubts persist about its durability and solidity, given the economy's deep external and fiscal imbalances. However, the markets have sufficient time and room to adjust gradually with low cost in terms of growth.

On this basis, the US economy will continue to grow at a satisfactory rate for several more quarters, which will stimulate world growth, including the emerging countries. In the medium term, the strength of world demand will also guarantee further increases in the prices of the raw materials exported by the emerging economies. Although these prices have been rising since last year, they are still below the maximum levels recorded at the end of 1996 and during other years of strong economic expansion.

Short-term interest rates are expected to be adjusted 100 bp in the United States for this year.

For Colombia, the current account of the balance of payments will contribute to the exchange rate stability, or at least will not bring on strong nominal depreciation. Exports will have a guaranteed external demand that is expanding with favorable terms of trade, coupled with income from remittances at the same or higher levels than in 2003. This higher income will offset the increase in imports consistent with the growth expected during the next few years without significantly increasing the current-account deficit.

However, the recent surge of inflationary pressures in the United States carries risks for world growth which were underestimated in the March report. This report has increased the forecast for the rises in interest rates for 2004. Currently short-term interest rates are expected to be adjusted 100 bp in the United States for this year, compared with the 50 bp that were expected in March. This adjustment is similar to that produced by the consensus of international analysts. For 2005 new rises of 175 bp are expected, bringing external rates very close to their long-term equilibrium levels.

Everything seems to indicate that rates will be raised gradually, which decreases risks to global growth and to the probability of a sharp reverse of capital flows for the emerging economies, weakening their currencies.

All this creates optimism about the exchange stability of the Colombian peso in the medium term. Taking these considerations into account and under the assumption that the country-risk premium will not change significantly in the next two years, the TMM predicts a average annual nominal depreciation of 4.2% in 2005 and 2.7% in 2006 (Table 10), less than forecasted in the March report (5.3% for 2005 and 11.3% for 2006). While not a substantial change from the forecasts of the last report, these figures offer an outlook that is a little more favorable in terms of future exchange rate pressures on inflation.

The TMM predicts a average annual nominal depreciation of 4.2% in 2005 and 2.7% in 2006.

For the output gap, the TMM continues to show a gradual reduction next year that does not differ from the previous report (Table 10). This scenario is consistent with the current growth in investment and with the still high levels of unemployment.

Expectations and inflation inertia continue to play a preponderant role for the inflation forecasts in the medium and long term. The increase in the inflation forecast for December of this year following the large adjustments in food and regulated prices, fuels inflation expectations for early 2005 compared with those presented in the March report. This way, transitory price shocks have a permanent effect on inflation and on the determination of monetary policy.

Table 10

Results of Central Model (TMM)
Basic scenario
(Percentage)

	Inflation			Output Gap	DTF	Devaluación promedio anual
	Total	Non-food	Food			
Mar-04	6.3	6.1	6.7	(1.8)	7.8	5.6
Jun-04	6.1	5.9	6.5	(1.7)	7.7	(1.2)
Sep-04	6.2	5.9	7.1	(1.6)	7.7	(4.7)
Dec-04	6.0	6.1	5.9	(1.4)	8.1	(6.7)
Mar-05	5.9	6.1	5.4	(1.2)	8.6	(4.4)
Jun-05	5.7	5.9	5.4	(0.9)	9.4	(2.1)
Sep-05	5.2	5.4	4.8	(0.8)	9.7	0.8
Dec-05	4.9	5.0	4.9	(0.8)	9.9	4.2
Mar-06	5.0	5.0	5.2	(0.8)	10.2	4.5
Jun-06	4.9	4.9	4.9	(0.8)	10.4	4.3
Sep-06	4.8	4.8	4.8	(0.9)	10.4	3.7
Dec-06	4.7	4.7	4.6	(0.9)	10.5	2.7

Source: Banco de la República.

As mentioned in past reports, inflation expectations usually decline very slowly. This tendency is confirmed by the trends observed for various indicators and by the fact that expectations continue to depend broadly on past inflation and not on the targets announced by the Bank, despite the possible gains in credibility of monetary policy in recent years.

