Report by the Board of directors to the Congress of the Republic

March 2005

Banco de la República

(Central Bank of Colombia)

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Contents

Graphs and Tables

I. Economic Activity and Employment

II. Inflation

III. Peso Appreciation

IV. Monetary and Exchange Policy

V. FISCAL POLICY

VI. BALANCE OF PAYMENTS

VII. INTERNATIONAL RESERVE LEVEL

VIII. FINANCIAL POSITION OF THE BANCO DE LA REPÚBLICA

Bogotá, Colombia
31 March 2005

Chairman and Members of the
Third Constitutional Standing
Committees of the Senate and the
House of Representatives

Dear Sirs:

The Board of Directors of the Banco de la República of Colombia (Banco de la República), pursuant to Article 5, Law 31/1992, submits herein a report to the Congress of the Republic of Colombia outlining the country's macroeconomic performance in 2004 and 2005 to date, the measures adopted by the Board of Directors for this year, and the outlook for the different macroeconomic variables. The last section of the report deals with the composition of international reserves and the projected financial position of the Banco de la República in 2005.

Sincerely,

José Dario Uribe Escobar
General Manager

Introduction

The margin of maneuverability a Banco de la República has to defend price stability, to encourage growth and employment, and to curb fluctuations in the exchange rate depends mainly on its credibility with society. It is this credibility that keeps inflationary expectations on target and expands the range of policies a Banco de la República has to achieve its objectives. Accordingly, credibility is the most important asset the monetary authority can have and is a public asset for society as a whole.

As Congress is well aware, the Banco de la República steers monetary policy towards a low and stable rate of inflation. This is an important objective, inasmuch as price stability is essential to enhancing the well-being of the population on a long-term basis and to creating an atmosphere of confidence and stability that is conducive to greater investment, employment and productivity. Monetary policy in Colombia is based on the inflation targeting strategy. This involves explicit quantitative goals for the rate at which prices increase, so as to guide expectations and to give the public a clear basis for assessing the effectiveness of monetary policy. In practice, the search for price stability as part of the inflation targeting strategy is coherent with the effort to smooth economic cycles. When projected inflation is below target and output is below its long-term tendency, monetary policy is looser. This helps to stimulate economic growth. When projected inflation is above target and output exceeds its potential level, monetary policy becomes stricter in an effort to curb rising demand and inflationary pressures. Therefore, the success of a policy based on inflation targeting consists of achieving the maximum amount of growth in employment and output that is consistent with price stability.

The performance of the Colombian economy and the way monetary policy has been managed during the current decade show how this approach operates. The Banco de la República has lowered its intervention interest rates by 550 basis points (bp) since 2000, amidst an economy that grew below its potential after the crisis in the late nineties. As a result of these policies and other factors, the economy has grown by nearly 4% in the last two years. Inflation in 2004 was on target and continued to decline towards its long-term levels. Investment returned to historic levels and employment increased. The quality of employment improved substantially in 2004 and the number of full-time jobs rose by 4.3%, which is the highest rate in several years. Nevertheless, output has yet to reach its long-term levels and jobs still are not being created fast enough.

The peso has appreciated as of the second quarter in 2003 and there continues to be surplus of productive capacity in the economy. Both these factors have helped to lower inflation and expectations of inflation. Given these circumstances, the course of monetary policy has been more expansive. The Banco de la República lowered interest rates on its open market operations and has purchased foreign exchange on the market. Intervention in the exchange market is considered useful to avoiding sharp and prolonged deviations in the exchange rate with respect to its long-term trend, as subsequent corrections in this rate could have a negative impact on economic stability, price levels and financial stability.

Based on these considerations, the Banco de la República purchased US$2,905 million (m) in 2004 and increased the stock of international reserves by nearly 25%. In absolute terms, this figure is the highest in the country's history; in percentage terms, it is one of the highest in the world. This policy staved off increased appreciation of the peso, which would have had a negative effect not only on economic activities that are exposed to international competition, but also on the sustainability of mid-term growth. As mentioned earlier, this operation was accomplished without affecting the inflation target and without interrupting the gradual decline in inflation to its long-term levels.

I the economy expanded beyond its capacity, these monetary policy and exchange measures would not have been possible. Under such conditions, intervention by the Banco de la República to mitigate peso appreciation would imply purchases of international reserves, liquidity growth and an incentive to spending, all of which are inconsistent with the inflation goals. The end result of this intervention would be negative for employment, well being and the credibility of the monetary policy. By the same token, a monetary and exchange policy aimed at a depreciated real exchange rate, contrary to its fundamental determinants, would raise inflation without affecting the trend in the real exchange rate and also would jeopardize the credibility of the country's monetary policy.

The margin of maneuverability a Banco de la República has to defend price stability, to encourage growth and employment, and to curb fluctuations in the exchange rate depends basically on its credibility with society. It is this credibility that keeps inflationary expectations on target and expands the range of policies a Banco de la República has to achieve its objectives. Accordingly, credibility is the most important asset a monetary authority can have and is a public asset for society as a whole. To uphold and enhance this credibility, the monetary authority must be conscious of the limits of its action and convey them to society in a clear and transparent way.

The present report illustrates the outcome of the inflation targeting strategy in terms of the continued decline in inflation and the incentive to growth

in output and employment. Chapter I summarizes economic activity and employment in 2004 and the prospects in this respect for 2005. Chapter II discusses the trend in inflation, its determinants and outlook for the future. The factors that explain recent appreciation in the exchange rate are analyzed in Chapter III, while Chapter IV offers an explanation of how the inflation targeting strategy works and the coherence of exchange policy measures adopted by the Banco de la República to restrain peso appreciation, without jeopardizing the inflation target. The country's fiscal policy is analyzed in Chapter V, and the position of international reserves and the how they are managed is described in Chapter VI. Finally, Chapter VIII reviews the financial position of the Banco de la República and projected income and expenses for 2005.

I. Economic Activity and Employment

The Colombian economy grew by almost 4% in 2004. This is not much different from average figure for growth as of 1970 and contrasts with the limited performance observed between 1998 and 2002. Yet, despite the progress that has been made, potential growth has yet to be achieved and, consequently, efforts to boost the economy must continue. However, they must be developed within a framework that is compatible with the attempt to control inflation.

At the end of 2004, the Colombian economy completed the second consecutive year of growth approaching its historic average (4.0%), following a profound crisis in the late nineties and a slow recovery in productive activity during the period from 2000 to 2002[1]. A number of factors were responsible for this outcome, such as a dynamic external environment, a rebound in confidence, and systematic application of macroeconomic policies that were conducive to an increase in production and employment and a reduction in prices.

World economic growth was the highest it has been in the last 20 years. This allowed for a sharp increase in Colombian exports and a considerable improvement in terms of trade. On the other hand, the broad liquidity found on international markets and the decline in country-risk premiums favored major capital flows towards the emerging economies, which helped to weaken the dollar against most of the world's currencies.

These circumstances caused the Colombian peso to appreciate substantially, despite the purchase of dollars by the Banco de la República. However, the increase in gross domestic product (GDP) was relatively balanced between the sectors that produce tradable good and those producing non-tradable goods and services. This was possible because the tradable sectors benefited from the increased demand for exports and the improvement in terms of trade.

Together with exports, private investment was the driving force of growth in 2004. This is explained by the financial recovery of companies and

[1] Subsequent to the *Report to the Colombian Congress by the Board of Directors,* the National Bureau of Statistics (DANE) reported 3.96% economic growth for 2004.

households, and by increased business confidence, thanks to better security conditions. Moreover, the trend in home consumption of durables was extremely dynamic, similar to that of investments. The monetary policy allowed for conditions that were conducive to this positive performance by providing broad liquidity and historically low interest rates. In contrast, there was less growth in the consumption of non-durables and services.

The outlook for 2005 suggests the Colombian economy will continue to expand at a rate similar to that of 2004.

The job market improved substantially in terms of the quality of employment, thanks to more jobs in the formal sector and more full-time employment. The unemployment rate declined, although the increase in new jobs during 2004 was less than in 2003. Less unemployment was due primarily to less growth in the labor supply because of better economic conditions, which enabled many people to return to school or to activities at home.

The outlook for 2005 suggests the Colombian economy will continue to expand at a rate similar to that of 2004. Investment and construction, which should keep growing at a fast pace, are among the most important factors in this expansion, as is the anticipated recovery in civil works. The recent increase in coffee prices on the international market also will have a positive impact on household demand. As to the external environment, the world economy will continue to grow, but not as quickly. These positive factors will be reinforced by a broad monetary policy that ensures low interest rates in an atmosphere of downward inflation.

Nevertheless, there is no denying the factors that could hinder further growth. To begin with, the world is expected to see a decline in international prices for certain commodities. Secondly, export growth might be less than the rise in imports, because of real peso appreciation and fewer sales to Venezuela. This could mean a larger current account deficit in the balance of payments.

Peso appreciation also might prompt a reallocation of productive resources towards the non-tradable sectors, unless the demand for exports grows stronger than anticipated in this report. Private investment should continue to support good performance, and household consumption is expected to accelerate sharply in comparison with 2004. This will be possible to the extent that continued economic growth results in more employment and more disposable household income.

A. Economic Activity

The Colombian economy grew by almost 4% in 2004, which is similar to the rate in 2003. This is not much different from the average rate of

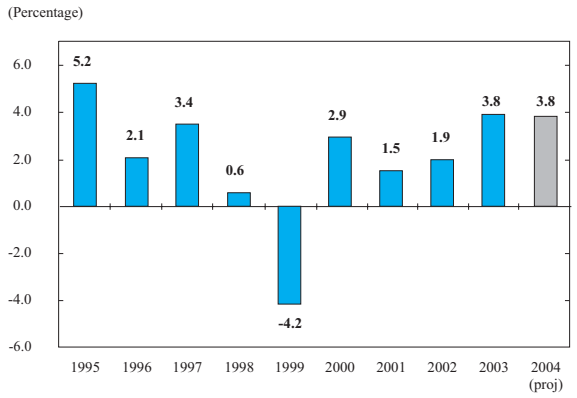
growth observed since 1970 and illustrates the precarious performance witnessed between 1998 and 2002, when the economy failed to expand by more than 0.5% per year. Thanks to growth during the last two years, per capita GDP has returned to levels near those registered prior to the crisis (Graph 1). However, in spite of the progress, potential growth has yet to be achieved and, consequently, efforts to boost the economy must continue, but within a framework that is compatible with the attempt to control inflation.

On the external front, the world economy was more dynamic in 2004 than at any time during the last two decades, mainly because of economic growth in the United States and China. Also, the recovery of the Venezuelan economy was extremely important for Colombia. As a whole, the economic growth experienced by our trading partners rose from 1.8% in 2003 to nearly 5% (Table 1). This contributed to a sharp rise in Colombian exports, particularly non-traditional goods, which were up 28.4% for the year (Graph 2).

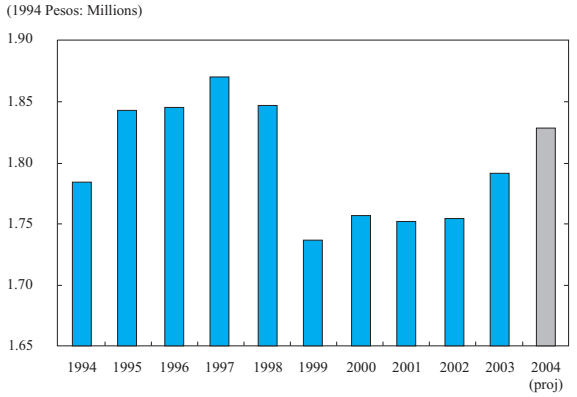
The international capital markets continued to have broad liquidity and low interest rates as a result of loose monetary policies in the United States and Europe, all of which boosted capital flows to the emerging economies. In the case of Colombia, most of the influx of capital came from foreign direct investment (FDI) (almost 70% of the total) and was used to finance export

GRAPH 1

ANNUAL GDP GROWTH



GDP PER CAPITA



(proj) Projection.
Source: National Bureau of Statistics (DANE). Projections by the Banco de la República.

TABLE 1

GROWTH OF TRADING PARTNERS
(PERCENTAGE)

	Actual	
	2003	**2004**
Developed Countries		
United States	3.0	4.4
Euro zone	0.5	1.8
Japan	2.5	2.9
Developing Countries		
Argentina	8.8	8.8
Brazil	(0.2)	5.1
Chile	3.3	5.9
Mexico	1.3	4.4
Peru	3.8	5.1
Ecuador	2.7	6.3
Venezuela	(7.6)	17.3
China	9.3	9.5
Trading Partners	1.8	4.9

Source: Datastream - Census Forecast.

sectors such as coal and petroleum. Other capital inflows originated with portfolio flows and private borrowing; most of the increase in both these items occurred during the final quarter of the year. On the whole, for the first time since 1997, the net inflow of capital into the country (other than FDI) was positive.

Terms of trade also were an important factor in the external situation, having increased as a result of high international prices for raw materials and commodity goods, particularly coal and oil. Prices for these items were equal to or near historic highs. The situation with gold and ferronickel prices was similar. The end of the year also saw rising prices for coffee on the international market. This trend continued during the early months of 2005 and approached levels not seen since 1999 (Graph 3).

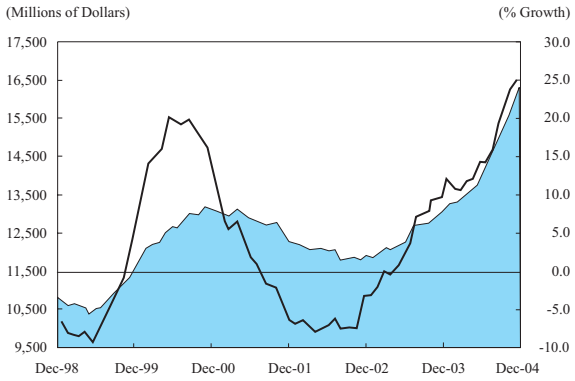
Export growth, better terms of trade and increased capital flows during 2004, in an international environment characterized by a weakening dollar, added to pressure towards appreciation of the Colombian peso. This situation is analyzed in Chapter III. Peso appreciation, coupled with the growth in economic activity, boosted imports in dollars by 20.1% (11.8% in real terms).

The increase in exports of goods and services exceeded the higher import growth mentioned earlier, lowering the current account deficit from 1.5% of GDP in 2003 to 1.0% in 2004. As discussed later in this report, were it not for the policy to stabilize the exchange rate and accumulate reserves, the influx of foreign capital and increased peso appreciation would have meant a wider deficit and a disincentive to the tradable sectors.

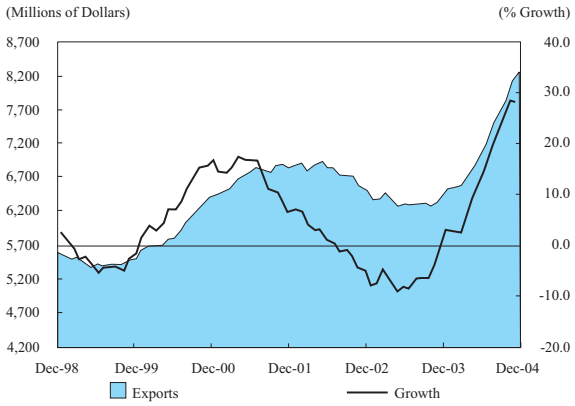
Internally, the factors that were favorable to growth in domestic demand continued or were reinforced during 2004. One of the most important is the broad liquidity the monetary authority has afforded to the market. This made it possible to keep interest rates low, particularly

GRAPH 2

TOTAL EXPORTS
(LAST 12 MONTHS)



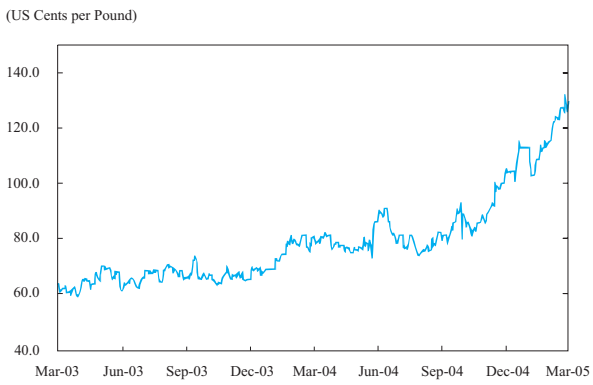
NON-TRADITIONAL EXPORTS
(LAST 12 MONTHS)



Source: DANE.

GRAPH 3

PRICE OF COLOMBIAN ARABIGO COFFEE
ON THE NEW YORK EXCHANGE



Source: Datastream.

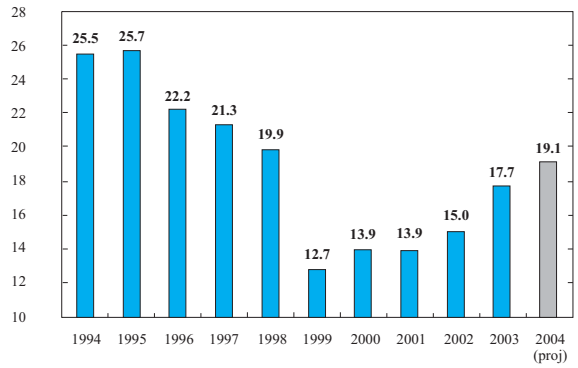
at a time when external rates were on the rise and without jeopardizing the inflation goals. The monetary strategy helped to rehabilitate household and company finances, making a recovery in credit viable. Consumer credit in particularly was quite dynamic, as illustrated in Chapter IV of this report.

In 2004, private investment was again the main source of growth. This includes both investment in housing and commercial buildings, as well as private investment to expand the productive apparatus for industry, agriculture and transportation. Thanks to this trend, the rate of investment in 2004 (nearly 19% of GDP) rebounded to levels similar to those in 1998, before plummeting during the crisis situations at the end of the decade (Graph 4).

Graph 4

Total Investment

(As a Percentage of GDP)



(proj) Projection.
Source: DANE. Banco de la República projections.

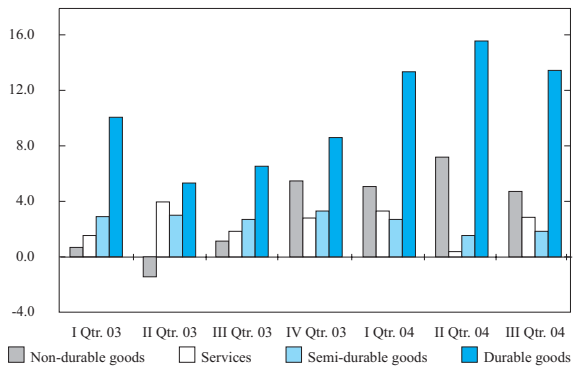
Consumption of durable goods, the demand for which is highly sensitive to low interest rates and appreciation in the exchange rate, grew at a fast pace. On the other hand, household consumption of non-durable goods was discreet (Graph 5).

Several negative factors for growth emerged during the third quarter of 2004, but were mostly temporary. The transportation strike in September and early October is an important example and affected sectors such as transport, business and agriculture. Another is the drop in gold and coffee sales. Several of these factors reversed themselves during the fourth quarter, helping to reestablish growth at a pace estimated to be near 4%. However, this increase was affected by a sharp drop in public demand, primarily because of the trend in investment. In fact, according to information from DANE, the annual accumulated reduction in civil works was 30.7% at September 2004.

Graph 5

Annual Growth in Household Consumption

(Percentage)



Source: DANE. Banco de la República projections.

As mentioned earlier, the outlook for 2005 anticipates no real change in growth compared with 2004. Private investment is expected to make a substantial contribution to economic growth, and household consumption is expected to accelerate in relation to 2004. Better employment conditions and the increase in disposable income associated with better terms of trade (mainly in the case of coffee) would make this possible. At the same time, household consumption should continue to benefit from factors

such as the existence of low interest rates and the rise in prices for assets like housing and stocks. Nevertheless, external conditions will be less favorable, inasmuch as the projection for world growth and that of Colombia's trading partners is lower. This probably will prevent exports from being as dynamic as they were last year.

Growth in public spending during 2005 is expected to increase compared with 2004, since the lag in budget performance accumulated by territorial agencies during the past year is likely to be spent in 2005. (See Chapter V).

Growth in imports should remain strong, which could widen the current account deficit. There would be no problem in financing this deficit, provided the influx of foreign capital is similar to what it was in 2004. In this respect, it is important to point out that increases in external interest rates above those anticipated for 2005 could have adverse repercussions on capital flows towards the emerging countries, including Colombia.

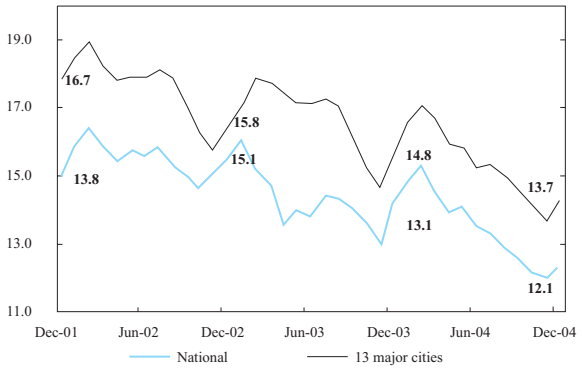
Finally, as will be explained later in this report, appreciation could prompt a redeployment of productive resources towards the non-tradable sectors, depending on the factors behind it. In this case, economic growth would be based on an expansion in the non-tradable sectors, with the tradable sectors playing less of a role. The extent of this redeployment or reallocation will depend on the force of exports and the trend in investment, as a number of tradable sectors, particularly manufacturers of capital goods, have benefited from the demand derived from both exports and investment.

B. Employment and Unemployment

A sharp drop in unemployment and an increase in the formal job rate were the principal tendencies on labor market in 2004. The total unemployment nationwide went from 13.1% in December 2003 to 12.1% in December 2004. This reduction also was evident in the unemployment rate for the country's 13 major cities, which declined 14.8% to 13.7% (Graph 6). As a result, 2004 was the third consecutive year that total unemployment nationwide and unemployment in the major cities decreased. Nevertheless, unemployment remains high, suggesting the economy still has room to absorb manpower without exerting added pressure on wages and inflation.

Graph 6

Unemployment Rate
(Three Period Moving Average - MA(3))



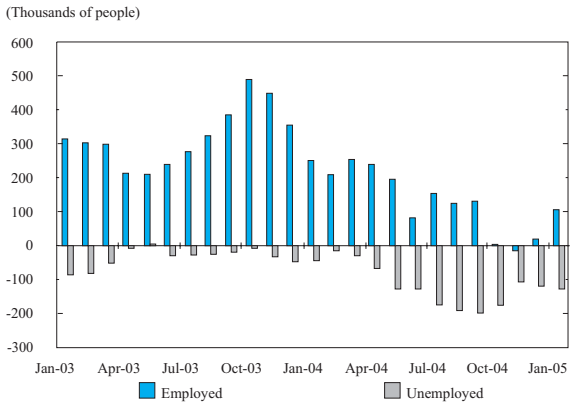
Source: DANE. Continuous Household Survey.

The drop in unemployment during 2004 was due to less of a labor supply. This variable is measured, in relative terms, by the global participation rate (GPR) or the portion of the working age population (WAP) that is economically active (EAP). Average EAP growth was only 0.01% compared with 2003. Because the WAP increased at an average annual rate of 2.2%, the GPR went from 64.5% in 2003 to 62.9% in 2004. This is the largest reduction in this indicator since the mid-nineties.

The employment rate (or the ratio of employed to the WAP) also declined. Accordingly, it is possible to conclude that the lower unemployment rate was due to a relative decline in the labor supply, which more than offset what also proved to be a relative reduction in the demand for labor. This contrasts with the situation in 2003. At that time, EAP rose by 3.1% (for the 13 cities), the GPR increased, and the unemployment rate declined (from 17.7% to 16.8%) because of more employment, as reflected by the higher job rate (Graph 7).

GRAPH 7

JOB CREATION
(IN 13 CITIES - THREE-PERIOD MOVING AVERAGE)

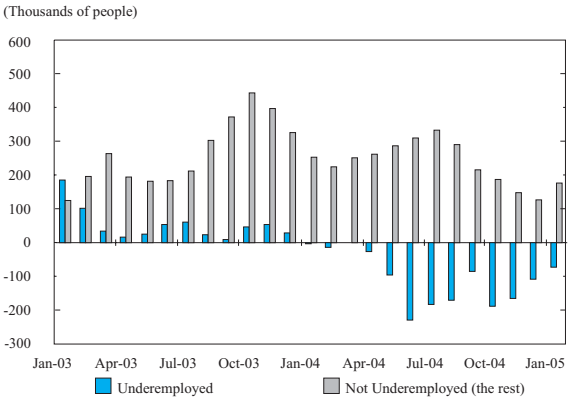


Observation: «Job creation» refers to the absolute change in the number of employed individuals compared with the same period the year before.
Source: DANE. Calculations by the Banco de la República.

The past year witnessed an important recomposition of employment in favor of quality jobs. In the 13 major cities, employment other than underemployment rose by 4.7% on average, compared with 2003, while underemployment was down by 3.5% (Graph 8). The labor reform bill adopted in 2003 may have had something to do with this increase in formal jobs.

GRAPH 8

BREAKDOWN OF URBAN JOB CREATION
(IN 13 CITIES - THREE-PERIOD MOVING AVERAGE)



Source: DANE. Calculations by the Banco de la República.

A more detailed analysis of the job situation in 2004 shows the reduction in employment during the last three quarters was concentrated in the 12-to-17 age group and among people over age 56 who live in the major cities. For the most part, these are individuals who regard their jobs are poorly paid and/or not suited to their skills. The number of jobholders declined in sectors such as commerce and social and personal services, where informal employment is more likely. In those sectors, these individuals were self-employed, unpaid family workers and/or domestic employees.

On the whole, this outcome is consistent with continued economic recovery during 2004. Initially, these processes occur on the basis of temporary manpower and growth in informal

employment. If economy recovery is reinforced, permanent employment begins to grow and the formal sector becomes more dynamic than the informal sector. The portion of the labor force that entered the job market because of low family income during a recession withdraws from the market. Above all, these people leave jobs that are unproductive (underemployment) and take on occupations seen as being more productive, even if they provide no immediate income (e.g. education and housework).

II. Inflation

The way monetary policy is being managed has helped to stabilize prices and inflationary expectations, and to put the country back on a path consistent with long-term levels of inflation. As literature and international experience illustrate, fewer expectations of inflation and more trust in the country's monetary policy lend compatibility to the objectives of lower inflation and increased growth, even in the short term.

Inflation declined again in 2004 and annual inflation at the end of that year, measured by the consumer price index (CPI), was 5.5%. This coincides with the goal set a year ago by the Board of Directors. With the exception of several brief interruptions associated with hikes in food prices, consumer inflation declined throughout the year (Graph 9). This was particularly obvious with the trend in core inflation, which excludes temporary price shocks (usually related to supply situations). As such, it more clearly reflects the connection with monetary policy. The average of the three indicators used by the Banco de la República (non-food inflation, nucleus 20, inflation without staple foods and without public utilities and fuel) went from 7.1% in December 2003 to 5.3% by the same month in 2004. The best-known indicator; that is, non-food inflation, dropped sharply from 7.0% to 5.5%, although mainly during the first half of the year. It was more stable during the last six months of 2004 (Graph 10).

Falling inflation was associated, in part, with smaller readjustments in prices for the tradable component of the consumer goods basket. This, in turn, was due to appreciation in the exchange rate (Graph 11). Total inflation in tradables was 5.1% by the end of the year, well below the rate observed a year earlier (8.7%). This last figure increased substantially because of high devaluation rates, which approached 30% between the second half of 2002 and the first quarter of 2003.

The non-tradable component of the consumer price index took an upward course in the first six months of 2004, which was reversed during the second half of the year (Graph 12). Rentals, which constitute a non-tradable service that accounts for a major portion of the consumer goods basket (approximately 20%), were stable during the second half of the year, after having exerted upward pressure on inflation in the first six

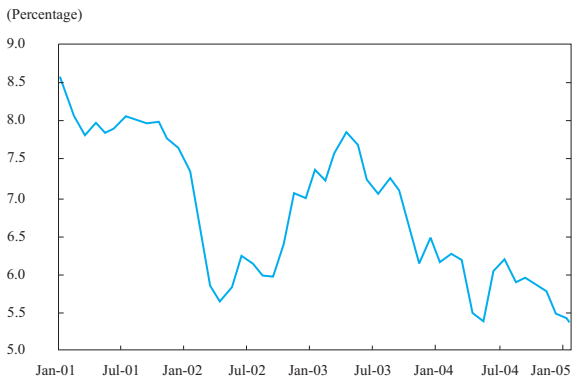
months. By the end of 2004, rental inflation (4.7%) was still below target.

The stability of non-tradable inflation and its proximity to the target appears to indicate the absence of major demand pressure in 2004. In other words, despite GDP growth at rates near 4% and the significant reduction in unemployment, the economy continued to operate below its potential and this gap has been growing as a result of more investment. In technical terms, this means the output gap; that is, the difference between actual and potential GDP, remained negative throughout 2004 (Graph 13).

In addition to exchange appreciation and limited pressure from demand, the decline in inflation was possible thanks to fewer inflationary expectations. Available indicators show a steady decline in this variable throughout the year (Graph 14), which helped to readjust wage contracts and prices at rates in keeping with the inflation target. This is particularly important considering that expectations had increased from 6% to above 7.5% between late 2002 and early 2003, and remained above 7% for most of that year. As indicated earlier, this was due, among other factors, to the inflationary shock associated with devaluation in 2002 and 2003.

GRAPH 9

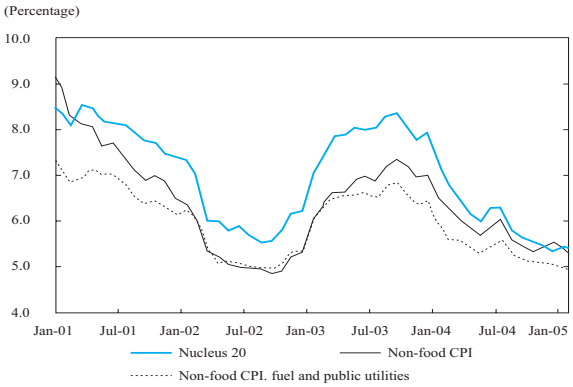
ANNUAL INFLATION



Source: DANE.

GRAPH 10

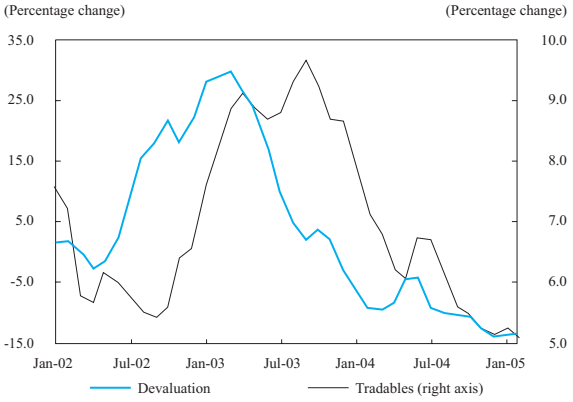
CORE INFLATION INDICATORS



Source: DANE. Calculations by the Banco de la República.

GRAPH 11

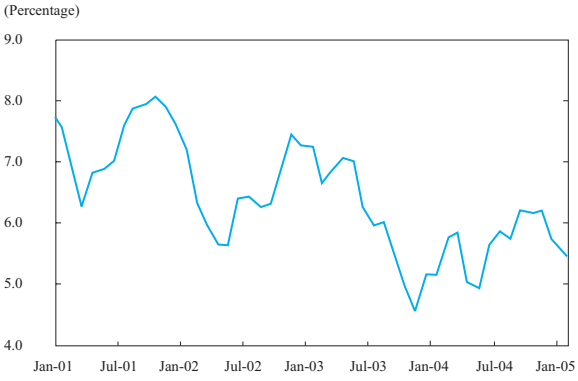
ANNUAL INFLATION IN TRADABLES AND ANNUAL NOMINAL DEVALUATION



Source: DANE and Banco de la República.

GRAPH12

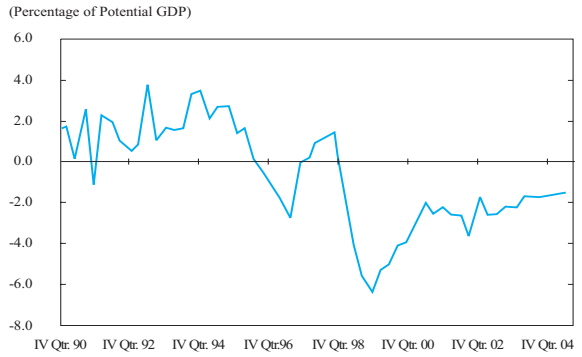
ANNUAL INFLATION IN NON-TRADABLES (CPI)



Source: DANE. Calculations by Banco de la República.

Graph 13

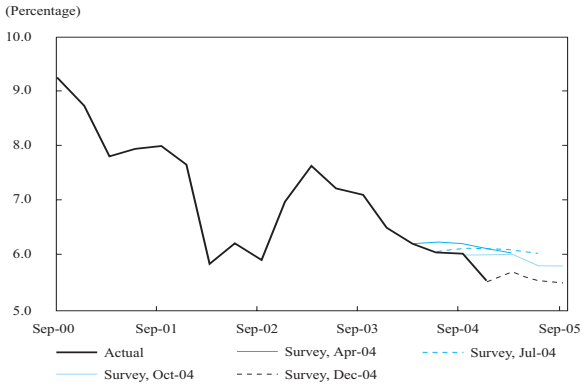
The Output Gap



Source: Banco de la República.

Graph 14

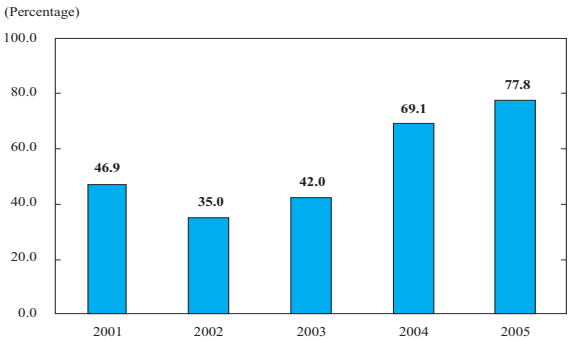
Inflation Expectations



Source: Banco de la República.

Graph 15

Credibility of the Inflation Target for the Years from 2001 to 2005



	Jan-01	Jan-02	Jan-03	Jan-04	Jan-05
Target	10.00%	8.00%	6.00%	5.00 %-6.00%	4.5 %-5.5%

Source: Banco de la República.

Consequently, the way monetary policy is being managed has helped to stabilize prices and expectations of inflation, and to put the country back on a path consistent with long-term levels of inflation. As literature and international experience illustrate, fewer expectations of inflation and more trust in the country's monetary policy lend compatibility to the objectives of lower inflation and increased growth, even in the short term.

One final factor that helped to push down inflation in 2004 was the favorable trend in food prices during the fourth quarter, particularly for perishables. The weather apparently was good for a number of these food groups. This curbed price increases, especially towards the end of the year when there is far more demand. In contrast, prices for fuel and public transportation pushed up inflation, as happened in most parts of the world due to high oil prices on the international market.

The first two months of 2005 saw no major change in these trends. The reduction in tradable inflation continued, thanks to the downward behavior of the exchange rate. The same is true of non-tradable inflation, thanks to demand pressures, which are still low. During this same period, accumulated non-tradable inflation was far less than in the first two months of 2004. One fact worth mentioning is the new decline in inflationary expectations in February and, particularly, the increased credibility of the target for 2005 compared with previous years (Graph 15). Lastly, food inflation continues to drop and should to do so for at least the first six months of the year.

The short and medium-term prospects for inflation are good. On the one hand, because of recent appreciation in the exchange rate, there is not expected to be much pressure on tradable goods. Given the lag in transferring exchange movement to inflation, the latter could continue to fall during the second and third quarters of 2005, even despite a moderate increase in the exchange rate.

On the other hand, the way non-tradable inflation behaves in the future will depend on the strength of domestic demand and how inflationary expectations develop. With excess productive capacity in the economy, GDP growth at around 4% in 2005 would imply no inflationary pressure from demand. Furthermore, with the downturn in inflationary expectations, it is reasonable to be optimistic about the behavior of non-tradable inflation in the next three months.

It is likely the annual increase in food prices will continue to decline over the next three or four months, thanks to good weather and exchange rate appreciation. There is a lot of uncertainty about the second half of the year, but prices for some perishable foods are expected to rise, lifting annual inflation for that group. However, these hikes would be limited and would not seriously jeopardize the target.

The inflation target for 2005 (between 4.5% and 5.5%) probably will be met. However, there are risks to be considered when establishing the Bank's policy, as they could have a negative effect on the inflation path this year. For example, a quick and significant rebound in the exchange rate could reverse the trend in tradable inflation and stimulate inflationary expectations, as happened at the end of 2002. There are other significant risks, such as a sharp rise in food prices during the second half of the year, due to possible supply problems or a major increase in demand, as appears to be the case with meat because of growing exports to Venezuela. Another is the possible inflationary impact of a larger-than-expected increase in fuel and transportation prices and, to a lesser extent, in public utility rates.

The short and medium-term prospects for inflation are good.

III. Peso Appreciation

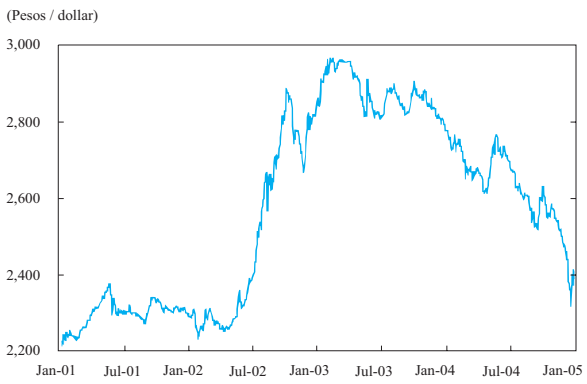
The extent to which many currencies have appreciated against the dollar, including the Colombia peso, is explained in part by two factors that tend to raise the demand for financial assets outside the United States. One is uncertainty about sustainability of the macroeconomic imbalances in the United States economy. The other is the broad liquidity existing on international markets.

A. Changes in Nominal and Real Exchange Rates

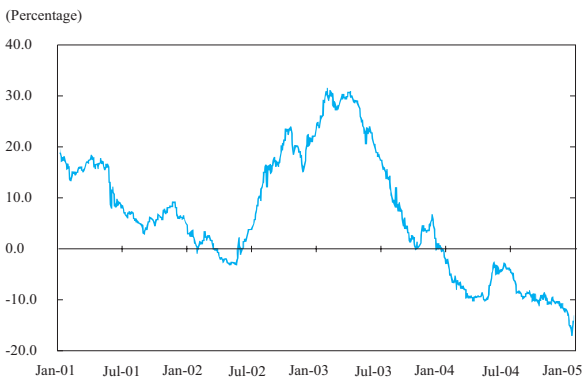
In 2004, the nominal peso rate of exchange against the dollar was 8.7% less than in 2003. In real terms, peso appreciation against the basket of currencies for Colombia's trading partners was 97% when deflated by the CPI and 6.5% for the year if the producer price index (PPI) is the deflator (Graphs 16 and 17). A comparison between exchange rates at the end of each year shows 14% nominal appreciation during 2004. In real terms, this implies 13.81% appreciation if the CPI is applied, or 10.51% when the PPI is used (see Box 1 for an explanation of how nominal and real exchange rates are calculated).

Graph 16

Representative Market Rate



Annual Nominal Depreciation



Source: Banking Superintendent. Banco de la República calculations.

There was appreciation in several Latin American countries and in developed economies such as Japan and the Euro zone, which have seen their currencies appreciate since early 2002 (Graph 18). The Latin American countries with the highest average nominal appreciation against the dollar were Brazil (5.0%), Chile (12.0%) and Colombia (8.7%). The Euro zone saw 9.0% average nominal appreciation, as opposed to 6.7% in Japan.

Revaluation of the Colombian peso came on the heels of sharp depreciation between the second half of 2002 and the first quarter of 2003, when nominal and real exchange rates soared to historic highs, prompted by political uncertainty in Brazil, corporate scandals in the United States and the drop in exports to Venezuela. Recent appreciation reversed the episode in 2002 and placed the exchange rate near to where it was in May and June of that year.

The bilateral real exchange rate with the United States (measured with the RERI-PPI) depreciated by 1.09% on average during the 2002-2004 period. Against other currencies in the region, the Colombian peso appreciated with respect to Mexico (1.2%), Venezuela (0.7%) and Argentina (11.2%), but depreciated in relation to Brazil (7.3%), Peru (1.0%), Ecuador (5.7%) and Chile (1.5%) (Table 2, Graph 19). On average, during the period between 2002 and 2004, the Colombian peso devaluated by 1.87% in nominal terms and by 2.58% in real terms against the currencies of the country's major trading partners.

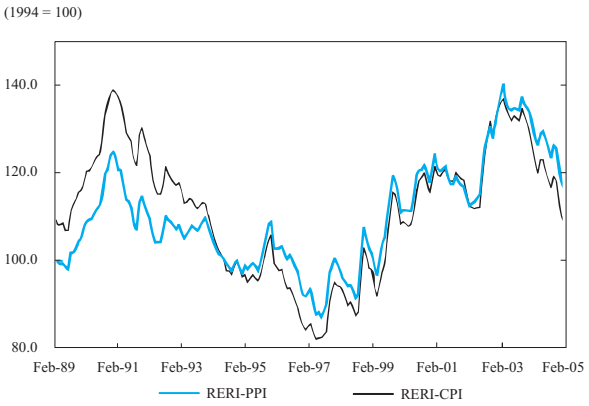
B. What Accounts for the Behavior of the Exchange Rate in Colombia During 2004?

1. The International Context

The extent to which many currencies appreciated against the dollar, including the Colombian peso, is explained in part by two factors that raised

Graph 17

Real Exchange Rate Index

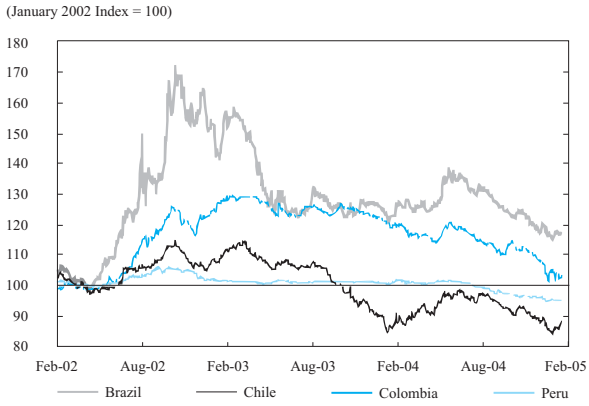


Source: Banco de la República.