Lastly, the TMM predictions presented in this report do not envisage any transitory price shocks for 2005 and 2006. In terms of the prices of regulated goods and services (especially fuel and public services), over the next two years the adjustments should not exceed the observed inflation at the end of 2004 (6.0%). Specifically, the possible inflationary effect of a change in the VAT system in 2005 is not taken into account.

In this context, the TMM predicts a gradual rise in rates for the fourth quarter of this year and for the next two years to guarantee the convergence of inflation to its 3% long-term target. The rise in rates in 2004 could be small (about 40 bp) with an additional 180 bp and 60 bp in 2005 and 2006, respectively. The resulting path for rates does not significantly vary in relation to the last report, which is consistent with the few changes made.

The change in the rates is explained by various factors:

The TMM predictions do not envisage the possible inflationary effect of a change in the VAT system in 2005.

- First, the level maintained by inflation expectations until well into 2005 (around 6.0%). This fact, added to a lower inflation target next year, requires a change in the monetary policy stance to align expectations with future targets.

- Second, the contraction of spare capacity in the next few quarters.

- And lastly, the low level of real interest rates in Colombia compared with their long-term equilibrium levels. This is not surprising if the demand situation is tending to normalize, as the TMM predicts, if inflation expectations have stabilized at 6%, and if monetary policy only acts on inflation with a minimum lag of four quarters.

- The previous factors compensate the downward effect on rates of the increased stability of the exchange rate.

For these assumptions and predictions, the Bank's central model projects an inflation of 4.9% and 4.7% for the end of 2005 and 2006. These long-term predictions assume that food inflation converges with non-food inflation at the end of next year (Table 10).

3. Balance of risks

The following considerations were taken into account for the construction of the balance of risks presented next:

- In 2004, the appreciation of the peso could axceed the Bank's forecast. Income from exports could be higher because of higher international prices and stronger external demand. Something similar could happen to net capital income, given the tranquility with which the markets assimilated the Fed's policy change. In contrast, for 2005 the bias could be toward more depreciation, given the risks on higher on world inflation and external rates.

- The gap could close more rapidly than expected. The latest data on real productive activity suggests that growth could be higher in 2004 and 2005 than forecasted in this report. Evenhough the estimate of the current level of the gap (-1.7%) in this report is uncertain, it has the same probability of being underestimated than overestimated.

In 2004, the appreciation of the peso could axceed the Bank's forecast. In contrast, for 2005 the bias could be toward more depreciation, given the risks on higher on world inflation and external rates.

- Food inflation in 2004 could exceed the STF as suggested by some of the Bank's models.

- Announcements on extending the VAT, if they occur, could result in increases in the inflation rate.

- Domestic fuel prices could rise above the inflation target again in 2005, given the recent trends in external prices and the vulnerability of world supply.

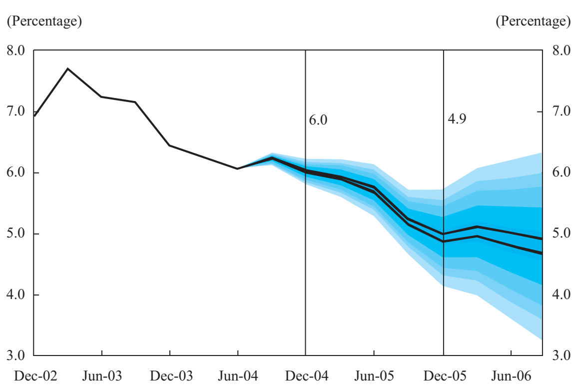
- For the moment, rises in the price of other regulated services and goods above the 2005 target cannot be ruled out.

- Production costs could increase more than expected for this report because of higher international prices and the possible appearance of bottlenecks in some production chains. The increase in construction costs and the recurring concerns of business owners according to ANDI are signs in this direction.

This balance of risks is shown in the probability distribution table (Fan Chart). The probability distribution for 2004 shows that inflation now has less probability of falling below 6.0% than one quarter ago (down from 90% to 49%). However, the probability of inflation below 5.5% for 2005 increased slightly with respect to previous results (83% vs. 80%). The confidence interval is balanced around the central path for the inflation prediction (Chart 39).