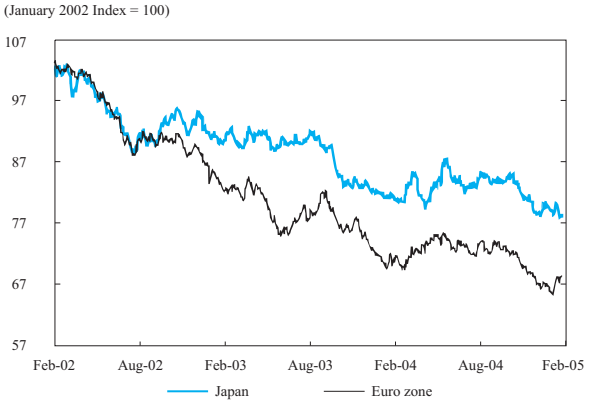
Graph 18

Exchange Rate for Various Currencies against the Dollar

Latin American Currencies



Euro and yen



Source: Datastream.

the demand for financial assets outside the United States. One is uncertainty about sustainability of the macroeconomic imbalances in the United States economy (Box 3); the other is the broad liquidity existing on international markets, as mirrored in low external interest rates and the decline in the risk premiums of emerging economies (Graph 20 and Graph 21). In addition, capital flows towards the emerging economies were spurred by more investor confidence in those economies because of their good growth rate last year.

Real growth in the United States economy was estimated at 4.4% for 2004. This is an improvement over the last four years, despite a slowdown in the fourth quarter. World growth and the increase in commodity prices were propelled by good economic performance in the United States and the vigorous growth of the Chinese economy. In this context, economic growth in Latin America was encouraged by more demand for exports and better terms of trade. Both these factors helped to appreciate most of the currencies in the region.

TABLE 2

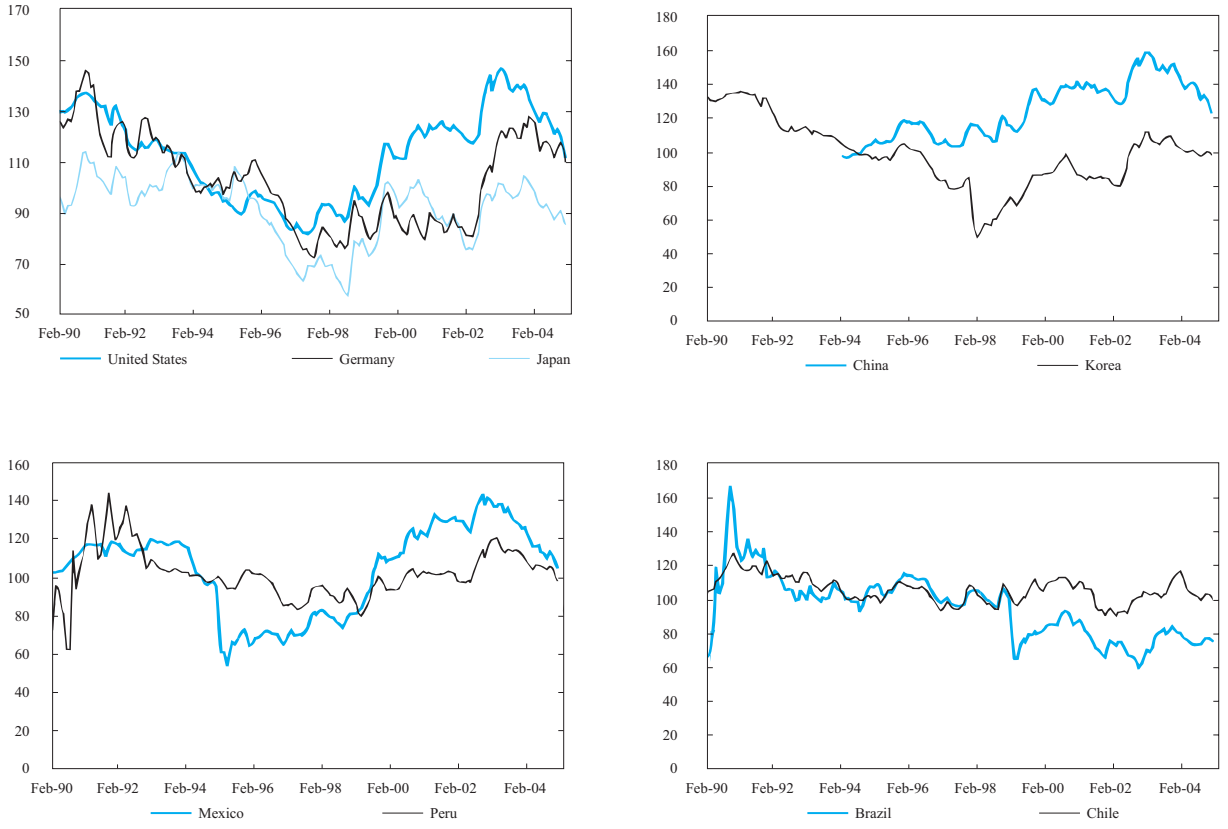
REAL AND NOMINAL DEPRECIATION OF THE COLOMBIAN PESO
(PERCENTAGE)

Country	Weights	RERI (average)		RERI-PPI (average)	
		2004	(2002-2004)	2004	(2002-2004)
Industrialized					
United States	43.7	(8.7)	4.5	(7.9)	1.1
Euro 1/	11.5	0.3	16.7	(3.2)	12.0
Japan	3.2	(2.2)	8.7	(5.9)	1.5
United Kingdom	1.4	2.3	13.3	(0.4)	7.7
Switzerland	3.1	(1.2)	15.8	(4.9)	8.9
Canada	1.5	(1.8)	10.8	(3.5)	4.8
Sweden	0.6	0.4	17.2	(2.3)	10.8
External	**65.0**	**(5.8)**	**8.2**	**(6.4)**	**3.8**
Developing					
Mexico	5.2	(12.7)	(1.9)	(9.3)	(1.2)
Venezuela	9.3	(21.8)	(24.0)	(3.1)	(0.7)
Ecuador	6.2	(8.7)	4.5	(10.8)	5.7
Brazil	4.0	(4.1)	(3.0)	(0.0)	7.3
Chile	2.6	3.3	5.9	(0.7)	1.5
Peru	3.3	(6.9)	5.5	(6.8)	1.0
Panama	3.3	(8.7)	4.5	(11.3)	(0.3)
Argentina	1.1	(8.4)	(27.1)	(4.9)	(11.2)
External	**35.0**	**(13.4)**	**(7.3)**	**(5.7)**	**0.1**
Total External	**100.0**	**(11.0)**	**1.9**	**(6.1)**	**2.6**
Other countries 2/					
China		(8.7)	4.5	(10.4)	(0.4)
Korea		(5.0)	8.8	(7.1)	5.6

1/ Includes Germany, Holland, Spain, France, Italy and Belgium.
2/ The RERI of these countries is CPI deflated.
Source: Banco de la República calculations.

Graph 19

Index of the Bilateral Real Exchange Rate with Several Countries
(Geometric Mean, 1994 = 100)

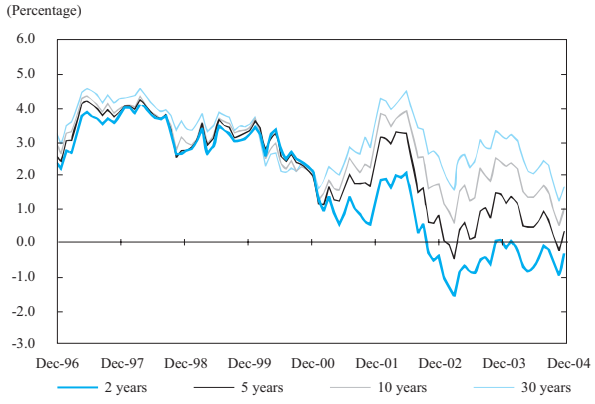


Source: Datastream. Banco de la República calculations.

Graph 20

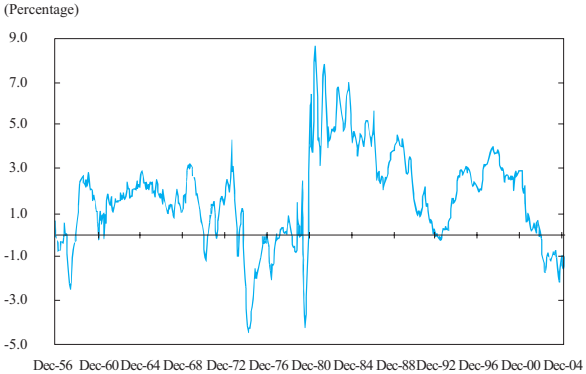
Real Interest Rates on Treasury Bonds

(Percentage)



Real Interest Rates Federal Reserve

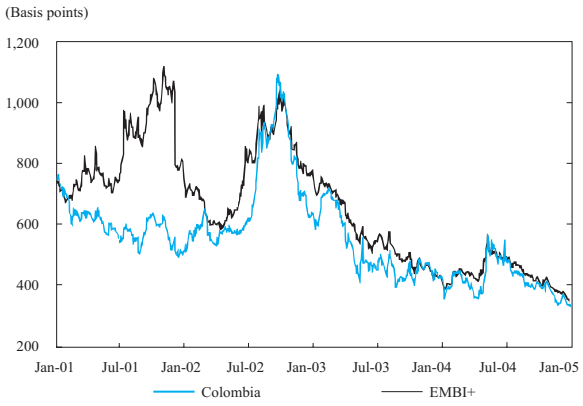
(Percentage)



Source: Datastream. Banco de la República calculations.

GRAPH 21

COUNTRY-RISK PREMIUM EMBI+
LATIN AMERICAN COUNTRIES

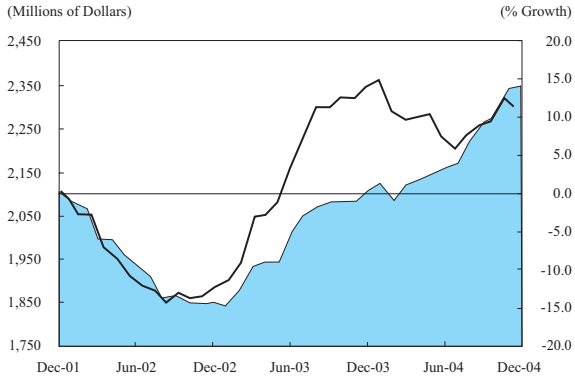


Source: Datastream.

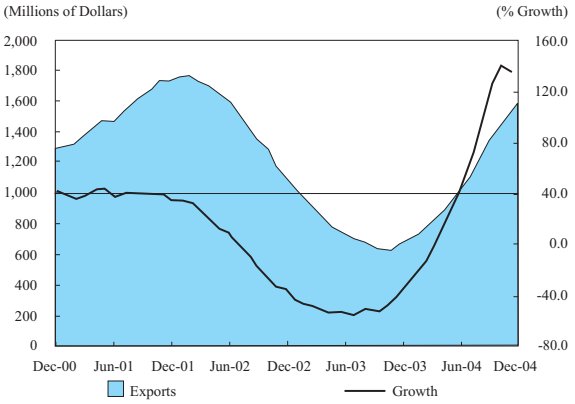
GRAPH 22

NON-TRADITIONAL EXPORTS
(LAST 12 MONTHS)

TO THE UNITED STATES



TO VENEZUELA



Source: DANE.

2. Appreciation in Colombia

Given the international context described earlier, appreciation in 2004 was due to several factors. In part, it originated with the balance of payments, specifically movement in the current account, coupled with better terms of trade, a rise in external demand for Colombian products and the influx of foreign remittances. On the other hand, like several other countries in the region, Colombia received capital inflows (portfolio, borrowing and FDI).

More growth in the world economy and particularly the recovery of the Venezuelan economy were evident in the growing external demand for non-traditional Colombian products. Sales of these items were up by 27% for the year, surpassing the historic highs seen in 2002. Exports to the Venezuelan market increased by 130% in 2004 to US$1,598 m, following US$639 m in 2003 (Graph 22).

Higher international prices for several of Colombia's leading exports such as coffee, oil, coal and ferronickel is the primary reason for the improvement in terms of trade. As a result of this price increase, traditional exports were up by 29% in 2004, even though coffee and oil exports were declined in terms of volume. The number bags of coffee exported by Colombia declined by 0.5% compared with sales in 2003, and the volume of oil exports dropped by almost 4.0%.

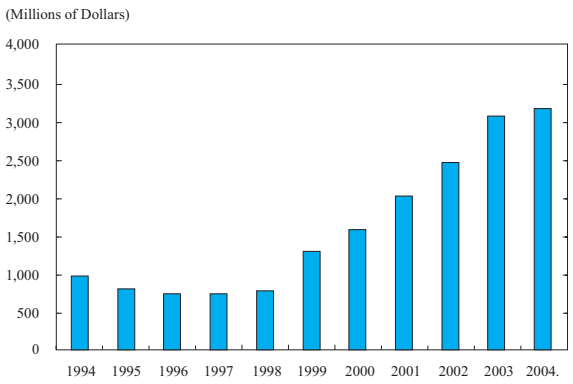
According to estimates, remittances from Colombians working outside the country came to nearly US$3.3 billion in 2004, up 8.0% compared with 2003 (Graph 23). Although this was less than the growth registered for this item in previous years, the amount of income from remittances indicates they have become an important and enduring source of foreign exchange. For example, between 2000 and 2004, foreign remittances added US$1,489 m to the annual supply of foreign exchange and their share of national income rose from 1.9% to 3.5% of GDP.

On the other hand, an important part of peso appreciation, particularly during the fourth quarter of 2004, was related to larger capital inflows to Colombia. These boosted the capital account surplus from 1.0% of GDP in 2003 to an estimated 3.4% of GDP in 2004 (Table 3). While the private sector reported US$319 m in net capital outflows during 2002 and US$473 m in 2003 (without FDI), inflows in 2004 were estimated at US$935 m.

Net inflows from foreign portfolio investment funds came to US$370 m in 2004, following US$20 m in net outflows during 2003. Nearly 80% of these investments were in the government bond market. Likewise, foreign portfolio

GRAPH 23

REMITTANCES FROM WORKERS



(*) Estimate - Balance of Payments.
Source: Banco de la República.

TABLE 3

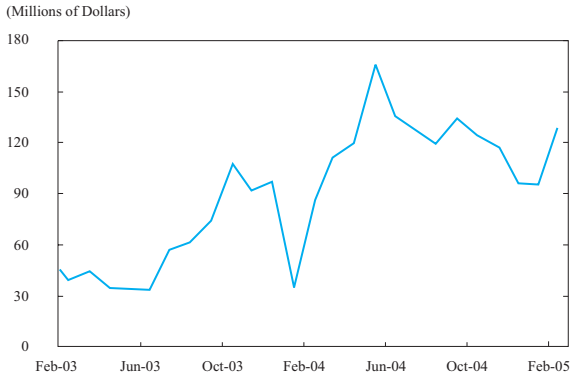
BALANCE OF PAYMENTS
CAPITAL AND FINANCIAL ACCOUNT (ANNUAL FLOWS)
(MILLIONS OF DOLLARS)

	2002	2003	2004 1/
Net direct investment	1,258	855	2,215
Foreign investment in Colombia	2,115	1,793	2,343
Colombian investment abroad	(857)	(938)	(128)
Total Public Sector	393	457	133
Financial Public Sector	(131)	(293)	(424)
Non-financial Public Sector	525	750	558
Long-term	(1,093)	1,457	910
Outlays	2,469	4,915	2,889
Amortization	3,561	3,459	1,979
Short-term	1,617	(707)	(353)
Total Private Sector without FDI	**(319)**	**(473)**	**935**
Non-financial private sector	(144)	(32)	399
Leasing	(160)	(319)	(125)
Long-term	(970)	(726)	(1,252)
Outlays	1,375	1,387	1,214
Amortization	2,345	2,112	2,466
Short-term	985	1,012	1,775
Portfolio investment (active)	431	(1,135)	(363)
Debts and others	554	2,147	2,138
Financial Private Sector	(174)	(441)	536
Long-term	(217)	(51)	(15)
Short-term	43	(390)	551
Memo item			
Private capital flows without adjusted FDI 2/	(915)	(1,285)	1,633

1/ Estimate.
2/ Capital flows are adjusted by transactions that are considered special, either due to their size or the agent involved.
Source: Banco de la República.

GRAPH 24

NET PURCHASES BY PROFESSIONAL FOREIGN EXCHANGE DEALERS MONTHLY FLOWS



Source: Banco de la República.

investments by the private sector, which meant an outflow of US$1,135 m in foreign exchange during 2003, amounted to US$363 m in 2004. As a result, the flow of capital from portfolio investments declined from US$1,169 m in net outflows during 2003 to US$306 m in 2004. This meant there was no longer a strong demand for foreign currency on the exchange market in 2004, as opposed to the situation in previous years, which undoubtedly added to the pressure for exchange rate revaluation.

Low interest rates in the international market, in an environment of anticipated peso appreciation, favored foreign borrowing in the fourth quarter of 2004, especially short-term credit. Net short-term credit (public and private) came to US$1,769 m in 2004, as opposed to a reported US$104 m in net payments for this item in 2003. The Colombian financial system brokered a sizeable volume of loans in foreign currency during 2004, which accounted for 52% of net external borrowing reported that year.

In addition to foreign portfolio investment and foreign borrowing, foreign direct investment flows also were an important item. 2004 saw a significant increase in resources from foreign direct investment in Colombia, while Colombian direct investment abroad declined. It is estimated that net FDI increased from US$855 m in 2003 to US$2,015 m in 2004. A large portion of these resources went to investments in oil and coal activity in Colombia.

Recent years also have seen a surge in cash dollar sales on the Colombian exchange market. Dollar transactions between professional foreign exchange dealers and brokers operating on the exchange market are an indicator of this pattern (Graph 24). These transactions amounted to US$1,376 m in 2004, surpassing net sales in 2003 by more than US$700 m. This foreign exchange can originate with capital transactions and probably includes money from illegal activities.

Appreciation in 2004 was due to several factors. In part, it originated with the balance of payments, specifically movements in the current account, as well as the improvement in terms of trade, the rise in external demand for Colombian products and the influx of foreign remittances.

As will be discussed in the following chapter, when defining the stance of monetary policy, the factors that influenced appreciation of the exchange rate in Colombia during 2004 should be separated into two groups. The first would include the factors that generate a supply of foreign currency, accompanied by immediate increases in aggregate demand, such as the rise in foreign demand for exports, better terms of trade and income from remittances. The second group would include the factors that cause the peso to appreciate but do not produce immediate growth in aggregate demand. Certain portfolio investment flows are an example.

IV. Monetary and Exchange Policy

The strategy combines monetary policy objectives with the instruments available to achieve them. In the case of the Banco de la República, the long-term objective is to gradually achieve stable and predictable inflation within a range of 2% to 4%. This is based on the principle that low inflation, together with other factors, is conducive to sustained growth in output.

A. The Inflation Targeting Strategy

The monetary strategy refers to the rules of the game and the criteria for arriving at monetary policy decisions and how they are conveyed to the public. In the Colombian case, and in a large and growing number of countries, the monetary strategy is based on "inflation targeting", which combines monetary policy objectives with the instruments available to achieve them. The long-term objective for the Banco de la República of Colombia is stable and predictable inflation within a range of 2% to 4%. This is based on the principle that low inflation, together with other factors, is conducive to sustained growth in output. The reduction in inflation is gradual, so as to avoid unwanted shifts in production and employment.

The following is an example of how the strategy operates. If the Banco de la República forecasts inflation above the quantitative target for the next 12 to 24 months, it will adopt a more restrictive monetary policy to curb the growth in demand and to reduce inflationary expectations. However, if the Banco de la República believes inflation will be below the quantitative target for the next 12 to 24 months, it will adopted a looser monetary policy to stimulate demand and boost output. The Banco de la República looks ahead at least 12 to 24 months, because monetary policy has a delayed impact on production and prices. Accordingly, in the short and medium term, monetary policy helps to smooth the economic cycle (by encouraging growth when output is below its long-term tendency and by curbing it when the opposite happens).

Consequently, the monetary policy strategy operates in a way that helps to detect possible monetary excesses (defects) that come in the form of

The two principal monetary policy instruments in an inflation targeting strategy like the one used by the Banco de la República of Colombia are intervention interest rates and the purchase and sale of foreign currency on the exchange market.

increases (declines) in the forecast for inflation. These occur because of imbalances between supply and aggregate demand, excessive depreciation (appreciation) in the nominal exchange rate, or inflationary expectations that are way off target.

The two principal monetary policy instruments in an inflation targeting strategy like the one used by the Banco de la República of Colombia are intervention interest rates and the purchase and sale of foreign currency on the exchange market. In the first instance, a policy for monetary contraction or expansion is implemented through respective increases or reductions in the intervention interest rates of the Banco de la República. When the Banco de la República is the net lender of the financial system, as is the case in most developed countries and was in Colombia in 1999, the basic instrument is the interest rate on repo transactions, which are used to provide the market with liquidity. This rate directly affects the short-term interest rate on the interbank market. However, when the Banco de la República is the net debtor of the financial system, as was the case in Colombia prior to 1999, the basic instrument is its deposit rate; that is, the rate at which it gathers monetary surpluses from the market.

The Banco de la República also uses exchange market intervention as a policy tool. If an expansionary monetary strategy is needed, the purchase of foreign currency is a way to complement reductions in intervention interest rates. This is precisely what happened in Colombia in 2004 and early 2005. Likewise, a policy aimed at monetary contraction can include the sale of international reserves on the exchange market to complement rising interest rates. This was the case in Colombia in the early months of 2003, when an accelerated rise in the exchange rate threatened to jeopardize chances for meeting the inflation target.

The more traditional approaches to the inflation targeting strategy were based on the idea that the exchange rate should fluctuate freely in the market and the Banco de la República should focus its policy entirely on managing the short-term interest rate[2]. As part of that scheme, intervention in the exchange market would be justified only to put international reserves at optimum levels or to reduce very short-term volatility. However, in recent years, the Banco de la Repúblicas that use the inflation targeting strategy have acknowledged, in practice, that exchange intervention under some circumstances can be an important tool for curbing mid-term tendencies in the exchange rate. Even a country like New Zealand, which is considered one of the pioneers of the inflation targeting strategy, have

[2] For example, see Svensson, L.E.O. (2000). «Open Economy Inflation Targeting» in *Journal of International Economics*, No. 50, pp. 155-183.

accepted exchange intervention for purposes that go beyond controlling short-term volatility.

One of the most difficult aspects of monetary policy management is determining the right response to changes in the exchange rate.

From an academic standpoint, authors like Peter Bofinger and Timo Wollmershäuser have shown that a monetary policy that uses these two instruments in a complementary way (i.e. the intervention interest rate and the purchase/sale of foreign currency on the exchange market by the Banco de la República) is better for stabilizing prices and growth in output. This type of monetary policy, which is now being applied in Colombia, is superior to a policy focused exclusively on interest rate management[3].

B. The Exchange Rate in the Inflation Targeting Strategy

One of the most difficult aspects of monetary policy management is determining the right response to changes in the exchange rate. This is because the response can differ substantially, depending on the reasons for these changes. When analyzing developments in the exchange rate, a Banco de la República must assess the transient nature and the origin of the movements it sees or anticipates.

Some changes in the exchange rate reflect permanent movements in the relative productivity of tradable sectors *vis à vis* non-tradable sectors, either in the composition of internal demand or in the country's wealth. These movements explain the tendential behavior of the real exchange rate and do not warrant a monetary policy response. In fact, if a Banco de la República tries to counter them, it may end up jeopardizing the inflation target without changing the pattern of the real exchange rate.

One case would be a permanent increase in the productivity of export sectors (in relation to other sectors of the economy) that might enhance the capacity of these goods to compete on international markets and, as such, exert pressure for appreciation of the real exchange rate. If the Banco de la República were to apply an expansive monetary policy so as to maintain a more depreciated exchange rate, it would only end up generating more inflation by eliminating the gains in competitiveness derived from nominal depreciation.

There are other movements in the exchange rate that reflect temporary deviations in relation to the long-term tendencies mentioned earlier. On

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[3] See Bofinger, P.; Wollmerhäuser, T. (2003). "Manager Floating as a Monetary Policy Strategy", Mimeograph, University of Wûrsburg and the Economic Research Institute (IFO), September.

It is crucial for the monetary authority to distinguish permanent movements in the real exchange rate from temporary ones.

occasion, these deviations are associated with appreciation or depreciation that is quick, excessive and might be traumatic to reverse from the standpoint of inflation, financial stability and economic output. In this case, a Banco de la República can help to smooth fluctuations in the exchange rate by means of monetary policy and exchange intervention, which would help to stabilize economic activity and inflation at the same time. However, this necessitates identifying the reason for the change in the exchange rate and the impact it might have on inflation and the macroeconomy in general.

Exchange intervention also can be used to reduce the external vulnerability of the economy. This lessens the probability of having to face critical situations in the future or makes them less costly to deal with. For example, if peso appreciation is related to a strong influx of short-term capital, it may be a good idea for the monetary authority to accumulate international reserves as a way to lessen appreciation and maintain a cushion with enough liquidity to cover a growing short-term external liability.

As to the latter, it must distinguish those that originate with changes (initial ones) in the demand for domestic goods and services from those that do not.

In summary, it is crucial for the monetary authority to distinguish permanent movements in the real exchange rate from temporary ones. As to the latter, it must distinguish those that originate with changes (initial ones) in the demand for domestic goods and services (e.g. changes in the growth of trading partners or terms of trade) from those that do not (e.g. certain changes in financial asset portfolios). In practice, these distinctions are not insignificant. Economies receive different kinds of shocks simultaneously. Some are temporary and others are more persistent; some affect the current account in the balance of payments; others impact the capital account. Some are accompanied by increases in aggregate demand, others are not. Also, the intensity and nature of the shocks to an economy change over time.

All of this makes it impossible for the monetary authority to apply standardized rules when dealing with abrupt changes in the exchange rate. Its capacity to curb sudden reductions or increases in the exchange rate is critically dependent on the macroeconomic conditions of the moment and the existence or lack of inflationary pressures. The possibility of intervening successfully in the exchange market to curb real appreciation of the local currency is much greater when there is a shortfall in aggregate demand compared with the economy's potential for output. In these circumstances, the purchase of foreign currency by a Banco de la República can curb appreciation while generating conditions for monetary expansion. In contrast, a measure of this type in an atmosphere of surplus aggregate demand in relation to potential production could easily translate into higher inflation. It is, therefore, extremely important for the monetary authority to conduct a detailed and regular assessment of the economy and to make good use of its

experience and wise judgment. This is precisely what the Banco de la República Board of Directors (CBBD) does on a monthly basis when its examines the *Inflation Report* in detail.

Generally speaking, deviations in the exchange rate from its long-term trend exert an influence on inflation through three channels:

- *The direct channel:* Movement in the nominal exchange rate directly affects the price of imported goods and, in a more general way, the price of tradable goods and services; that is, exportable or importable goods and services.

- *The expectation channel:* Movement in the exchange rate can translate into inflationary expectations. Intense and prolonged nominal devaluation tends to raise inflationary expectations; revaluation tends to lower them.

- *The demand channel:* Sharp and prolonged movements in the real exchange rate alter aggregate demand by changing the relative price of Colombian goods and services and by affecting purchases of products made inside the country and abroad. These movements also change the peso value of the external debt and the interest it incurs. All of this alters the balance between aggregate supply and demand and, hence, inflation and the growth in output and employment.

In an analysis of inflation targeting, the first two channels are relatively easy to identify in terms of data. However, it is difficult to determine and quantify precisely how the demand channel operates. This is because some movements in the exchange rate originate with factors that alter the demand for Colombian goods and services, while others do not. Consequently, with respect to movement in the exchange rate, the major challenge to the monetary authority is to understand what causes it and to arrive at a good estimate of its ultimate impact on the balance between aggregate supply and demand. When this balance changes, so do prices, production and employment (the last two, at least in the short-term). This analysis also should be supplemented by reviewing a long list of economic variables that help to understand what is happening in the economy as a whole and its prospects.

The major challenge to the monetary authority in terms of exchange rate movement is to understand what causes it and to arrive at a good estimate of its ultimate impact on the balance between aggregate supply and demand.

C. Policy Measures Adopted by the Banco de la República Board Of Directors

Two conclusions can be drawn from the inflation and exchange diagnosis and the forecast outlined earlier, which guided monetary and exchange

Much of the appreciation in the Colombian peso is considered temporary, although it is uncertain just how long the factors behind it will last.

policy decisions in 2004 and in 2005 to date. On the one hand, much of the appreciation in the Colombian peso is considered temporary, although it is uncertain just how long the factors behind it will last. On the other, inflation has declined and should continue to do so for the following reasons.

I. The inflation forecasts developed with econometric methods place consumer inflation at around 5% by the end of 2005, which is in the middle of the target range set by the Board of Directors for this year. Also, the mid-term forecasts show inflation will continue to decline gradually in 2006.

II. The core inflation indicators, which attempt to provide an idea of macroeconomic inflation, are at around 5%. Moreover, according to short-term forecasts (one year) based on statistical models, these indicators are declining.

III. Inflationary expectations, including those measured with surveys and those based on TES market figures, have fallen off considerably. According to the expectations reflected by the surveys, trust in the inflation target for this year is extremely high. And, although expectations measured with TES market information are near the 6% level, they are shrinking.

IV. Various indicators point to excess supply in the economy. Calculations of the output gap, which is the difference between actual and potential output, are small but negative. Output gap forecasts, with GDP growth near 4%, show no major closure in this gap. Unemployment remains high, despite the recent sharp reduction. Total job creation has been weak although, as seen earlier, the quality of the jobs being created has definitely improved. Growth in investment in plant, machinery and equipment has been high, raising the capacity of the economy to produce. Lastly, the pace of inflation in non-tradable goods and services, which are extremely sensitive to the trend in demand, is declining and coherent with the targets for inflation.

V. The considerable degree of peso revaluation in the last 12 to 18 months has prompted a drop in tradable goods inflation and has eased inflationary expectations somewhat. But even more important is the fact that much of the pressure for peso revaluation comes from broad international liquidity and the imbalances and economic policy of the United States. These circumstances are reflected mostly in the growing demand for Colombian money and financial assets, which allows for a looser monetary policy than would have been possible under other external conditions.

The monetary and exchange policy decision taken by the CBBD since 2004 have been motivated by actual and expected tendencies in inflation and the exchange rate. The situation and outlook for inflation permits a looser monetary policy, without jeopardizing the inflation targets. This translates into lower interest rates on open market transactions conducted by the Bank. To curb peso appreciation and lessen the country's external vulnerability, the Banco de la República intervened in the exchange market through the discretional purchase of foreign currency and by auctioning off put options. Both these policy decisions are coherent in terms of their impact on the exchange and monetary markets (curbing revaluation, in the first case, and reducing the cost of money in the second).

The Banco de la República's policy to lower interest rates directly influenced the drop in interbank rates (IIR)....

1. Intervention Interest Rates and Primary Liquidity

During the course of 2004, the CBBD reduced the rates on its monetary control operations three times, by 75 bp in all. Furthermore, in December, it decided to shut down the Bank's contraction windows temporarily, a decision that has not been reversed. In other words, the CBBD has opted for a broader monetary policy of late, contrary to many countries where the Banco de la Repúblicas have raised intervention interest rates in the last few months. Interest rates in Colombia are at historically low levels, both in real and nominal terms. Moreover, surveys of executives in the financial system indicate there is broad liquidity in the economy.

2. Exchange Market Intervention

In 2004, the Banco de la República purchased US$2,904 m on the exchange market (US$1,580 m through auctions of put options and US$1,325 m through discretional intervention in the exchange market). It also sold US$500 m to the national government (Table 4). International reserves increased by nearly 25%, thanks to net dollar purchases and returns on international reserves. This figure, in absolute terms, is the highest on record for the country in a single year. In percentage terms, it was one of the highest in the world in 2004. At its recent meetings, the CBBD reiterated that the Banco de la República's intends to continue to purchase international reserves during 2005. In fact, it purchased US$603 m in January and February of this year, and remained active in March. The intervention figure for March will be published in early April, a practice scheduled to continue in the months ahead.

In mid-February, the CBBD announced plans to sell US$1,250 m in international reserves directly to the government, specifically during the remainder of the first quarter of 2005. The mechanism for this sale is identical to the transaction for US$500 m, which was approved at the

.... and indirectly affected the decline in interest on deposits in TES and credit.

TABLE 4

FOREIGN CURRENCY PURCHASE-SALE TRANSACTIONS BY THE BANCO DE LA REPÚBLICA
(MILLIONS OF DOLLARS)

	2004	2005		
		January	February	Accumulated 1/
Purchases	2,904.9	267.9	335.5	603.4
Put options	1,579.6	0.0	0.0	0.0
To accumulate international reserves	1,399.7	0.0	0.0	0.0
To control volatility	179.9	0.0	0.0	0.0
Discretional intervention	1,325.3	267.9	335.5	603.4
Sales	500.0	0.0	250.0	250.0
National government	500.0	0.0	250.0	250.0
Net Purchases	2,404.9	267.9	85.5	353.4

1/ Accumulated at February.
Source: Banco de la República.

end of 2003 and conducted in 2004. In an operation of this type, the Banco de la República purchases treasury bonds (TES) on the secondary market for an amount equivalent in pesos to the dollars it sells to the government. This has no effect on the amount of money in the economy and gives the Bank a sizable stock of government bonds, which can be used later to control liquidity in the economy. As announced by the government, the foreign exchange from this transaction will be used to pay off in advance a special loan contracted with the Inter-American Development Bank (IDB).

D. INTEREST RATES AND MONETARY AGGREGATES

The Colombian economy saw low nominal interest rates in 2004 on both lending an deposits. The Banco de la República's policy to lower interest rates directly influenced the drop in interbank rates (IIR) and indirectly affected the decline in interest on deposits in TES and credit. Although interest on term deposits (TDR) was relatively stable throughout 2004, it had declined substantially by February 2005. On the other hand, the more liquid monetary aggregates (base money and M1) continued to grow at high rates. In real terms, these rates exceeded the increase in output, as has been the trend in recent years. However, unlike previous years, the increase in demand for base money during 2004 was due not only to the larger demand for cash, but also to the increase in reserves associated with the growth in liabilities subject to reserve requirements (LSRR). This also explains the acceleration in broad aggregate (M3) growth, which has been particularly strong since 2003.

1. Interest Rates

a. Banco de la República Intervention Interest Rates

In Colombia, the Banco de la República supplies the market with liquidity through routine auctions of expansionary repos and via special windows to help brokers with sporadic liquidity problems, at Lombard rates. The 75 bp reduction in intervention rates during 2004 placed the minimum expansion auction rate at 6.5% and the Lombard expansion rate at 10.25%. In addition, the contraction auctions and windows used to collect surplus liquidity from the market operated up until December 21 at the rates shown in Table 5.

b. Market Interest Rates

The interbank interest rate (IIR) averaged 6.75% in December 2004, down 75 bp from the rate in December 2003 (Graph 25). In real terms, the IIR remained low throughout 2004, at 1.04% on average. The 25 bp reduction in the Banco de la República's intervention rates on December 17 of last year, coupled with closure of the contraction window on December 21, led to a reduction of 43 bp in the IIR between that date and the end of February 2005.

As illustrated in Graph 26, the decline in Banco de la República interest rates also affected the term-deposit rate (TDR). In December 2004, this

TABLE 5

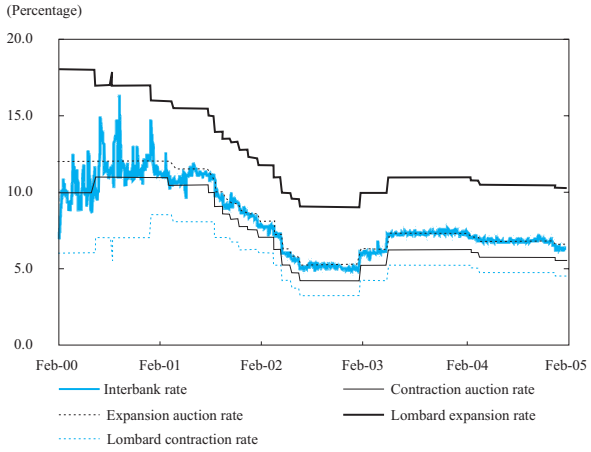
BANCO DE LA REPÚBLICA INTERVENTION RATE
(PERCENTAGE)

Effective Dates		Contraction Minimum (Lombard)	Contraction Auction Maximum	Expansion Auction Minimum	Expansion Maximum (Lombard)	Interbank Rate		
From	To					Average for the period	End of	Real
Dec-17-01	Jan-18-02	6.25	7.50	8.50	12.25	8.43	7.86	0.46
Jan-21-02	Mar-15-02	6.00	7.00	8.00	11.75	7.82	7.83	1.83
Mar-18-02	Apr-12-02	5.25	6.25	7.25	11.00	7.29	7.21	1.48
Apr-15-02	May-17-02	4.25	5.25	6.25	10.00	6.15	6.04	0.19
May-20-02	Jun-14-02	3.75	4.75	5.75	9.50	5.69	5.63	(0.58)
Jun-17-02	Jan-17-03	3.25	4.25	5.25	9.00	5.22	5.06	(2.17)
Jan-20-03	Apr-28-03	4.25	5.25	6.25	10.00	6.15	6.23	(1.50)
Apr-29-03	Feb-20-04	5.25	6.25	7.25	11.00	7.41	7.38	1.03
Feb-23-04	Mar-19-04	5.00	6.00	7.00	10.75	7.16	7.08	0.82
Mar-23-04	Dec-17-04	4.75	5.75	6.75	10.50	6.93	6.87	1.30
Dec-20-04	Dec-21-04	4.50	5.50	6.50	10.25	6.62	6.63	1.07
Dec-22-04	Feb-28-05 *	—-	—-	6.50	10.25	6.45	6.44	1.13

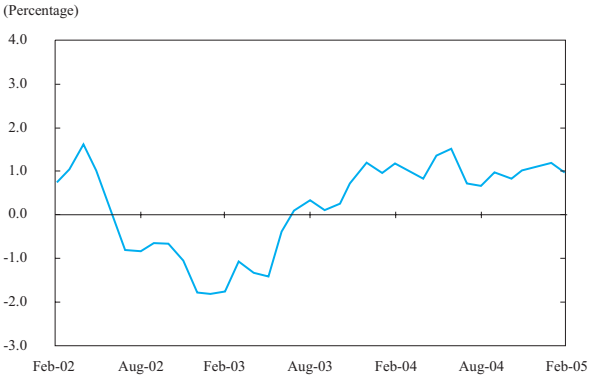
(*) The Banco de la República closed the deposit window (auction and Lombard) from December 22, 2004.
Source: Banco de la República and the Banking Superintendent (interbank rate).

Graph 25

Interbank and Intervention Rates Set by the Banco de la República



Real Interbank Rate



Source: Banco de la República.

last indicator averaged 7.76%, down 19 bp compared with the same month the year before. The average TDR was 7.41% at February 2005, down 35 bp from the average at December 2004. In real terms, the rate on term deposits was 2.14% at the end of the year, up 77 bp compared with December 2003 but still well below its historic level (Graph 27).

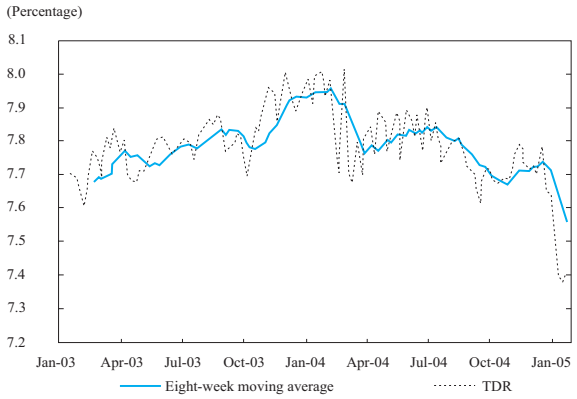
As shown in Table 6, interest rates on loans were down as well. Compared with 2003, the drop of nearly 180 bp in average consumer credit rates during 2004 is one example. In real terms, consumer, regular, preferred and treasury rates were 18.42%, 10.58%, 5.47% and 3.83% respectively (Graph 28).

c. Interest Rates on Government Bonds

In 2004, the domestic market for government bonds was characterized by a downturn in bond interest rates. This trend was interrupted briefly on several occasions. From the start of the year until mid-April, treasury rates (TES) dropped as a result of good national and international

Graph 26

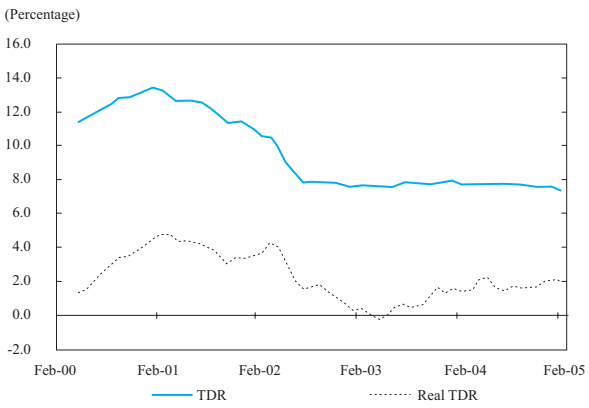
Interest Rate on Term Deposits (TDR)



Source: Banco de la República.

Graph 27

Nominal and Real TDR Rates (*)



(*) CPI deflated.
Source: Banking Superintendent and Banco de la República.

liquidity, among other reasons. This was accompanied by appreciation in both the peso and the stock market.