Chart 39

Inflation probabilities distribution (Fan chart)



Inflation ranges (%)	2004		2005				2006
	Sep.	Dic.	Mar.	Jun.	Sep.	Dic.	Mar.
[6,0-6,5]	100,0	50,9	31,0	13,0	0,6	1,2	5,3
[5,5-6,0]	0,0	49,1	67,2	66,6	16,1	10,6	16,8
[5,0-5,5]	0,0	0,0	1,7	20,0	55,7	33,0	29,2
[4,5-5,0]	0,0	0,0	0,0	0,3	26,1	37,3	28,0
[4,0-4,5]	0,0	0,0	0,0	0,0	1,5	15,3	14,7
[< 4,0]	0,0	0,0	0,0	0,0	0,0	2,4	5,0

Source: DANE, Bank´s own calculations.

The Impact of Higher Oil Prices on the Colombian Economy

In recent months, the world economy has been affected by a significant increase in international oil prices, which rose from US$32.14 per barrel (WTI) in December 2003 to an average of US$40.47 per barrel in July 2004, stimulated mainly by a strong demand from Asia and United States.

The effect of the higher prices on world economic activity and each country's performance responds to the particular factors in each economy. For the world economy, a study by the International Energy Agency (IEA)[1] estimates that a sustained increase of US$10 in crude prices between 2004 and 2008 could produce a decrease of around 0.4% in the GDP in the growth of the member countries of the Organization for Economic Cooperation and Development (OECD). Inflation in these countries could increase 0.5% and the unemployment rate 0.1%. World growth could be negatively affected by 0.5% of GDP, since the benefits obtained by the exporting countries do not offset the cost of the high prices for importers.

Colombia simultaneously exports crude and imports part of the gasoline that it requires to satisfy domestic demand because of the look of refining capacity. This Box evaluates the possible direct effects of a US$5 increase in the crude price on the balance of payments, public sector finances and inflation[2]. It also quantifies some indirect effects (through movements in the real exchange rate, or higher revenue) based on a multi-sectoral general equilibrium model.

I. Effects on the balance of payments

A US$5 rise in crude price increases current revenue of the balance of payments by US$69 million (Table R2.1) due to an increase of US$219 million in the trade surplus, as a result of a rise of US$655 million in crude exports. This additional revenue offset the drop in revenue from non-traditional exports, due to the real appreciation of 2.5% caused by higher oil exports, and the rise of US$257 million in imports. This appreciation also increases the deficit on the non-factorial services account by US$46 million. The rise in oil revenue also generates outflows of US$104 millions on the factor income account due to higher remittances from associated foreign companies.

II. Effects on public finances

Oil activity is an important source of funds for the State through payments of income tax, VAT, gasoline taxes, concession of royalties (property rights over the subsoil), dividend distribution (Ecopetrol's profits belong to the State

1 International Energy Agency (IEA) (2004). "Analysis of the Impact of the High Oil Prices on the Global Economy."

2 This increase corresponds to the change in the average export price of crude which, in the official projections, rises from US$29.04 in 2003 to US$34.14 in 2004. The international price of Colombian crude is about US$2 below the benchmark price (WTI).

Table B2.1
Effect of change in oil price
On balance of payments
(As GDP percentage)

Current account	69,0
A. Goods	219,0
1. General commerce	238,0
Exports	495,0
Coffee	0,0
Oil and products	655,0
Coal	0,0
Ferronickel	0,0
Non-traditional	(160,0)
Imports FOB	257,0
2. Special foreign trade operations	(19,0)
B. Non-factorial services	(46,0)
C. Income from factors	(104,0)
D. Current transfers	0,0

Source: Banco de la República.

as owner), and expenditure with fiscal objectives (gasoline subsidies, infrastructure works, contribution to the gas extension program, etc).

As Table R2.2 shows, the higher crude prices improve Ecopetrol's surplus by 0.1 percentage points of GDP. However, assuming the complete dismantling of the subsidies on gasoline prices, the impact on company finances would be of around 0.3% of GDP, according to preliminary calculations by the Consejo Superior de Política Fiscal (Confis, Fiscal Policy Council).

In the scenario without elimination of subsidies, Ecopetrol's income increases 0.3% of GDP, while expenses are 0.2%. The rise in income is associated with the higher value of exports, while the increased expenses are explained mainly by the higher value of gasoline imports, and the transfer of royalties to the Nation. The larger surplus results in an increase in income tax payments to the Nation, but this would not take place until the following year.

III. Impact on consumer inflation

Assuming that about 80.0% of the increase in oil prices pass through to gasoline prices (this proportion results from a comparison of the change in these prices between December 2002 and May 2004), a US$5 rise in the oil price would increase the CPI by 0.53%.

This effect breaks down into a direct effect associated to the rise in fuel prices (14%) which has an inflationary impact of 0.1%, and an indirect effect of 0.43% due to the impact on transport costs and other items [3]. The latter assumes

[3] This calculation uses a Leontief model based on an input-product matrix for 1997.

Table B2.2
Impact of oil price increase on Ecopetrol finances
(as percentage of GDP)

	(US$ / barrel)	
	34.14	**29.04**
Total income	5.6	5.3
Gross production	5.3	4.9
Domestic sales	3.1	3.1
Exports	2.2	1.8
Other income	0.2	0.2
Ingresos causados	0.0	0.0
Savings /(dissaving) FAEP	(0.1)	(0.2)
Total expenses	4.9	4.7
Commercial operations	1.9	1.8
Raw material purchases	0.5	0.5
Imports	0.2	0.1
BOMT. Ocensa	0.4	0.4
Other operating expenses	0.8	0.8
Transfers	2.0	1.9
Dividends to the nation	0.4	0.4
Income tax	0.3	0.3
Royalties	0.9	0.8
Other transfers	0.4	0.4
Rest of operations. capital payments and other payments	1.0	1.0
Total surplus	0.7	0.6

Source: Confis based on Ecopetrol information.

that the cost increases are entirely passed through to higher prices and that there is no effect on the exchange rate. If the appreciation predicted by the balance-of-payments model takes place, the total inflationary effect will be about 0.4%.

IV. Macro-sectoral results

According to the general equilibrium model of the Economic Studies Unit (SGEE), the US$5 rise in the external crude price generates a real appreciation of 1.9%, slightly less than the balance-of-payments projection. The higher income from exports has an expansionary effect on household consumption and domestic savings. These positive effects on economic activity contrast with the 1.3% fall in non-traditional exports due to a real appreciation of 1.8% and stronger growth of imports. Overall, GDP grows 0.3% (Table B2.3).

The model shows a Dutch disease-type effect that favors mining and service sectors (mainly non-tradable activities), while industrial sector (mainly tradables) contract 0.33%. Although agriculture added value does not change significantly, its exports fall 0.14% (Table B2.4).

Table B2.3
Real growth of GDP on expenditure side
(Percentage)

Consumption	0.35
GDP	0.28
Total investment	2.46
Private investment	3.28
Exports	(0.80)
Non-traditional exports	(1.34)
Imports	1.77

Source: Banco de la República.

Table B2.4
Real growth of sectoral GDP
(Percentage)

	GDP	Exports	Imports
Agriculture	0.00	(0.14)	1.34
Mining	0.06	0.10	0.50
Industry	(0.33)	(1.99)	1.82
Services	0.43	(0.62)	1.59

Source: Banco de la República.

Local and External Analysts' Projections of the Key Macroeconomic Variables

This is a review of the latest projections by local and foreign analysts for the key variables of the Colombian economy at the end of 2004 and 2005. At the time of the consultation the agents had information to June.