TABLE 6

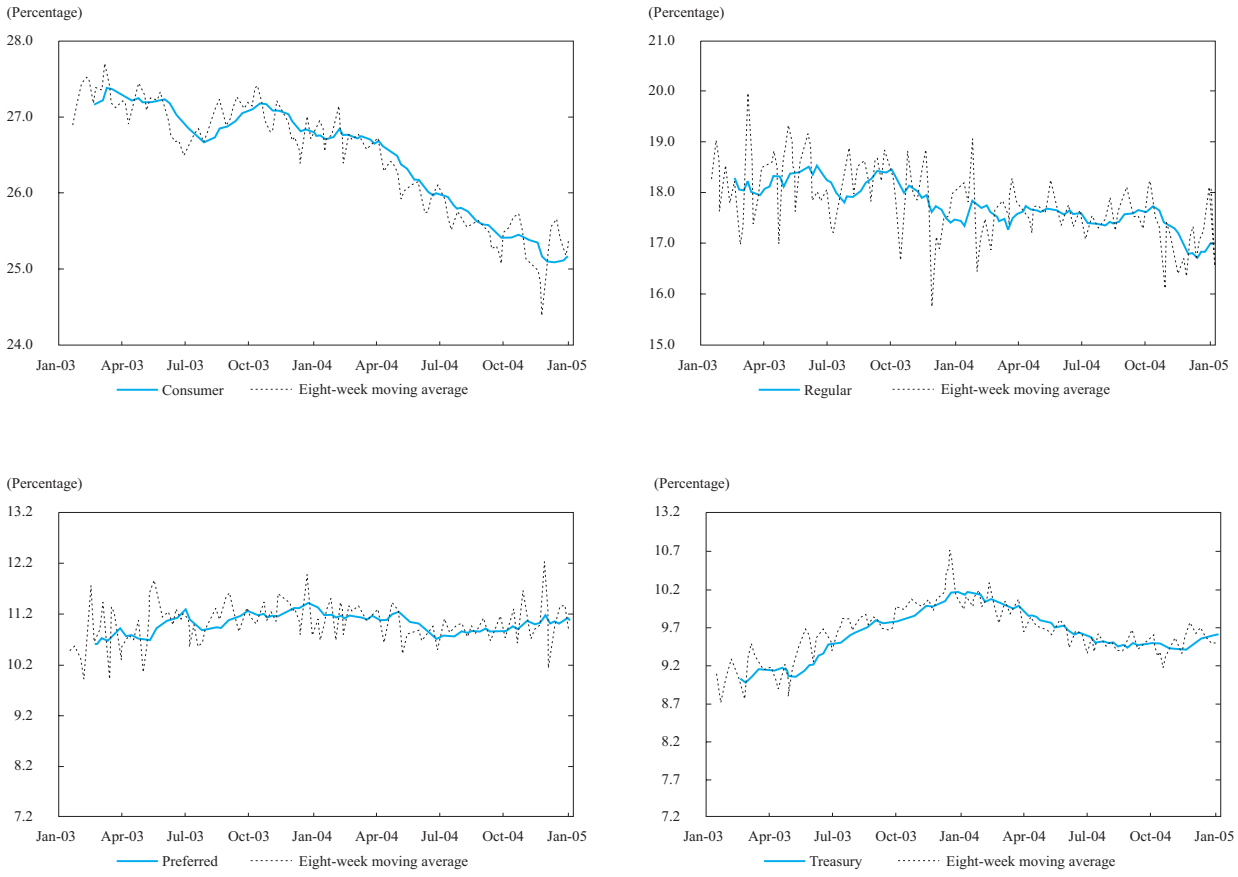
LENDING RATES

Year	Consumer		Regular		Preferred		Treasury	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
2000	33.46	22.73	20.42	10.73	18.64	9.10	15.98	6.64
2001	31.32	21.99	19.40	10.91	14.14	6.03	13.89	5.80
2002	27.00	18.70	17.14	9.48	10.93	3.68	8.97	1.86
2003	26.73	19.01	16.81	9.69	11.38	4.59	10.24	3.52
2004	24.93	18.42	16.66	10.58	11.27	5.47	9.54	3.83

Source: Banco de la República calculations based on information from the Banking Superintendent.

GRAPH 28

INTEREST RATES ON LOANS

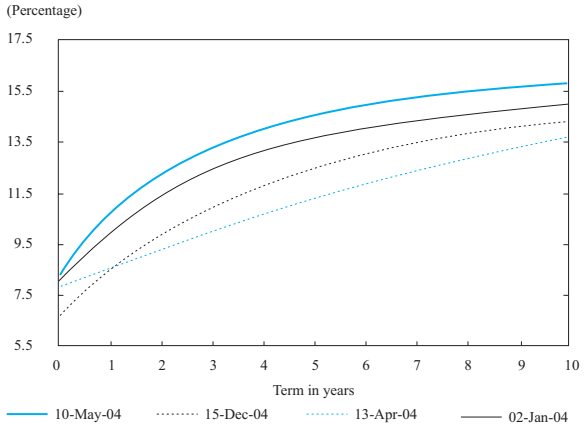


Source: Banco de la República calculations.

On April 13, the TES market rates hit a low for the year. There was some increase after that date, thanks to a change in the way agents expected international markets to behave. The biggest uncertainty with respect to those markets was prompted by an increase in the interest rate on U.S. Treasury Bonds, followed by a rise in the region's sovereign risk premium, and finally an increase in the yield curve for domestic bonds (TES) and in the exchange rate. During the period from April 13 to May 10, the spot curve for fixed-rate TES rose by 275 bp, on average, up from what it had been at the beginning of the year (Graph 29).

Graph 29

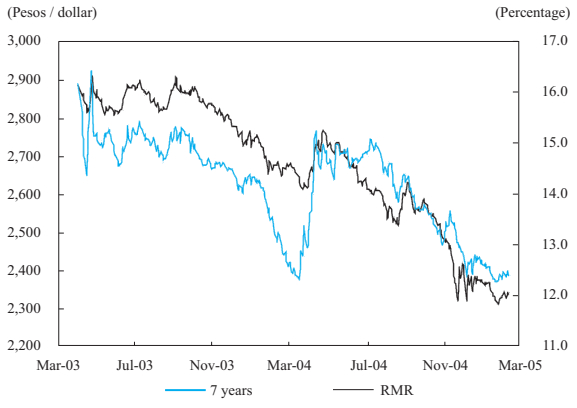
Spot Curve: Fixed Rate TES



Fuente: Bolsa de Valores de Colombia (BVC).

Graph 30

Trend in the Fixed Rate Spot Curve in Pesos for 7-year TES and the Average RMR
April 2003 - March 2005



Source: BVC.

At the end of June, following an increase of 25 bp in the reference rate set by the Fed (United States Federal Reserve Bank), the market sensed that external interest rates would be adjusted gradually. The four additional increases of 25 bp, which put the rate on federal funds at 2.25% by the end of the year, were in line with what agents expected. This lent an atmosphere of relative stability to operation of the market, and rates resumed their downward trend. Following the Fed's last rate increase for the year, on December 14, the TES fixed-rate spot curve was down an average of 198 bp from its maximum level.

Between August and September, the market watched closely for any measures that might be adopted by the Ministry of Finance and Public Credit or the Banco de la República to curb revaluation of the peso. In September, when the CBBD announced it intended to intervene in the exchange market at its own discretion for up to US$1 billion in the last quarter of the year, there were temporary increases in the exchange rate and TES market rates. Once the exchange market was back on a revaluation track, TES trading rates continued to drop (Graph 30). These movements suggest an influx of capital for portfolio investment.

2. Monetary Aggregates

Average base money in 2004 rose at an annual rate of 16.3%, which is similar to the rate during the last four years (16.9% on average). As Graph 31

illustrates, real growth rates for base money have surpassed the growth in output since 2000. According to use, the increase in base money was due to more demand for reserve money as well as cash. The tax imposed on bank transactions (currently 0.004%) was part of the reason for the increased demand for cash. The average annual nominal and real variation in cash was 17.6% and 11.0%, respectively, and was 13.3% and 7.% for reserves (Graph 32).

An analysis of base money by sources shows the increase in 2004 (Col$2,647 billion) was due mainly to the expansionary impact of net foreign currency purchases by the Banco de la República (Col$6,194 b) (Table 7). This is contrary to previous years when the growth in base money was primarily the result of operations with the government. These effects, coupled with Col$803 b in profits transferred to the government by the Banco de la República, were mitigated by contractions originating with (i) a decline in TES maintained by the Bank, (Col$2,524 b); (ii) a reduction in the Bank's net expansion repos (Col$1,058 b); and (iii) an increase in government deposits with the Banco de la República (Col$1,039 b).

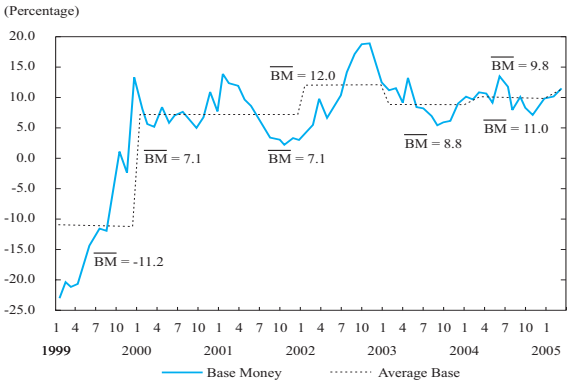
Last year, the average money supply (M1) increase at an annual rate of 15.0%, down 1.6 percentage points from 2003. Less M1 growth is due to the current accounts, with an annual increase (12.6%). This was 3.2 percentage points less than the increase in 2003 (Graph 33).

The broad monetary aggregate (M3) continued the upward trend that began in early 2001 (Table 8, Graph 34). In 2004, average nominal and real M3 rose at respective annual rates of 13.5% and 7.2%. These figures exceed nominal and real growth in the economy.

A look at M3 growth, by components, shows a 13.0% rise in LSRR for the year, as opposed to 10.4% in 2003. Savings accounts and term deposit certificates (CDs), which account for more than 70% of LSRR, were the deposits that

Graph 31

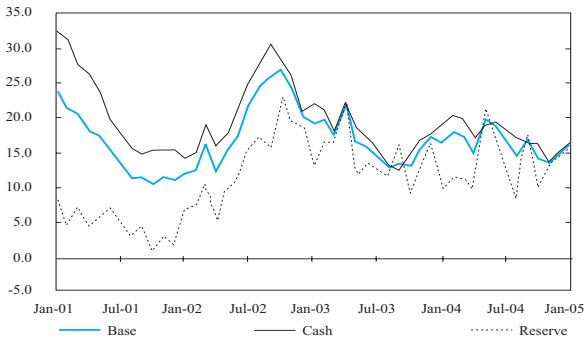
Real Base Money
(Annual percentage change)



Source: Banco de la República.

Graph 32

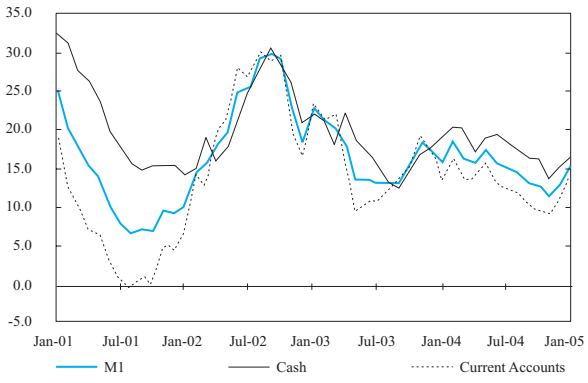
Base Money and Its Uses
(Annual Growth Rate for the Monthly Average)



Source: Banco de la República.

Graph 33

M1 and Its Components
(Annual Growth Rate for the Monthly Average)



Source: Banco de la República.

TABLE 7

BASE MONEY SOURCES
(BILLIONS OF PESOS)

	2001	2002	2003	2004
I. Government	1,537	645	914	(236)
Profits transferred	1,453	575	830	803
Pesos	1,453	1,226	1,481	803
Dollars	0	(651)	(651)	0
Deposits with the Banco de la República	84	70	83	(1,039)
II. TES Regulation	(954)	150	568	(2,524)
Definitive purchases	160	1,208	893	1,017
Definitive sales				(2,967)
Maturity	(1,113)	(1,058)	(325)	(575)
III. Repos	(1,250)	1,349	1,492	(1,058)
Expansion 1/	(1,109)	1,322	1,386	(1,086)
Contraction	(141)	28	106	28
IV. Foreign Currency	1,445	601	(703)	6,194
Put options	1,445	601	(703)	4,183
Discretional intervention				3,264
Foreign currency sold to the government				(1,252)
V. Others 2/	159	(289)	239	272
Total change in base money	937	2,457	2,510	2,647
Base money position	11,648	14,105	16,615	19,262

1/ Includes one-day, overnight and medium-term repos.
2/ Includes the monetary impact of the Banco de la República income statement, TES A maturities, and investments by the Banco de la República.
Source: Banco de la República.

increased the most in relation to the previous year, registering respective average annual variations of 18.8% and 7.6%. The annual increase of 46.8% in bonds issued by credit establishments also is an important element.

Private deposits with the financial system were up by 17.0% for the year, possibly because of agents decided to redistribute their portfolios between internal and external assets, given the difference in profitability created by low interest rates on the international market. This trend is particularly evident in the amount of term deposit certificates (CDs) constituted by the private sector, which rose by 11.6% during the year (Table 9). The sharp increase in private sector investments in government bonds, which continued to growth at very high rates (30.3% annual) as indicated in Table 10, might mirror this decision as well.

Public sector deposits with the financial system were up 23.4% in 2004, which is 2.2 percentage points less in relation to the same month in 2003. The biggest increases were in savings accounts (56.9%), CDs (37.84%) and current accounts (19.2%) (Table 9).

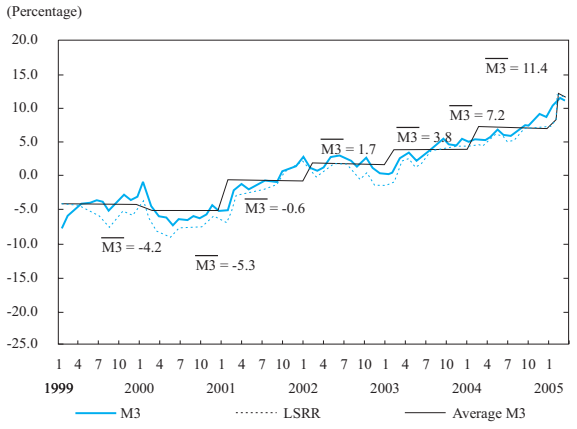
Monetary Aggregates

	Annual Nominal Percentage Change in the Monthly Average for Weekly Data							
	Base	**Cash**	**Reserve**	**M1**	**Quasi-money**	**M2**	**LSRR**	**M3**
Jan-03	19.2	22.0	12.8	22.9	5.2	10.0	6.5	8.2
Feb-03	19.7	21.0	16.7	21.1	7.1	10.8	8.9	10.2
Mar-03	17.6	18.3	16.1	20.3	9.1	12.1	10.5	11.4
Apr-03	22.2	22.0	22.8	18.2	9.2	11.6	8.9	10.3
May-03	16.6	18.6	11.9	13.4	9.3	10.4	9.6	10.6
Jun-03	16.0	17.1	13.5	13.6	10.3	11.2	10.6	11.3
Jul-03	14.6	15.5	12.5	12.9	10.5	11.2	11.4	11.9
Aug-03	13.0	13.6	11.6	12.9	12.3	12.5	13.4	13.4
Sep-03	13.5	12.5	16.1	13.0	10.0	10.9	12.1	12.1
Oct-03	13.1	14.9	8.9	15.3	9.9	11.4	11.0	11.5
Nov-03	15.7	16.9	12.7	18.2	10.1	12.3	11.2	11.8
Dec-03	17.3	17.5	16.7	17.3	9.4	11.8	11.1	11.9
Jan-04	16.5	19.0	9.9	15.8	9.9	11.6	11.0	12.0
Feb-04	17.9	20.5	11.4	18.4	9.5	12.1	10.9	12.0
Mar-04	17.4	20.0	11.2	16.5	9.7	11.6	11.6	12.5
Apr-04	15.0	17.2	9.7	15.3	9.5	11.2	12.3	12.8
May-04	19.8	19.0	21.7	17.3	11.6	13.2	11.1	12.0
Jun-04	18.7	19.6	16.5	16.0	13.5	14.2	11.3	12.3
Jul-04	14.6	17.3	8.0	14.6	13.9	14.1	12.7	13.2
Aug-04	16.9	16.4	18.1	13.1	14.9	14.4	13.4	13.7
Sep-04	14.4	16.2	10.0	12.6	16.2	15.2	13.9	14.1
Oct-04	13.5	13.8	12.7	11.3	15.5	14.3	15.8	15.5
Nov-04	15.1	15.3	14.7	12.9	16.1	15.2	15.2	15.1
Dec-04	16.3	16.5	15.7	15.9	19.0	18.0	17.0	16.8
	Annual Average in Nominal Terms							
2003	16.5	17.5	14.4	16.6	9.4	11.3	10.4	11.2
2004	16.3	17.6	13.3	15.0	13.3	13.8	13.0	13.5
	Annual Real Percentage Change in the Monthly Average for Weekly Data							
	Base	**Cash**	**Reserve**	**M1**	**Quasi-money**	**M2**	**LSRR**	**M3**
Jan-03	11.0	13.6	5.0	14.4	-2.0	2.4	-0.8	0.8
Feb-03	11.6	12.8	8.8	12.9	-0.1	3.3	1.6	2.8
Mar-03	9.3	9.9	7.9	11.8	1.4	4.2	2.7	3.5
Apr-03	13.3	13.1	13.9	9.6	1.2	3.5	1.0	2.3
May-03	8.2	10.1	3.9	5.3	1.4	2.5	1.8	2.6
Jun-03	8.2	9.2	5.8	6.0	2.9	3.7	3.2	3.8
Jul-03	7.1	7.9	5.1	5.4	3.3	3.9	4.1	4.5
Aug-03	5.4	5.9	4.1	5.2	4.7	4.9	5.7	5.7
Sep-03	6.0	5.0	8.4	5.5	2.7	3.5	4.6	4.6
Oct-03	6.1	7.8	2.2	8.2	3.2	4.6	4.2	4.6
Nov-03	9.0	10.2	6.2	11.3	3.7	5.8	4.8	5.4
Dec-03	10.1	10.4	9.6	10.2	2.7	5.0	4.3	5.0
Jan-04	9.7	12.1	3.5	9.1	3.5	5.1	4.5	5.4
Feb-04	10.9	13.4	4.8	11.4	3.0	5.4	4.3	5.4
Apr-04	9.0	11.1	4.0	9.3	3.8	5.4	6.4	6.9
May-04	13.7	13.0	15.5	11.3	5.9	7.4	5.5	6.3
Jun-04	11.9	12.8	9.9	9.4	7.0	7.7	5.0	5.9
Jul-04	7.9	10.5	1.7	7.9	7.3	7.5	6.1	6.6
Aug-04	10.4	9.9	11.5	6.8	8.5	8.0	7.1	7.4
Sep-04	7.9	9.7	3.8	6.3	9.6	8.7	7.4	7.7
Oct-04	7.1	7.4	6.4	5.1	9.1	7.9	9.3	9.0
Nov-04	8.8	9.0	8.4	6.7	9.7	8.8	8.8	8.8
Dec-04	10.2	10.4	9.7	9.9	12.8	11.9	10.9	10.7
	Annual Average in Real Terms							
2003	8.8	9.6	6.7	8.8	2.1	3.9	3.1	3.8
2004	9.8	11.0	7.0	8.6	7.0	7.4	6.7	7.2

Source: Banco de la República calculations based on information from the Banking Superintendent.

GRAPH 34

REAL M3
(ANNUAL PERCENTAGE CHANGE)



Source: Banco de la República.

Figures show the M3 increase in 2004 was used first and foremost to finance the government and secondly for loans (Table 11). Credit agencies increased their investments in government bonds by 42.8% for the year, while the rise in credit during 2004 came to 6.8% (if the securitization-adjusted net portfolio is taken into account, the annual increase was 10.4%). The consumer and mortgage portfolios saw respective increases of 29.2% and 10.6%, while the securitization-adjusted mortgage portfolio was down by 5.8%. In short, M3 growth exceeded the increase in credit and was associated with capital inflows, given the decision by agents to recompose their portfolios.

TABLE 9

BROAD AGGREGATE (M3) COMPOSITION (*)
(BILLIONS OF PESOS)

	March			June			September			December		
	2003	2004	Percentage	2003	2004	Percentage	2003	2004	Percentage	2003	2004	Percentage
Private M3	60,279	66,554	10.4	61,461	69,495	13.1	61,955	69,475	12.1	66,941	78,048	16.6
Cash	8,780	10,383	18.3	9,338	10,750	15.1	9,215	10,547	14.5	12,070	13,832	14.6
LSRR	51,500	56,170	9.1	52,123	58,745	12.7	52,741	58,928	11.7	54,871	64,215	17.0
Current accounts	6,484	7,796	20.2	6,893	8,086	17.3	7,069	7,582	7.3	8,880	10,236	15.3
CD	21,970	23,159	5.4	21,733	23,803	9.5	22,291	24,471	9.8	21,890	24,422	11.6
Savings	19,154	20,530	7.2	19,608	21,672	10.5	19,700	21,613	9.7	20,317	24,428	20.2
Others	3,892	4,685	20.4	3,888	5,184	33.3	3,681	5,262	42.9	3,784	5,129	35.5
Public M3	13,814	17,145	24.1	15,478	16,621	7.4	15,427	18,474	19.7	15,450	19,068	23.4
Current accounts	3,528	3,790	7.4	3,577	3,666	2.5	3,266	3,780	15.7	4,240	5,055	19.2
CD	1,846	1,566	(15.1)	2,137	2,064	(3.4)	1,967	2,614	32.9	1,649	2,272	37.8
Savings	4,567	6,542	43.2	4,726	7,255	53.5	5,055	7,870	55.7	5,233	8,209	56.9
Repos	2,235	3,405	52.4	3,316	1,589	(52.1)	3,506	2,265	(35.4)	2,328	1,194	(48.7)
Others	1,638	1,842	12.4	1,722	2,047	18.8	1,633	1,945	19.1	1,999	2,337	16.9
Total M3	74,093	83,699	13.0	76,939	86,115	11.9	77,383	87,949	13.7	82,390	97,116	17.9

(*) Annual Change.
Source: The Banking Superintendent.