1. Projections for 2004

Table A1 shows the forecasts for 2004. A local analysts maintained their growth prediction at 3.8%, while foreign analysts made an upward correction to 4.2%. Four of the nine analysts maintained their prediction, four made upward corrections and only Revista Dinero lowered its forecast for the end of the year (-40 bp). Idea Global is the most optimistic, forecasting 4.8%, while the most pessimistic is Dinero which forecasts 3.6%. On inflation, the consensus among agents seems to be 5.9%, with Goldman Sachs being the most pessimistic at 6.4%. All the local analysts believe that the target will be met, although their forecasts are at the ceiling of the interval fixed by the Bank at the beginning of the year. The most optimistic forecast comes from Suvalor-Confinsura, which alone seems to believe that is still possible to achieve the 5.5% target. It is worth recalling that the Bank's inflation forecast for the end of the year (included in this report) is 6%, slightly above the agents' average.

For the exchange rate, the difference between the forecast of the local and foreign agents is only 5 pesos. Three analysts maintained their forecasts, five reduced them and only Deutsche Bank made an upward correction, which

Table A1
Proyección de las principales variables macroeconómicas para 2004

	Growth of real GDP %	CPI inflation %	Nominal exchange rate (end of)	Nominal DTF 1/ %	Deficit (% of GDP)		Unemployment rate %
					Fiscal (CPS)	Current account	
Local analysts							
Revista Dinero	3.6	6.0	2,780	8.0	2.8	n.a.	14.8
Suvalor-Corfinsura	4.0	5.5	2,800	7.8	2.5	n.a.	n.a.
Corfivalle	3.7	5.8	2,800	8.9	2.8	1.5	14.5
ANIF	3.8	6.0	2,750	7.9	2.8	n,a,	13.2
Fedesarrollo	3.9	6.0	2,738	7.9	2.7	1.9	13.5
Average	**3.8**	**5.9**	**2,774**	**8.1**	**2.7**	**1.7**	**14.0**
Foreign analists							
Goldman Sachs	3.8	6.4	2,880	n.a.	2.5	2.2	n.a.
IDEA Global	4.8	5.7	2,700	7.8	2.5	0.3	12.5
J, P, Morgan Chase	4.0	5.5	2,725	7.8	2.8	1.8	14.5
Deutsche Bank 2/	4.0	6.1	2,770	8.3	5.9	1.7	14.6
Average	**4.2**	**5.9**	**2,769**	**8.0**	**2.6**	**1.5**	**13.9**

CPS: consolidated public sector
n.a. Not available
1/ Average for year
2/ Deutsche Bank data for fiscal deficit relates to national central govt, not included in average.
Source: Banco de la República.

brought it to the average of the others. This suggests that the market now has higher expectations of appreciation for the year. For the DTF the forecasts average 8.0%. The fiscal deficit has not changed much. Agents expect on average a 2.7% deficit as proportion of GDP for the end of the year[1].

For the current account deficit local analysts corrected their forecasts downward by 30 bp approaching what foreign analysts have been forecasting since the last report. The deficit forecasts range from 0.3% (Idea Global) to 2.2% (Goldman Sachs) as a proportion of GDP. Finally, the agents, on average, expect the (national) unemployment rate to be 14%. Local analysts reduced their forecast of one quarter ago by 20 bp, while the foreign analysts increased it by 40 bp. Dinero is the most pessimistic with unemployment around 15%, while Idea Global is again the most optimistic with the indicator at 12.5%.

II. Projections for 2005

Table A2 shows some forecasts for 2005. For next year analysts expect average growth of 4.0%, almost equal to three months ago, with forecasts ranging from 3.4% (Goldman Sachs) to 5.0% (Idea Global).

For inflation, local analysts expect an average of 5.2%, almost equal to that expected at the end of the first quarter. No individual forecast is higher than 5.5%. Expectations for the exchange rate are now closer: there is only a difference of 60 pesos between the rate forecast by local and foreign analysts for the end of 2005 (2,889 and 2,953 pesos, respectively). With regard to the last report, local analysts corrected their forecast downward about 250 pesos, which is an average implicit devaluation of 4.0% against 10.0% expected three months ago. Foreign analysts corrected their forecast upward about 50 pesos, which an average implies depreciation of 6.5% against 4.0% expected in the last report.