TABLE 10

FINANCIAL PORTFOLIO OF THE PRODUCTIVE SECTOR
(BILLIONS OF PESOS)

	Productive Sector Total								
	Total			Public Sector			Private Sector (,)		
	M3	TES	M3 + TES	M3	TES	Total	M3	TES	Total
Balances									
2002 December	73,073	28,859	**101,931**	12,304	17,141	**29,446**	60,768	11,717	**72,486**
2003 March	74,093	30,618	**104,712**	13,814	17,629	**31,443**	60,279	12,990	**73,269**
June	76,939	31,540	**108,479**	15,478	17,714	**33,192**	61,461	13,826	**75,287**
September	77,383	31,995	**109,378**	15,427	17,764	**33,192**	61,955	14,231	**76,186**
December	82,390	31,613	**114,003**	15,450	16,612	**32,061**	66,941	15,001	**81,942**
2004 March	83,699	34,320	**118,019**	17,145	16,774	**33,919**	66,554	17,546	**84,100**
June	86,115	33,449	**119,564**	16,621	17,137	**33,758**	69,495	16,311	**85,806**
September	87,949	35,821	**123,770**	18,474	18,167	**36,641**	69,475	17,654	**87,130**
December	97,116	36,408	**133,524**	19,068	16,869	**35,937**	78,048	19,539	**97,587**
Absolute annual change									
2003 December	9,318	2,754	**12,072**	3,145	-529	**2,616**	6,172	3,283	**9,456**
2004 March	9,605	3,702	**13,307**	3,331	-854	**2,477**	6,274	4,556	**10,831**
June	9,176	1,909	**11,085**	1,142	-577	**566**	8,034	2,485	**10,831**
September	10,566	3,826	**14,392**	3,046	403	**3,449**	7,520	3,424	**10,831**
December	14,725	4,795	**19,521**	3,619	257	**3,875**	11,107	4,539	**10,831**
Annual percentage change									
2003 December	12.75	9.54	**11.84**	25.56	(3.09)	**8.88**	10.16	28.02	**13.04**
2004 March	12.96	12.09	**12.71**	24.11	(4.84)	**7.88**	10.41	35.08	**14.78**
June	11.93	6.05	**10.22**	7.38	(3.25)	**1.70**	13.07	17.97	**13.97**
September	13.65	11.96	**13.16**	19.75	2.27	**10.39**	12.14	24.06	**14.36**
December	17.87	15.17	**17.12**	23.42	1.55	**12.09**	16.59	30.26	**19.09**
Average	14.10	11.32	**13.30**	18.67	(1.07)	**8.02**	13.05	26.84	**15.55**

(*) Does not include TES in the financial sector.
Source: Calculations by the Economic Studies Division (SGEE) of the Banco de la República, based on DFV.

TABLE 11

NET PORTFOLIO AND INVESTMENTS OF THE FINANCIAL SYSTEM 1/

	Balances (billions of pesos) at December 31			Percentage Annual Growth at December 31			Percentage Average Annual Growth 2/ January-December Average		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
I. Net portfolio									
A. Local currency	43,865	48,211	52,759	4.22	9.91	9.43	(0.54)	9.26	9.23
Mortgage	9,998	8,685	6,695	(15.11)	(13.13)	(22.92)	(12.36)	(13.64)	(13.97)
Consumer	7,634	9,355	12,582	8.01	22.54	34.50	5.73	20.43	29.17
Microcredit	366	557	821	0.00	52.01	47.41	0.00	143.60	44.04
Commercial	25,866	29,613	32,661	11.29	14.49	10.29	3.44	15.46	10.64
B. Adjusted mortgage portfolio	10,979	10,239	9,890	(6.79)	(6.74)	(3.41)	(9.43)	(6.08)	(5.79)
C. Foreign currency	3,256	2,256	3,46	7.78	(30.70)	53.69	(3.84)	(11.91)	14.02
D. Total (A + C)	47,121	50,467	56,227	4.46	7.10	11.41	(2.27)	6.61	6.79
E. Adjusted total 3/	48,102	52,020	59,422	6.63	8.15	14.23	(0.02)	9.45	10.45
II. Investments									
A. Local currency	23,404	27,551	35,997	27.64	17.72	30.66	30.08	18.93	24.95
B. Foreign currency	1,701	1,805	1,614	(23.25)	6.07	(10.56)	17.03	(9.23)	(2.50)
C. Total (A + B)	25,106	29,356	37,611	22.15	16.93	28.12	28.69	16.29	23.08
Ítem									
TES - Nominal value	8,621	11,621	16,510	76.36	34.80	42.07	130.86	33.73	42.81

1/ Does not include FEN (Financiera Energética Nacional) or institutions in the process of liquidation.
2/ Pertains to annual growth in the monthly average for weekly data.
3/ Includes legal tender, foreign currency and mortgage portfolio securitization. Includes sale of the Granahorrar mortgage portfolio to CISA in December 2004.
Source: Weekly format 281 on asset and liability accounts.

Box 1

Nominal and Real Exchange Rates: Definition and Determinants

A. Nominal Exchange Rate (NER)

The NER is defined as the rate at which the currency of one country can be traded for the currency of another. Changes in the NER are known as nominal devaluation (depreciation) when this rate increases, and as nominal revaluation (appreciation) when it declines.

The method used to measure the "extent" of appreciation or depreciation in a country's NER, although apparently simple, is not at all trivial. It is not uncommon for agents to use changes in the peso price of the United States dollar as an estimate of this measurement. Nevertheless, for the effects of monetary policy, this indicator is not always the best approximation, since the devaluation of our currency against the currencies of the countries with which Colombia trades or competes also should be taken into account.

The exchange rate is the price of an asset and, as such, is affected not only by what the market expects but also by the information agents have at their disposal. Accordingly, changes in the NER can reflect actual or anticipated changes in the economic variables that modify national income in a temporary or permanent way. Also, because the NER is a relative price between two or more currencies, its change not only mirrors what is happening in Colombia, but also in the countries that enter into the equation. Therefore, a change in the peso-dollar exchange rate reflects what is happening in Colombia as well as in the United States.

For example, deterioration in the perception of sustainability with respect to the U.S. public and external debt will cause depreciation and expectations of depreciation in the dollar against other currencies, including the Colombian peso. If the current account deficit in Colombia declines (increases) because of a surge (drop) in exports or an improvement (deterioration) in terms of trade, and agents expect this pattern to continue, the result can be expectations of peso appreciation (depreciation) because of the anticipated increase (decrease) in the supply of dollars. This will lower (raise) the NER.

The NER also can appreciate (depreciate) when agents anticipate more (less) capital income from abroad, because, for example, they expect external interest rates to remain low (high) or because the perception of the country's risk premium will improve (deteriorate).

With this measurement, it is natural for the NER to be volatile and its future behavior to be uncertain. It is impossible to predict changes in the NER with any real degree of certainty and different agents can have very different opinions in this respect.

B. Real Exchange Rate (RER)

The real exchange rate (RER) is calculated by comparing the rate at which goods and services of one country can be traded for goods and services of another (*). The RER is a measure of competitiveness.

$RER = NER \times P^*/P$

Where:

P = the price in local currency of a basket of goods and services produced domestically.

P^* = the price in foreign currency of a basket of goods and services produced in another country.

NER = the nominal exchange rate

The RER also is a comparative measure of the buying power of one currency against another. For example, an increase in the RER (real depreciation) due to nominal devaluation or to a drop in domestic prices reflects an increase in the buying power of a foreign currency in a particular country. This, in turn, is an incentive to the sale of domestic goods abroad and a disincentive to imports. However, a drop in the RER (real appreciation), either because of nominal revaluation or higher domestic prices, gives more buying power to local currency in its country of origin, reducing demand for the country's exports and raising imports.

Nominal devaluation does not necessarily cause real long-term depreciation. If nominal depreciation of a currency is not accompanied by, for example, a reduction in domestic spending, domestic prices can increase as much as devaluation. This would place the RER at its original level and result in added inflation.

The first methodological problem when constructing a RER index (RERI) is the selection of countries for a comparison of prices in the national economy. In economic literature, two criteria are applied to this end: i) the country's major trading partners that do not necessarily produce the same goods, and ii) its competitors on international markets; that is, countries selling the same goods.

A RERI among highly complementary trading partners; that is, countries producing mostly different goods and services, measures the changes in the buying power of local currency against foreign currency. The Banco de la República measures two weighted RERI based on non-traditional commerce with Colombia's major trading partners: the RERI-CPI and the RERI-PPI. As illustrated in Table B1.1, real appreciation in 2004, with the RERI-CPI, was 9.2% on average. With the RERI-PPI, it was 6.1% for the year.

The Banco de la República also calculates what is known as the RERI with third countries (RERI-C). This index measures the increase or loss of Colombia's competitiveness in relation to countries that export the same goods. It is obtained by comparing the Colombian CPI to that of its direct competitors in the United States market for coffee, bananas, flowers and textiles, based on a common currency. In 2004, average annual appreciation in the RERI-C was 10.1% (Table B1.2). Nevertheless, as mentioned in Chapter III, any assessment of the country's competitiveness should be for longer periods of time.

The factors that determine the RER are basically those that affect supply and demand for tradable goods (internationally) and non-tradables. Most international literature points to the following determining factors or "fundamentals":

Table B1.1
Nominal and Real Exchange Rates

Country	Weighted (%)	ERI Nominal Devaluation		RERI-PPI Real Devaluation		RERI-CPI Real Devaluation	
		Dec-04	Average	Dec-04	Average	Dec-04	Average
Industrialized Countries							
United States	43.74	(14.10)	(8.71)	(11.70)	(7.85)	(15.77)	(11.54)
Euro(*)	11.5	(6.49)	0.30	(8.02)	(3.24)	(9.05)	(3.11)
Japan	3.23	(10.80)	(2.21)	(12.97)	(5.90)	(14.94)	(7.71)
United Kingdom	1.36	(5.58)	2.29	(7.09)	(0.40)	(7.15)	(0.45)
Switzerland	3.05	(5.21)	(1.20)	(8.03)	(4.94)	(9.36)	(6.12)
Canada	1.52	(7.46)	(1.80)	(5.40)	(3.45)	(10.76)	(5.78)
Sweden	0.62	(5.80)	0.35	(5.47)	(2.25)	(9.75)	(4.80)
External	65.04	**(11.90)**	**(5.83)**	**(10.69)**	**(6.35)**	**(13.97)**	**(9.00)**
Developing Countries							
Mexico	5.22	(13.72)	(12.67)	(10.48)	(9.28)	(14.70)	(13.85)
Venezuela	9.26	(28.42)	(21.84)	(16.25)	(3.12)	(19.14)	(10.09)
Ecuador	6.22	(14.10)	(8.71)	(16.34)	(10.80)	(17.02)	(11.43)
Brazil	4.04	(7.61)	(4.09)	(0.66)	(0.02)	(6.25)	(3.47)
Chile	2.61	(10.05)	3.34	(11.66)	(0.71)	(12.38)	(1.41)
Peru	3.25	(9.09)	(6.93)	(8.31)	(6.81)	(17.02)	(11.43)
Panama	3.29	(14.10)	(8.71)	(15.89)	(11.26)	(16.58)	(11.88)
Argentina	1.07	(14.29)	(8.41)	(9.62)	(4.90)	(14.19)	(9.74)
External	34.96	**(21.41)**	**(13.35)**	**(10.53)**	**(5.71)**	**(13.17)**	**(9.37)**
Total External	100	**(18.59)**	**(11.00)**	**(10.51)**	**(6.06)**	**(13.81)**	**(9.22)**

(*) Includes Germany, Holland, Spain, France, Italy and Belgium.
Source: Banco de la República.

- The relative productivity of tradable sectors versus non-tradable sectors. Greater productivity in the country's tradable sectors (compared with productivity in the non-tradable sectors) causes real peso appreciation.

- Continuous income from the economy. For example, the discovery of an exportable natural resource and/or a constant increase in remittances from workers outside the country prompts real peso appreciation.

- The extent of spending, both public and private. More spending produces real appreciation by increasing the relative price of non-tradable goods and services.

- External flows, assets and liabilities of residents.

According to studies by the Banco de la República of Colombia (Carrasquilla and Arias, 1996), the main factors behind real appreciation in the first half of the nineties were, in order of importance, excess private and public spending, a relative increase in the productivity of tradable goods, and oil discoveries. Together, these factors probably accounted for more than 80% of the real appreciation that occurred between 1990 and 1996.

It should be noted that monetary variables can have an effect on the real exchange rate to the extent that prices in markets for goods and factors are rigid or inflexible. However, if there is no change in the real

determinants, these effects will be temporary. Therefore, in the event of a positive shock coming from the external sector (through more exogenous exports or larger capital inflows), a nominal devaluation induced by the country's monetary policy will have only a temporary impact, unless it is accompanied by a downturn in spending (public or private).

The equilibrium RER, or the RER that is coherent with the current and expected trend in "fundamentals", can be defined once the fundamental determinants of the RER have been identified. The equilibrium RER is not constant over time, as it depends on factors that are changing all the time. Therefore, it is not logical to expect the level of RER equilibrium to remain constant or that it necessarily pertains to a level achieved during a particular period.

Although identifying an equilibrium RER is an important step towards analyzing the present and future course of this variable, its calculation is particularly difficult and debatable. Also, the RER can deviate considerably from its equilibrium path. In spite of the difficulties in estimating the equilibrium RER, there is no stable relationship between the real exchange rate and its fundamentals, and it can swerve a long ways away from its equilibrium path. This is one of the main justifications for a policy based on exchange intervention or managed floats. From this perspective, nominal devaluation also depreciates the RER

Table B1.2
Real and Nominal Exchange Rates with Third Countries

Country	Weighted Average 2004 (%)	ERI Nominal Devaluation		RERI-C Real Devaluation	
		Dec-04	Average	Dec-04	Average
Brazil	7.0	(7.6)	(4.1)	(5.7)	(3.4)
Canada	2.5	(7.5)	(1.8)	(10.4)	(5.6)
China	9.0	(14.1)	(8.7)	(16.6)	(10.4)
Costa Rica	8.7	(21.5)	(16.9)	(15.8)	(11.9)
Dominican Republic	1.8	14.2	(31.8)	39.3	(2.1)
Ecuador	14.0	(14.1)	(8.7)	(17.0)	(11.4)
El Salvador	1.7	(14.1)	(8.7)	(14.2)	(10.0)
Guatemala	9.9	(11.3)	(8.8)	(8.2)	(7.4)
Honduras	3.8	(18.1)	(13.0)	(15.3)	(11.2)
Hong Kong	2.9	(14.2)	(8.7)	(18.6)	(14.2)
India	2.4	(10.8)	(6.2)	(12.3)	(8.1)
Indonesia	5.1	(21.0)	(12.4)	(20.3)	(12.3)
Italy	1.7	(6.3)	0.3	(9.4)	(3.2)
Kenya	0.7	(18.0)	(12.3)	(9.6)	(7.7)
korea	1.2	(2.5)	(5.0)	(4.8)	(7.1)
Mexico	9.6	(13.7)	(12.7)	(14.0)	(13.7)
Holland	5.7	(6.3)	0.3	(10.1)	(4.1)
Nicaragua	1.8	(18.3)	(13.2)	(15.6)	(11.1)
Panama	0.3	(14.1)	(8.7)	(16.6)	(12.0)
Peru	1.8	(9.1)	(6.9)	(10.7)	(8.9)
Philippines	1.6	(15.2)	(11.7)	(13.3)	(12.0)
Thailand	1.8	(12.9)	(5.9)	(15.2)	(8.9)
Venezuela	0.3	(28.4)	(21.8)	(19.1)	(10.1)
Vietnam	4.6	(14.8)	(10.0)	(16.0)	(11.7)
Total	100.0	**(13.6)**	**(8.6)**	**(13.2)**	**(10.1)**

Source: Banco de la República.

and makes the economy more competitive, provided the RER is overvalued (below equilibrium) at the time of devaluation. However, if the RER is initially above its equilibrium level (undervalued peso), and if devaluation is not accompanied by a decline in domestic spending, the increase in domestic prices will eliminate the effect of that devaluation. In this case, the RER returns to its original level, leaving only the inflationary cost of the monetary policy.

Box 2

What Have Other Countries Done to Curb Revaluation and Inflationary Pressures?

One of the principal features of international capital markets in recent years is their broad liquidity. This is explained mostly by a lax monetary policy in the United States as of 2001, when that economy began to show signs of a slowdown. The sharp reduction in interest rates set by the Federal Reserve Bank and the macroeconomic imbalances in the United States have generated strong pressure for devaluation of the dollar against the world's other currencies, and the Latin American countries are no exception (Table B2.1).

Table B2.1
Devaluation, Exchange Rates at March 9, 2005

	Devaluation		
	Year to date	**Full year**	**Two years ago**
Colombia	(2.51)	(12.48)	(21.05)
Brazil	2.40	(6.29)	(20.18)
Mexico	(1.19)	0.52	1.44
Argentina	(1.18)	0.84	(5.71)
Venezuela	11.94	11.96	34.36
Peru	(0.67)	(5.89)	(6.39)
Uruguay	(2.67)	(13.21)	(10.39)
Chile	5.92	(2.30)	(20.69)

Source: Bloomberg.

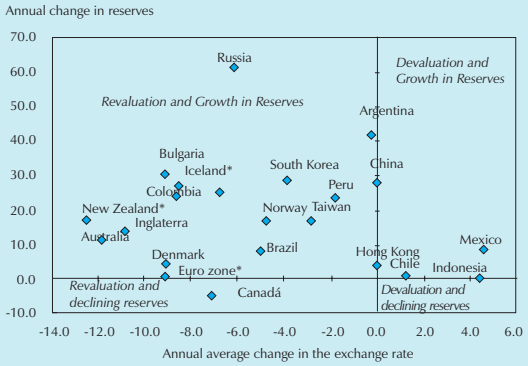
In an effort to curb appreciation of their currencies, the policies of a sample of countries, particularly those that use the inflation targeting strategy, combine accumulation of international reserves with the use of monetary policy instruments. Graph B2.1 shows the average annual change in the exchange rate and the annual change in international reserves during 2004 (compared with 2003)[1]. In 17 of these countries, the average exchange rate appreciated during 2004. A similar number of countries raised their international reserves by more than 5%. In the case of Colombia, the increase was 24%, which is higher than the majority of countries and comparable to those that accumulated the most foreign exchange.

On the other hand, the majority of the countries with a monetary policy based on inflation targeting, like Colombia, raised intervention interest rates on two or more occasions in 2004 (Table B2.2 and Graph B2.2).

[1] The sample includes the countries for which information was obtained.

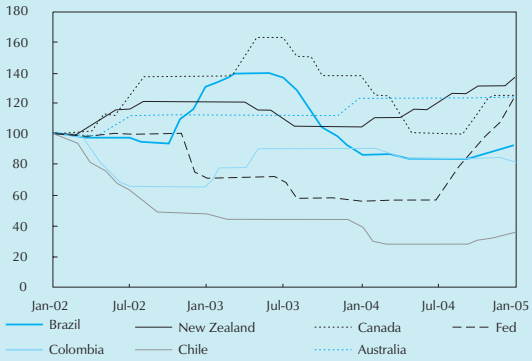
The exceptions were Australia, which made no change in these rates, and Colombia, which lowered them on three occasions.

Graph B2.1
Annual Change in the Average Exchange Rate versus the Change in Reserves in Some Counties 2003-2004



(*) Change during the year to date, based on the latest data available.
Source: Information from the web sites of Banco de la República.

Graph B2.2
Intervention Interest Rates of Some Banco de la Repúblicas
(January 2002 = 100)



Source: Bloomberg.

Table B2.2
Movement of Several Monetary Indicators in Countries with Inflation Targeting

Country	Changes in the reference interest rate 2004	Accumulation or deaccumulation of NET (billions of dollars/ percentage change) 2004	Average change in the nominal exchange rate (Percentage)		Economic growth (Percentage)	
			2003	2004	2003	2004 (*)
Australia	none	3.7	(16.2)	(11.8)	3.0	3.6
		11%				
New Zealand	Up 6	1.0	(20.3)	(12.4)	3.4	4.2
		17%				
Brazil	Down 2	3.6	(5.4)	(5.0)	(0.2)	4.0
	Up 4	74%				
Canada	Down 3	(1.8)			2.0	2.9
	Up 2	-5%	(10.8)	(7.1)		
Chile	Down 2	0.2	0.2	1.2	3.3	4.9
	Up 4	10%				
Peru	Up 2	2.4			4.1	4.5
		24%	(1.1)	(1.9)		
Colombia	Down 3	2.6	14.9	(8.7)	3.8	3.8
		24%				

(*) IMF estimates.
Source: Banco de la República calculations using information from Banco de la República and the IMF.

V. Fiscal Policy

The size of the deficit declined considerably in relation to 2003, thanks to better performance in the decentralized sector. Improved finances in this sector and the profits generated by the Banco de la República of Colombia (0.5% of GDP) and Fogafin (0.3%) partly offset the national government's fiscal imbalance, which came to 5.6% of GDP in 2004 (Col$13,983 b).

A. Fiscal Performance in 2004

According to preliminary figures, the consolidated deficit in the public sector was Col$3,016 b at the close of 2004. This is equivalent to 1.2% of GDP and signals compliance with the fiscal target agreed on with the International Monetary Fund (IMF); that is, 2.3% of GDP. The size of the deficit declined considerably in relation to 2003, thanks to better performance in the decentralized sector. The surplus in this sector rose from 2.5% of GDP in 2003 to 4.2% of GDP in 2004. This improvement in performance is due to accumulation of a surplus in several special public pension funds and a favorable situation for territorial finances, because of a slow spending process that probably will reverse itself 2005 (Table 12).

Improved finances in the decentralized sector and profits generated by the Banco de la República of Colombia (0.5% of GDP) and Fogafin (0.3%) partly offset the central national government's fiscal imbalance, which came to 5.6% of GDP in 2004 (Col$13,983 b).

The government's financial deficit was the result of a 16.0% increase in revenue coupled with 17.3% growth in expenditure. The biggest sources of revenue were income tax, the external and internal value added tax (VAT), and the tax on bank transactions, which increased by 29.4%, 16.7%, 13.3% and 38% respectively. The way these levies performed is tied to the latest tax reforms, especially those that increased the number of people who are required to file an income tax return and raised the bank transaction tax from 0.0003% to 0.004% (Table 13).

With respect to government spending, the reduction in external interest rates, largely because of exchange rate appreciation, was an important aspect, as was the increase in transfers, particularly for the general government revenue-sharing system and pension outlays. Pension

CONSOLIDATED PUBLIC SECTOR 2003-2004 FISCAL BALANCE(*)

Items	Billions of pesos		Percentage of GDP	
	2003	2004 (pr)	2003	2004 (pr)
Electricity	755.0	485.0	0.3	0.2
Emcali	379.0	271.0	0.2	0.1
EPM	(11.0)	502.0	(0.0)	0.2
FAEP	(139.0)	167.0	(0.1)	0.1
Ecopetrol	1,247.0	296.0	0.5	0.1
Telecom	(123.0)	261.0	(0.1)	0.1
Other agencies	693.0	799.0	0.3	0.3
Social security	1,703.0	4,163.0	0.7	1.7
Regional and local	968.0	3,407.0	0.4	1.4
National Coffee Fund	310.0	37.0	0.1	0.0
1. Decentralized Sector Subtotal	5,782.0	10,388.0	2.5	4.2
2. National Government	(11,528.1)	(13,983.2)	(5.1)	(5.6)
A. Total non-financial public sector (SPNF) (1 + 2)	(5,746.1)	(3,595.2)	(2.5)	(1.4)
B. Cash profit and loss of Banco de la República	1,437.0	1,225.0	0.6	0.5
C. Cash profit and loss of Fogafin	582.0	720.0	0.3	0.3
D. Financial system restructuring cost	(941.0)	(920.0)	(0.4)	(0.4)
E. Adjustments	(1,577.0)	(446.0)	(0.7)	(0.2)
F. Consolidated Public Sector Total (A + B + C + D + E)	(6,245.1)	(3,016.2)	(2.7)	(1.2)

(pr) Preliminary.
1/ Deficit (-) or surplus (+).
Source: CONFIS.

payments rose by 30%, following depletion of the pension reserves of the Social Security Institute (ISS). This means an added fiscal burden for the nation as of 2004. Investment spending was up 8.5%.

Deficit financing came from internal and external credit, profits transferred by the Banco de la República, and use of the portfolio and other resources of the National Treasury. During 2004, the policy on financing gave preference to internal sources. The government financed 23.1% of its deficit through external borrowing and 47.7% with internal loans[4]. The remainder (29%) was financed via other sources, including profits transferred by the Banco de la República of Colombia. The government saw an increase in its external borrowing by Col$3,446 b as a result of Col$6,978.1 b in outlays and Col$3,531.9 b in amortization. The growth in domestic borrowing came to Col$7,122 b, following Col$16,429 b in new outlays and Col$9,307 b in amortization. Class B Treasury Bonds were the primary instrument for domestic borrowing, with Col$16,219 b in gross proceeds.

[4] In 2003, these percentages were 45.0% and 495, respectively.

Despite the high central government deficit, the outstanding balance was down from 54.3% of GDP in 2003 to 51% of GDP at the end of 2004. This was largely because of appreciation in the exchange rate during the year, which lowered the external component of the debt from 25.2% of GDP in 2003 to 21.2% in 2004.

TABLE 13

CENTRAL GOVERNMENT OF COLOMBIA
2003-2004 FISCAL BALANCE
(BILLIONS OF PESOS)

	2003	2004 (pr)	Annual Growth 2003 - 2004
I. Total Revenue (A + B + C + D + E)	34,445.4	39,951.4	16.0
A. Tax Revenue	31,372.7	36,735.6	17.1
Income	11,729.5	15,181.7	29.4
Internal VAT	8,887.9	10,073.7	13.3
External VAT	4,183.5	4,881.9	16.7
Levy	2,158.9	2,233.1	3.4
Gasoline	1,025.0	1,057.4	3.2
Bank transactions	1,621.5	2,237.6	38.0
Democratic Security Policy	1,231.0	0.0	(100.0)
Others	535.4	1,070.2	99.9
B. Non-tax revenue	205.8	201.6	(2.0)
C. Special funds	321.0	380.9	18.7
D. Capital resources	2,419.0	2,508.3	3.7
Financial returns	535.1	489.9	(8.4)
Financial surpluses	1,674.4	1,845.4	10.2
Others	209.5	173.0	(17.4)
E. Accrued revenue	126.9	125.0	(1.5)
II. Total Expenditure (A + B + C + D + E + F)	45,973.5	53,934.6	17.3
A. Interest	9,655.2	10,266.0	6.3
External	4,349.2	4,320.0	(0.7)
Internal	5,306.0	5,946.0	12.1
B. Operational	32,566.7	37,430.7	14.9
Personal services	6,130.0	6,581.5	7.4
General expenses	2,162.7	2,227.2	3.0
Transfers	24,274.0	28,622.0	17.9
C. Investment	2,882.8	3,126.5	8.5
D. Net loan	864.8	298.2	(65.5)
E. Floating debt	(558.0)	2,198.0	(493.9)
F. Indexed investment in TES B denominated in UVR	562.0	615.2	9.5
III. Deficit (-) or Surplus (+) (I - II) (*)	(11,528.1)	(13,983.2)	21.3
Financial system reconstruction cost	941.1	919.7	(2.3)
IV. Financing (A + B + C + D)	(12,469.2)	(14,902.9)	19.5
A. Net external credit	5,600.0	3,446.2	(38.5)
Disbursements	12,784.0	6,978.1	(45.4)
Amortization	7,184.0	3,531.9	(50.8)
B. Net internal credit	6,144.1	7,122.0	15.9
Disbursements	13,538.1	16,429.0	21.4
Amortization	7,394.0	9,307.0	25.9
C. Banco de la República profits	1,479.7	802.8	(45.7)
D. Others	(754.6)	3,531.9	(568.0)
V. Deficit as a Percentage of GDP	(5.1)	(5.6)	

(pr) Preliminary.
(*) Does not include the cost of restructuring the financial system.
Source: CONFIS.

B. The Financial Plan for 2005

The deficit target approved for 2005 by the Council on Fiscal Policy (CONFIS) is equivalent to 2.2% of GDP. It could be raised to 2.5% of GDP, provided that investment projects with a high social rate of return are conducted during the year, but without affecting the mid-term sustainability of the public debt. If so, the finances of the decentralized public sector would have to generate a surplus that amounts to nearly to 3.7% of GDP, so as to comply with the fiscal goal. This would partially offset the estimated CGC deficit of 6.1% of GDP (Table 14).

According to current estimates by CONFIS, the CGC deficit (6.1% of GDP) would stem from an estimated 9.7% growth in revenue and an 11.8% rise in expenditure. As to tax revenue, an increase of 11.8% in income tax revenue is expected, along with 9.3% growth in internal VAT and 17.6% in revenue from the gasoline tax. The growth in income tax revenue will depend primarily on the reduction in certain exemptions, as well as economic performance in 2004 and the elimination of all local tax deductions when calculating this levy. The trend in internal VAT will

Table 14

Consolidated Public Sector Fiscal Balance: 2004 and 2005 (*)

Items	Billions of Pesos		Percentage of GDP	
	2004(pr)	2005	2004	2005
Electricity	485.0	605.0	0.2	0.2
Emcali	271.0	420.0	0.1	0.2
EPM	502.0	327.0	0.2	0.1
FAEP	167.0	(458.0)	0.1	(0.2)
Ecopetrol	296.0	1,040.0	0.1	0.4
Telecom	261.0	59.0	0.1	0.0
Other agencies	799.0	1,989.0	0.3	0.7
Social security	4,163.0	4,703.0	1.7	1.7
Regional and local	3,407.0	1,333.0	1.4	0.5
National Coffee Fund	37.0	12.0	0.0	0.0
1. Decentralized Sector Subtotal	10,388.0	10,030.0	4.2	3.7
2. National Government	(13,983.2)	(16,475.0)	(5.6)	(6.1)
A. Total non-financial public sector (SPNF) (1 + 2)	(3,595.2)	(6,445.0)	(1.4)	(2.4)
B. Cash profit and loss of Banco de la República	1,225.0	182.0	0.5	0.1
C. Cash profit and loss of Fogafin	720.0	383.0	0.3	0.1
D. Financial system restructuring cost	(920.0)	(996.0)	(0.4)	(0.4)
E. Adjustments	(446.0)	0.0	(0.2)	0.0
F. Consolidated Public Sector Total (A + B + C + D + E)	(3,016.2)	(6,876.0)	(1.2)	(2.5)

(*) Deficit (-) or surplus (+).
(pr) Preliminary.
Source: CONFIS.

reflect the increase from 7% to 10% in the rate applicable to the goods and services stipulated in Law 788/2002. Revenue from the global gasoline tax will depend mostly on the economic activity anticipated for 2005.

As to CGC spending, the expectation is that interest on the debt will be up by 17.2%, operating expenses by 19.8% and investment by 59.7%. As much as Col$2.4 b in transfers to the Territorial Pension Fund (FONPET) will be an important part of the operating expenses in 2005, as will pension outlays, which will increase by almost 50%. As mentioned earlier, the growth in this last item is due to the depletion of ISS reserves, a situation that will require a transfer of almost $4 trillion (t) to ISS this year. The rise in investment will originate with items that have been added to the budget, namely for more military equipment and to build facilities in several parts of the country. The net loan will come to Col$404 b, up by 35.1% compared with the payments made in 2005.

The CGC will finance its debt mostly through domestic credit (Col$12,193 b net) and with the National Treasury portfolio and other resources (Col$3,276 b net). Domestic credit transactions will include the sale of Col$24,031 b in TES B, with Col$9,499 b of this amount to be auctioned.

Official estimates point to an improved fiscal situation in the decentralized public sector, thanks to better performance expected of several government-owned companies. Ecopetrol is one example. Also, there is expected to be a sizable surplus in social security given the accumulation of resources in several public pension funds. In the case of Ecopetrol, the fiscal situation is expected to be more relaxed due to the positive trend in international prices for crude oil.

In general, the outlook for public-sector finances in 2005 is relatively favorable. There are, however, several lingering concerns, particularly about the central government's finances. A serious lack of flexibility in spending and a limited margin of maneuverability to significantly increase tax revenue hamper the fiscal performance of the central government. Once again, the depletion of ISS pension reserves will imply an enormous increase in government outlays. These will have consequences for the future, given the excessively large pension liability incumbent on the State. This makes it particularly difficult to achieve a steady reduction in the size of the deficit and in the extent of the central government's debt. At the same time, the future of the oil industry will have to be analyzed carefully, since hydrocarbon reserves are being depleted and there have been no new discoveries.

There are, however, several lingering concerns, particularly about the central government's finances. A serious lack of flexibility in spending and a limited margin of maneuverability to significantly increase tax revenue hamper the fiscal performance of the central government.

VI. Balance of payments

The growth in exports of goods and services surpassed the rise in imports mentioned earlier, lowering the current account deficit from 1.5% of GDP in 2003 to 1.0% in 2004.

A. Balance of Payments: 2004

Estimates [5] show a US$1,002 m balance of payments deficit in the current account for 2004 (1.0% of GDP) and US$3,235 m in net capital inflows (3.4% of GDP). The accumulation in gross reserves came to US$2,585 m in 2004 for a balance of US$13.540 m at December (Table 15).

1. Current Account

The current account deficit in 2004 was down by US$100 m in relation to 2003. This was due to US$459 m less of a deficit in the balance for non-financial goods and services. Coupled with an increase of almost US$328 m in net income from foreign transfers, this offset the larger deficit (by US$686 m) in payment for factor services.

The trade surplus was US$513 b more than in 2003 due to an increase of 25.6% in merchandise exports as opposed to 20.0% import growth. As indicated earlier, the significant rise in exports is explained by better terms of trade and by added growth in the economies of our major trading partners. In 2004, the GDP of these economies rose by 5.6%, on average, as opposed to 0.9% in 2003. This raised foreign demand for non-traditional goods. Exports of these items rose by 28.4% after having fallen off 4.9% in 2002 and -0.4% in 2003. An important part of this performance is explained by the sizeable increase in sales to Venezuela. These were stimulated by the recovery of that country's economy, which grew at an annual rate of 18.1% in 2004, following a drop of 7.6% the year before.

The significant rise in exports is explained by better terms of trade and by added growth in the economies of our major trading partners

[5] At the time this report was presented, there was no final information on the balance of payments for 2004.

Table 15

Balance of Payments Summary - Colombia

	Millions of dollars			As a Percentage of GDP			Difference 2004-2003 Millions of dollars
	2002	2003 (pr)	2004 (e)	2002	2003 (pr)	2004 (e)	
I. Current account	(1,371)	(1,101)	(1,001)	(1.7)	(1.4)	(1.0)	100
Income	17,902	19,777	23,535	22.0	25.0	24.5	3,758
Outlays	19,273	20,878	24,536	23.6	26.4	25.6	3,657
A. Non-factor goods and services	(1,227)	(989)	(530)	(1.5)	(1.2)	(0.6)	458
1. Goods	239	524	1,037	0.3	0.7	1.1	513
Exports	12,316	13,782	16,948	15.1	17.4	17.7	3,166
Imports	12,077	13,258	15,910	14.8	16.7	16.6	2,653
2. Non-factor services	(1,466)	(1,513)	(1,568)	(1.8)	(1.9)	(1.6)	(55)
Exports	1,866	1,879	2,066	2.3	2.4	2.2	187
Imports	3,332	3,392	3,634	4.1	4.3	3.8	242
B. Factor income	(2,848)	(3,446)	(4,132)	(3.5)	(4.4)	(4.3)	(686)
Income	711	548	623	0.9	0.7	0.6	75
Outlays	3,559	3,994	4,755	4.4	5.0	5.0	760
C. Current transfers	2,704	3,334	3,662	3.3	4.2	3.8	328
Income	3,008	3,568	3,898	3.7	4.5	4.1	331
Outlays	304	234	236	0.4	0.3	0.2	3
II. Capital and Financial Account	1,303	810	3,235	1.6	1.0	3.4	2,425
A. Financial account	1,303	810	3,235	1.6	1.0	3.4	2,425
1. Long-term financial flows	(1,421)	995	1,554	(1.7)	1.3	1.6	559
a. Assets	857	938	128	1.1	1.2	0.1	(810)
i. Colombian direct investment abroad	857	938	128	1.1	1.2	0.1	(810)
ii. Loans 1/	0	0	0	0.0	0.0	0.0	0
iii. Leasing	0	0	0	0.0	0.0	0.0	0
iv. Other assets	0	0	0	0.0	0.0	0.0	0
b. Liabilities	(535)	1,962	1,731	(0.7)	2.5	1.8	(231)
i. Foreign direct investment in Colombia	2,115	1,793	2,343	2.6	2.3	2.4	550
ii. Loans 1/	(2,487)	507	(477)	(3.0)	0.6	(0.5)	(984)
Public sector	(1,300)	1,283	790	(1.6)	1.6	0.8	(493)
Private sector	(1,187)	(776)	(1,267)	(1.5)	(1.0)	(1.3)	(491)
iii. Arrendamiento financiero	(162)	(337)	(134)	(0.2)	(0.4)	(0.1)	203
Public sector	(3)	(19)	(9)	(0.0)	(0.0)	(0.0)	9
Private sector	(160)	(319)	(125)	(0.2)	(0.4)	(0.1)	194
iv. Other liabilities	0	0	0	0.0	0.0	0.0	0
c. Other long-term financial movement	(30)	(30)	(50)	(0.0)	(0.0)	(0.1)	(20)
2. Short-term financial flows	2,724	(185)	1,681	3.3	(0.2)	1.8	1,866
a. Assets (2,335)	61	458	(2.9)	0.1	0.5	397	
i. Portfolio investment	(2,030)	1,741	1,524	(2.5)	2.2	1.6	(218)
ii. Loans 2/	(305)	(1,680)	(1,065)	(0.4)	(2.1)	(1.1)	615
b. Pasivos	389	(124)	2,139	0.5	(0.2)	2.2	2,263
i. Portfolio investment	16	(20)	370	0.0	(0.0)	0.4	390
ii. Loans 2/	373	(104)	1,769	0.5	(0.1)	1.8	1,873
B. Special capital flows	0	0	0	0.0	0.0	0.0	0
III. Net Errors and Omissions	207	108	351	0.3	0.1	0.4	243
IV. Change in Gross International Reserves 3/	138	(184)	2,585	0.2	(0.2)	2.7	2,769
V. Gross International Reserve Balance	10,844	10,921	13,540	13.3	13.8	14.1	2,619
VI. Net International Reserve Balance	10,841	10,916	13,536	13.3	13.8	14.1	2,620
Months worth of merchandise imports	11	10	10				
Months worth of goods and service imports	7	6	7				
Nominal GDP in millions of dollars	81,552	79,186	95,868				
VII. Change in Net International Reserves	188	(188)	2,585	0.2	(0.2)	2.7	2,773

(pr) Preliminary.
(e) Estimate.
1/ Includes portfolio investment, direct loans and commercial credit.
2/ Includes direct loans and commercial credit.
3/ According to the balance-of-payments methodology
Source: Banco de la República.

Table 16 summarizes export performance during the year, by product. In terms of dollar sales, coffee and hydrocarbon exports increased by 17.8% and 23.5%, respectively, while growth in ferronickel exports came to 51.0%. However, exports of these products declined in terms of volume (Table 17). Coal exports rose by 29.4%, due to an increase in sales volume and export prices.

TABLE 16

EXPORTS CLASSIFIED BY LEADING PRODUCTS AND ECONOMIC SECTORS

	Millions of dollars			Absolute Change (Millions of dollars)		Percentage Change	
	2002	2003 (pr)	2004 (pr)	2003	2004	2003	2004
Traditional exports	5,496	6,692	8,227	1,195.5	1,535.1	21.8	22.9
Coffee	772	806	949	34.1	143.1	4.4	17.8
Petroleum and petroleum by-products	3,275	3,383	4,180	108.2	796.3	3.3	23.5
Coal	990	1,422	1,841	432.3	418.5	43.7	29.4
Ferronickel	272	415	626	142.2	211.4	52.2	51.0
Non-monetary gold	94	585	556	490.8	(28.9)	519.9	(4.9)
Emeralds	92	80	74	(12.1)	(5.5)	(13.1)	(6.9)
Non-traditional exports (*)	6,411	6,388	8,205	(23.1)	1,816.4	(0.4)	28.4
Agricultural sector	1,383	1,367	1,594	(15.7)	227.0	(1.1)	16.6
Industrial sector	4,954	4,890	6,413	(63.4)	1,522.5	(1.3)	31.1
Mining	75	131	198	56.0	66.9	74.8	51.1
Total exports of goods	11,907	13,080	16,431	1,172.5	3,351.4	9.8	25.6

(pr) Preliminary.
(*) Does not include temporary exports and others. Includes balance-of-payment adjustments.
Source: DANE and Banco de la República calculations.