Table A2
Projection of key macroeconomic variables for 2003

	Growth of real GDP %	Inflation CPI %	Nominal exchange rate (end of)
Analistas locales			
Revista Dinero	n.a.	n.a.	n.a.
Suvalor-Corfinsura	3.5	5.3	2,948
Corfivalle	4.0	5.5	2,880
ANIF	3.9	5.5	2,838
Fedesarrollo	4.1	5.0	2,890
Promedio	**3.9**	**5.3**	**2,889**
Analistas externos			
Goldman Sachs	3.4	4.9	3,050
IDEA global	5.0	5.0	2,800
J, P, Morgan Chase	4.0	5.3	n.a.
Deutsche Bank	3.9	5.2	3,008
Promedio	**4.1**	**5.1**	**2,953**

n.a. Not available
Source: Banco de la República.

[1] The data on fiscal deficit corresponds to the consolidated public sector. The Deutsche Bank is not included in the average because its corresponds to the deficit of the national central government.

Monetary Policy Decisions in the Last Three Months

A. Background

In the March *Report on Inflation*, the two most significant macroeconomic trends were: continuation of the economic recovery thanks to favorable external and internal conditions, and the higher exchange appreciation in the first quarter due to the ongoing improvements in export prices and volumes, the fall in capital outflows from residents, and new borrowing.

The report stated that tradables inflation had returned to levels prior to the devaluation shock by the economy suffered in mid-2002 and which lasted for almost a year. The inflation pressures on non-tradable prices predicted in the December report seemed not to have appeared: annual rental inflation, which had been increasing slowly at the end of 2003, stabilized in the first quarter, while core inflation of non-tradable goods, excluding rent and regulated prices, remained at levels below 6.0%. As a result, this inflation remained was stable despite the faster growth, probably favored by a lowering of inflation expectations. It was considered that this trend was consistent with the existence of spare capacity, although some indicators suggested a contraction of spare capacity in the industrial sector.

The good performance of core inflation in the first quarter of the year offset the higher than expected increase in food inflation (6.7% in March against 5.0% projected in December), while rises in prices of the basket of regulated goods and services remained above 10.0%. Consequently, total inflation was relatively stable in the quarter (about 6.2%).

The revision of the inflation forecast was based on a higher nominal appreciation of the peso (6.0% on average for 2004 vs. 0.5% in the December report), faster growth of the economy in 2004 (4.0% vs. 3.8%), but at the same time, a slower closing of the output gap (1.0% in December report vs. 0.7% in the March average for 2004) due to higher estimated growth of potential output.

The increased appreciation and the slower closure of the output gap decreased inflation forecasts, which implied that it was possible to achieve inflation levels compatible with the ranges announced for the 2004 and 2005 targets, with lower interest rates than those projected in the December report. In this context, the Board cut its intervention interest rates by 50 bp (25 bp in February, and 25 bp in March).

The Board also considered that the episode of appreciation of the exchange rate since late 2003 was transitory, and therefore prudently made an additional accumulation of international reserves to cover, in the medium and long term, possible reverses in capital flows and adjustments to the exchange rate that could affect the future trend of inflation. At its meeting on March 19, the Board announced the purchase of US$700 million of international reserves on the exchange market between April and July 2004 through put option auctions for amounts announced monthly. The first for US$200 million was called in April and fully exercised.

B. Monetary policy decisions in the second quarter of 2004

The March report explicitly stated that monetary policy strategy in the coming months would depend on the following factors:

1. The effect of the higher appreciation on tradables inflation in the first quarter.

2. The expected trend in the exchange rate for 2004 and 2005 and its effect on tradables inflation and inflation expectations.

3. The size of the output gap and the speed with which it might close in the context of faster economic growth, and its effect on non-tradables inflation.

4. The possible emergence of cost-push inflation associated with higher international raw material prices and possible rises in the cost of some local inputs.

As described in Chapter 1 of this report, the trend in the macroeconomy in the second quarter showed a strengthening of the economic recovery and a significant appreciation of the peso, despite a slight rise in the exchange rate in May. This trend was not substantially different from the diagnosis presented in the March *Report on Inflation*. The main differences have to do with the existence of more severe supply shocks in 2004 than expected, and a projected lower exchange rate in 2004 and 2005. The inflation forecast does not vary significantly from the last report because the effects of these two trends offset each other. Even so, the forecasts indicate that inflation will end 2004 very close to the targeted-range ceiling, although the probability that it goes beyond this upper limit is also higher than in the March report.

On this basis, the path of short-term interest rates consistent with the achievement of decreasing inflation targets in the future is only slightly higher than that obtained three months ago (according to results of the transmission mechanisms model, TMM). This path includes an adjustment of the rates in the second half of this year and during 2005.

This result reflects the following facts:

1. There are various signs that the output gap in Colombia is closing at a faster rate despite the increase in investment. This may be indicated by greater utilization of installed capacity in industry, and faster growth of private GDP and household consumption in particular.

   As the product converges to its potential level, the real interest rate should also converge to its long-term equilibrium level. In the international context a similar process has begun: aggregate expenditure and production are recovering and external interest rates are converging toward their equilibrium levels, higher than the current ones.

2. Currently, the real interest rate in Colombia is below its historical average and, very probably, below its equilibrium level. Although monetary policy affects the speed of convergence, it cannot affect the real long-term interest rate; an attempt to maintain short-term interest rates below their equilibrium level for a long period could produce excess demand, macroeconomic instability and undesirable surges of inflation. A rise

in interest rates does not mean that monetary policy is having contractive effects on economic activity; while real interest rates remain below their long-term equilibrium levels, the monetary policy stance continues to be expansionist, although to a lesser extent.

3. Given the lags between the movements of the intervention interest rates, their pass-through to the other interest rates in the economy, and their impact on aggregate expenditure, which are estimated between six and eight quarters, monetary policy has to act sufficiently early to prevent the emergence of demand-pull inflation. Although the rise in interest rates may not necessarily be immediate, monetary policy has to evaluate the current state of the determining factors of inflation and predict their trend in the short and medium term.

4. The trend in inflation expectations is one of the fundamental variables in this process. As the credibility of monetary policy is enhanced and reflected in declining expectations of inflation, the increases required in interest rates can be more gradual, and even lower.

Based on these considerations, the Board decided to maintain the intervention interest rates at the following levels: expansion minimum 6.75%, expansion of Lombard 10.50%, contraction maximum 5.75% and contraction Lombard 4.75% (Table A).

During the second quarter, the Board continued its policy of accumulation of international reserves through put option auctions under the premise that, given the prevailing situation on capital markets, it was prudent to make additional accumulations in order to respond to possible abrupt changes in access to capital markets and movements in the exchange rate. The Board also decided to sterilize part of the monetary effect of the intervention through sales of TES on the secondary market to prevent short-term interest rates from reaching levels incompatible with achievement of the inflation targets.

Table A
Latest changes to the Bank's intervention rates
(Percentage)

Date		Lombard	Auction	Lombard	Auction
		Contraction		Expantion	
2001	Dec. 17	6.25	7.50	8.50	12.25
2002	Jan. 21	6.00	7.00	8.00	11.75
	Mar. 18	5.25	6.25	7.25	11.00
	Apr. 15	4.25	5.25	6.25	10.00
	May 20	3.75	4.75	5.75	9.50
	Jun. 17	3.25	4.25	5.25	9.00
2003	Jan. 20	4.25	5.25	6.25	10.00
	Apr. 29	5.25	6.25	7.25	11.00
	Feb. 23	5.00	6.00	7.00	10.75
2004	Mar. 23	4.75	5.75	6.75	10.50

Source: Banco de la República.

Between April and July, auctions were held for US$850 million, of which US$600 million were exercised (Table 2). These purchases had an expansionary effect of 1,615 billion pesos, which were sterilized with sales of TES for 766 billion pesos. These measures prevented the Bank from becoming a net debtor to the financial system, which would have exerted upward pressure on the interest rates.

Table B
Put option auctions for accumulation of international reserves
April-July 2004
(Millions of dollars)

Effective date (*)	Amount	
	Auctioned	**Exercise**
Abril	200	200
Mayo	250	0
Junio	200	200
Julio	200	200
Total	850	600

(*) Does not necessarily coincide with the date of the option auctions. The auction is held on the last business day of the month prior to the exercise.
Fuente: Banco de la República.