TABLE 17

TRADITIONAL EXPORTS AND GOLD: VOLUMES AND PRICES

	2003	2004 (pr)	2005 (proj)	Percentage Change	
				2004	2005
Coffee					
Export volume (millions of bags)	10.2	10.2	10.2	(0.5)	0.0
Ex Dock price (dollars per pound)	0.7	0.9	1.0	29.1	9.9
Coal					
Export volume (thousands of tons)	50,992.6	51,359.7	57,522.9	0.7	12.0
Price (US$ per ton)	28.2	35.8	35.8	27.3	0.0
Ferronickel					
Export volume (thousands of tons)	131.9	138.1	138.1	4.7	0.0
Price (dollars per pound)	1.4	2.1	2.1	43.5	1.3
Gold					
Export volume (thousands of troy ounces)	1,871.5	1,756.5	1,774.1	(6.1)	1.0
Price (dollars per troy ounce)	362.5	369.7	437.5	2.0	18.4
Oil					
Crude export volume (thousands of barrels/day)	237.4	226.0	221.0	(4.8)	(2.2)
Price (dollars per barrel)					
Average crude	**29.0**	**35.3**	**41.3**	21.6	17.0
Cusiana	29.8	38.2	47.1	28.4	23.2
Other crudes	27.7	32.8	40.4	18.5	23.2
Fuel-Oil	20.6	22.7	27.9	10.0	23.2
ACPM	35.7	44.3	54.6	24.2	23.2
Other crudes	42.7	46.4	57.1	8.7	23.2

(pr) Preliminary.
(proj) Projection.
Source: DANE. Banco de la República estimates according to international analysts, coffee advisers, Ecopetrol and IMF.

Remittances from workers outside the country were estimated at US$3,170 m.

On the other hand, sales to Venezuela, which rose by 130.3%, were an important part of the growth in non-traditional exports, as were those to the United States, which grew by 12.7% and account for 42.2% of total exports (Table 18).

Imports increased significantly in all the merchandise groups, but primarily with respect to raw materials and capital goods for industry. The growth in purchases of consumer durables (27.9% during the year) also was important (Table 19). This surge in the demand for imports for industry is a good indicator of the force of investment and industrial activity in 2004.

In 2004, remittances from workers outside the country and foreign donations rose by US$331 m (9.3%) compared with 2003. The dollar value of remittances from Europe accounted for nearly 36% of the total; it also increased because the Euro appreciated. On the other hand, nearly 49% of all remittances from Colombian workers abroad originate in the United States.

2. Capital Account

In 2004, 48.0% of the net receipts for the capital account (US$3,235 m) were explained by long-term capital (equivalent to 1.6% of GDP) and 52.0% by short-term capital. Medium and long-term capital flows were in the form of net foreign direct investments, which came to US$2,215 m

TABLE 18

PERCENTAGE OF GROWTH IN THE DOLLAR VALUE OF NON-TRADITIONAL EXPORTS (PR)
JANUARY-DECEMBER 2004

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	Others	Total
Totals	**12.7**	**130.3**	**26.0**	**29.9**	**(0.2)**	**41.8**	**27.1**	**25.6**
Non-traditional Exports	**7.3**	**134.3**	**21.4**	**5.9**	**(8.4)**	**18.7**	**18.4**	**25.3**
Agricultural sector	2.8	261.4	(11.0)	11.7	(20.6)	(32.2)	8.3	16.6
Industrial sector	17.6	119.8	19.3	7.5	16.0	19.2	19.3	31.1
Food, beverages and tobacco	12.4	58.8	(7.0)	14.5	102.4	95.5	11.2	20.0
Yarn, thread and fabric	(3.2)	227.3	9.7	0.0	17.5	12.7	3.6	39.6
Clothing	20.0	130.8	47.1	216.7	(34.4)	47.4	43.2	33.5
Plastic and rubber products	66.6	93.3	1.4	n.a.	214.3	21.2	31.6	31.8
Leather and leather goods	10.5	266.4	20.1	321.7	12.4	18.1	3.9	15.6
Wood and wood products	(39.3)	176.8	21.9	n.a.	30.0	265.1	(12.7)	(15.5)
Printing and publishing	1.3	52.8	18.5	(5.4)	35.7	(8.6)	13.7	16.4
Chemical industry	29.4	46.5	17.0	(30.1)	(4.2)	(4.0)	22.5	23.7
Non-metallic minerals	9.4	160.2	19.1	(33.3)	n.a.	(19.3)	(4.1)	12.4
Base metal industry	66.7	171.9	37.5	(59.0)	(43.1)	52.8	34.7	53.7
Machinery and equipment	57.8	101.2	21.7	90.9	103.0	47.3	32.9	49.5
Transport material	(27.9)	1.021.5	39.0	n.a.	80.0	(34.5)	59.3	179.5
Optical, cinema and other equipment	(60.8)	93.3	22.9	62.5	(50.0)	59.3	43.5	8.6
Other industries	(8.1)	125.8	23.2	70.0	(50.6)	13.2	15.4	15.6
Mining sector **(*)**	(10.4)	71.7	46.5	(0.5)	6.4	(36.4)	34.0	4.1

(pr) Preliminary.
n.a. Not applicable.
(*) Includes gold and emeralds.
Source: DANE and Banco de la República calculations

(2.3% of GDP). This is a substantial increase compared with 2003 (US$855 m). Most of the capital that entered the country as direct foreign investment was used to develop coal fields and for oil exploration. These receipts more than offset net payments on the long-term debt (US$612 m) in 2004, particularly on the private-sector portion (US$1,392 m), since the public sector obtained US$780 m in net disbursements. With this, the total outstanding medium and long-term debt at the close of 2004 was estimated at US$34,151 m (35.6% of GDP), 73.4% of which is owed by the public sector (Table 20).

An estimated US$1,681 m in short-term capital entered the country in 2004, following a reported US$185 m in capital outflows during 2003 (Table 15). These capital inflows are consistent with the weakening stance of the dollar on international financial markets, which prompted investors to look for investment alternatives in emerging countries like Colombia. This resulted in the exchange pressures that were explained in Chapter III. Foreign investment funds invested US$370 m, as opposed to a reported US$ 20 m in outflows during 2003. According to estimates, this capital was invested primarily in TES (US$299 m) and, to a lesser degree, in the Colombian stock market (US$71 m). For their part, private Colombian investors behaved similarly to foreigner investors and recomposed their asset portfolios by paying off external debts or investing in Colombian pesos.

TABLE 19

IMPORTS ACCORDING TO THE CUODE CLASSIFICATION
(MILLIONS OF DOLLARS (FOB))

	January-December		Change	
	2003	2004	Absolute	Percentage
Consumer goods	2,499.0	2,944.3	445.3	17.8
Durables	1,184.8	1,515.8	331.0	27.9
Non-durables	1,314.2	1,428.5	114.3	8.7
Intermediate goods	6,114.2	7,612.4	1,498.1	24.5
Fuel and lubricants (,)	222.2	243.5	21.3	9.6
For agriculture	496.3	605.3	109.0	22.0
For industry	5,197.9	6,498.8	1,301.0	25.0
Building materials	197.9	264.7	66.8	33.8
Capital goods	4,391.3	5,041.9	650.6	14.8
For agriculture	50.7	51.8	1.1	2.1
For industry	2,787.8	3,238.6	450.8	16.2
Transport equipment	1,552.8	1,751.5	198.7	12.8
Unclassified goods	25.2	30.5	(8.0)	21.2
Total imports	**13,029.7**	**15,629.1**	**2,586.0**	**19.9**

(pr) Preliminary.
(*) Includes by-products of petroleum and coal.
Source: DANE and the Bureau of Internal Revenue and Customs (DIAN).

TABLE 20

COLOMBIA'S OUTSTANDING EXTERNAL DEBT

	Millions of dollars					GDP Percentage (,)				
	2000	2001	2002	2003	2004 (pr)	2000	2001	2002	2003	2004
Total Balance	**36,130**	**39,109**	**37,337**	**38,066**	**39,560**	**43.1**	**47.7**	**45.8**	**48.1**	**41.3**
Public sector	20,608	23,469	22,781	24,528	25,778	24.6	28.6	27.9	31.0	26.9
Private sector	15,522	15,640	14,555	13,538	13,782	18.5	19.1	17.8	17.1	14.4
1. Medium and long term	**33,616**	**35,987**	**33,845**	**34,701**	**34,151**	**40.1**	**43.9**	**41.5**	**43.8**	**35.6**
a. Public sector, by lender	20,305	23,053	22,262	24,228	25,321	24.2	28.1	27.3	30.6	26.4
Non-financial public sector	18,695	22,020	21,428	23,634	24,856	22.3	26.9	26.3	29.8	25.9
Government	14,326	18,188	18,013	20,663	22,335	17.1	22.2	22.1	26.1	23.3
Decentralized agencies	4,369	3,832	3,415	2,971	2,521	5.2	4.7	4.2	3.8	2.6
Financial public sector	1,610	1,033	834	594	465	1.9	1.3	1.0	0.7	0.5
b. Private sector	10,489	10,332	9,145	8,369	6,858	12.5	12.6	11.2	10.6	7.2
Financial	717	434	217	166	151	0.9	0.5	0.3	0.2	0.2
Non-financial	9,772	9,898	8,928	8,203	6,707	11.7	12.1	10.9	10.4	7.0
c. Financial leasing	2,822	2,601	2,438	2,104	1,972	3.4	3.2	3.0	2.7	2.1
Public	104	95	91	76	66	0.1	0.1	0.1	0.1	0.1
Private	2,717	2,507	2,347	2,028	1,906	3.2	3.1	2.9	2.6	2.0
2. Short term	**2,514**	**3,122**	**3,492**	**3,365**	**5,409**	**3.0**	**3.8**	**4.3**	**4.2**	**5.6**
a. Public sector	199	320	429	224	391	0.2	0.4	0.5	0.3	0.4
b. Private sector	2,315	2,802	3,063	3,141	5,018	2.8	3.4	3.8	4.0	5.2
Memorandum item:										
Total balance minus financial leasing	**33,308**	**36,508**	**34,899**	**35,962**	**37,588**	**39.8**	**44.5**	**42.8**	**45.4**	**39.2**
Public	20,504	23,374	22,691	24,452	25,712	24.5	28.5	27.8	30.9	26.8
Private	12,805	13,134	12,208	11,510	11,876	15.3	16.0	15.0	14.5	12.4

(pr) Preliminary.
(*) Calculated on the basis of the exchange rate at the end of the period.
Source: Banco de la República.

The sizeable rise in short-term external borrowing compared with the year before (US$1,873 m) was another highlight. This increase is linked to the growth in commercial activity, particularly the rise in imports. Likewise, with expectations of peso revaluation, the difference between domestic and external profitability tends to encourage borrowing in dollars. The short -term debt in 2004 is calculated at US$5,409 m (5.6% of GDP), with 92% in the private sector. In all, the country's external debt position at the end of 2004, both public and private, came to US$39,560 m (41.3% of GDP), with US$$25,778 m (26.9% of GDP) in the hands of the public sector and US$13,782 m (14.4% of GDP) in the private sector. The notable decline in the amounts outstanding on the total external debt as a portion of GDP reflects the accounting impact of debt stock revaluation.

In short, excluding capital from foreign direct investment, the private sector brought nearly US$935 m in net resources into the country in the form of new loans and liquidated investments abroad (deaccumulation of external assets). In contrast, the four previous years saw an accumulation of external assets (Table 21).

However, it should be noted that much less capital entered the country in 2004 than, for example, between 1993 and 1998. This is demonstrated by the size of the current account deficit expected for

CAPITAL AND FINANCIAL BALANCE
ANNUAL FLOWS (MILLIONS OF DOLLARS)

	2000	2001	2002	2003	2004 (e)
Net foreign investment in Colombia	2,069	2,509	1,258	855	2,215
Foreign investment in Colombia	2,395	2,525	2,115	1,793	2,343
Colombian investment outside the country	(325)	(16)	(857)	(938)	(128)
Public Sector Total	496	1,478	393	457	133
Non-financial	1,297	1,951	525	750	558
Financial	(801)	(473)	(131)	(293)	(424)
Non-financial private sector total without FDI	(2,447)	(1,476)	(319)	(473)	935
Non-financial	(2,135)	(1,445)	(144)	(32)	399
Financial	(313)	(31)	(174)	(441)	536
Non-financial private sector	(2,135)	(1,445)	(144)	(32)	399
Leasing	(109)	(211)	(160)	(319)	(125)
Long-term	(479)	126	(970)	(726)	(1,252)
Short-term	(1,547)	(1,360)	985	1,012	1,775
Private financial sector	(313)	(31)	(174)	(441)	536
Long-term	(520)	(284)	(217)	(51)	(15)
Short-term	208	253	43	(390)	551

(e) Estimate.
Source: Banco de la República.

2004 (1.0% of GDP versus an average 4.8% of GDP between 1993 and 1998) and the financial and capital account surplus (3.4% of GDP versus 5.03% of GDP, on average, between 1993 and 1998). In effect, the current account deficit declined in 2004, while growth in domestic absorption remained high. This suggests that part of exchange rate appreciation came from exogenous movements in the current account, such as the improvements in terms of trade, transfers and the rebound in external demand for Colombian products.

3. Change in International Reserves

The Banco de la República of Colombia was actively involved in the exchange market during 2004. As noted earlier, the country's international reserves experienced a 24% increase, placing them at US$13,536 m. This is equivalent to 10.2 months worth of merchandise imports, 6.7 months worth of imports of goods and services, and 1.6 times the value of public and private debt amortization in one year.

B. OUTLOOK FOR THE BALANCE OF PAYMENT IN 2005

As to the balance of payments, the current account deficit forecast for this year is close to US$2,750 m (2.4% of GDP), primary because of the

projected decline in the merchandise trade balance from a surplus in 2004 (US$1,037 m) to a deficit in 2005 (-US$896 m) (Table 22).

The expectation is that imports, in particular, will continue to grow at a high rate in dollars (17.4%). This is consistent with the anticipated force of growth in GDP and especially in domestic demand. However, merchandise exports in dollars are expected to be less dynamic, mainly due to the anticipated drop in revenue from crude oil exports and less demand for non-traditional goods, because of less world growth and real appreciation in 2004. Also, since exports to Venezuela increased by more than 100% in 2004, this is not expected to happen again in 2005.

Although oil exports will be similar in volume to what they were in 2004, poorer quality crude will account for a larger share, which means less income from oil exports. On the other hand, in response to the estimated increase in the average ex dock export price of coffee, which should go from US$0.91 to US$1.00 per pound, these exports are expected to be up by US$289 m. Coal exports should see an increase of US$221 m, since larger volumes are expected. As mentioned earlier, non-traditional exports probably will be less dynamic than in 2004.

On the other hand, 2005 should see an additional US$353 m in factor income. This substantial improvement is associated mainly with a reduction of US$303 m in payments for profits and dividends, given the smaller transfers planned for this item (Table 22).

TABLE 22

BALANCE OF PAYMENTS - COLOMBIA
(MILLIONS OF DOLLARS)

	Millions of dollars			GDP Percentage		
	2003	2004 (e)	2005 (proj)	2003	2004 (e)	2005 (proj)
I. Current Account	**(1,101)**	**(1,001)**	**(2,750)**	(1.4)	(1.0)	(2.4)
A. Non-factor goods and services	**(989)**	**(530)**	**(2,678)**	(1.2)	(0.6)	(2.4)
1. Goods	524	1,037	(896)	0.7	1.1	(0.8)
2. Non-factor services	(1,513)	(1,568)	(1,782)	(1.9)	(1.6)	(1.6)
B. Factor income	**(3,446)**	**(4,132)**	**(3,779)**	(4.4)	(4.3)	(3.3)
C. Transfers	**3,334**	**3,662**	**3,707**	4.2	3.8	3.3
II. Capital and financial account and change in gross domestic reserves	**734**	**6,169**	**1,443**	0.9	6.4	1.3
A. Net foreign direct investment	855	2,215	2,138	1.1	2.3	1.9
B. Other capital movement (*)	(121)	3,954	(695)	(0.2)	4.1	(0.6)

(proj) Projection.
(e) Estimate.
(*) Includes operations in the public and private sectors, errors and omissions and the change in gross international reserves.
Source: Banco de la República.

VII. Level of International Reserves

The strategy adopted by the Banco de la República to accumulate international reserves recognizes the importance of having enough international liquidity to deal with external shocks.

A. Level Of Reserves and External Vulnerability of the Economy

As indicated in the June 2004 Report to Congress, the strategy adopted by the Banco de la República to accumulate international reserves recognizes the importance of having enough international liquidity to deal with external shocks. These can originate with shocks to terms of trade, financial scares and contagion or, in general, events that cause investors to overreact and prompt a quick turnaround in capital flows. In this context, having enough international reserves is not only useful in dealing with these liquidity shocks, but also helps to lessen the chance of their occurrence.

In Colombia, two criteria are used to assess the level of international reserves: 1) indicators of the risk of external vulnerability; and 2) analysis of the cost-benefit of maintaining a stock of reserves[6].

1. External Vulnerability Indicators

The following are the more appropriate indicators for assessing the country's external vulnerability:

a. *Debt amortization indicator* (reserves/year-to-date amortization);

b. *Debt service indicator* (reserves/total external debt service):

[6] The trend in reserves also is affected by the Bank's policies to smooth movement in the exchange rate.

c. *Indicator of adequate liquidity position* (reserves/(amortization + current account deficit)).

The first indicator is sufficient in countries where there is no current account deficit and the local currency is not overvalued. In these cases, the need for international liquidity is limited to amortization of the total debt. The second indicator is relevant if the country relies on the international market to finance amortization of the total debt and to fund the interest on this obligation. The third indicator is particularly appropriate for measuring the external vulnerability of countries that not only have sizeable amortization and interest payments and a current account, but also want to avoid a quick and abrupt current account adjustment in the event that international markets are eventually closed to them.

International markets look carefully at each country's characteristics and the value of these indicators. A relevant indicator below 1.0 sets off a warning signal about the external vulnerability of the economy under study for investment.

Table 23 shows Colombia's international reserve indicators for the period between 2002 and 2004. At the close of 2004, the indicators of external debt amortization were above one (and in a range of 1.13 to 1.62). The indicators of total debt service and adequate liquidity position were near one. The reserves/total debt service indicators were between 0.92 and 1.24 and the reserves/(amortization + current account deficit) indicators were between 1.45 and 0.92.

TABLE 23

INTERNATIONAL RESERVE INDICATORS FOR COLOMBIA

	2002	2003	2004	2005 (e) (*)
Balance				
Net international reserves (millions of dollars)	10,841	10,916	13,536	12,589
IMF international reserves (millions of dollars)	10,507	10,524	13,197	12,221
Indicators				
A. External debt amortization indicator				
External debt amortization (millions of dollars)	10,146	10,173	8,366	12,018
Net reserves/year-to-date external debt amortization	1.07	1.07	1.62	1.15
Net reserves/external debt amortization in the following year	1.07	1.30	1.13	1.25
B. Debt service indicator				
NIR/ (current year debt service)	0.86	0.87	1.24	0.94
NIR/ (following year debt service)	0.86	1.00	0.92	1.01
C. Indicator of adequate external liquidity position				
NIR/ (current year debt amortization + current year c,a, deficit)	0.94	0.97	1.45	0.94
NIR/ (following year debt amortization + following year c,a, deficit)	0.96	1.17	0.92	0.98

(e) Estimate.
(*) The international reserve position at February 2005, adjusted to account for the sale of US$1,250 m in foreign exchange to the government.
Source: Banco de la República estimates.

2. Cost-benefit Models

If the cost of the crisis were higher, the adequate level of reserves would be higher as well.

With these models, a larger stock of reserves lessens the likelihood and the cost of an eventual external crisis by facilitating macroeconomic adjustment. On the other hand, a larger stock of reserves has an opportunity cost that comes from the difference between the return on reserves, when invested in low-risk liquid assets, and the return on other alternative uses.

According to a calculation in December 2004, based on a cost-benefit model, with crisis cost equal to 5.5% of GDP, the adequate level of international reserves would be US$12,455 m. If the crisis cost were higher, the adequate level of reserves would be higher as well.

Inasmuch as the country had nearly US$14 billion in international reserves by February 2005, the various international reserve indicators and the reserve cost-benefit calculations suggest that transferring profits in dollars to the government (US$196 m) and selling the government US$1,250 m in reserves to pay off the external debt in advance would not make the economy substantially more vulnerable. It also would save on the opportunity cost of the reserves. Moreover, because of the way the transaction was structured, the sale of dollars to the government enabled the Bank to purchase TES for its monetary transactions and to sterilize any additional purchase of reserves that might be necessary. Table 23 contains an estimate of the vulnerability indicators for 2005, provided the net reserve position declines from US$13,830 m to US$12,589 m as a result of the aforementioned transactions.

B. Current Level of International Reserves and Criteria for Their Management

Net international reserves came to US$13,535.8 m by December 2004, which is US$2,620.2 m more than at December 2003[7]. The investment portfolio is the main component of Colombia's international reserves and accounts for 91.1% of the total (US$12,336.3 m). The rest include (i) the reserve position with the IMF and the Latin American Reserve Fund (FLAR), US$764.1 m; (ii) US$189.9 m in special drawing rights (SDR); (iii) US$240.2 m in gold, Andean pesos and positive balances from international agreements; and (iv) US$16.4 m in demand deposits and cash. External short-term liabilities stood at US$4.1 m in December 2004 (Table 24).

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[7] These are provisional figures. Net reserves are equal to total international reserves, or gross reserves, minus the external short-term liabilities incumbent on the Central Bank. The latter are comprised of sight liabilities in foreign currency with non-resident agents.

The criteria used by the Banco de la República to manage international reserves are security, liquidity and profitability, in that order. Based on these standards and to comply with the macroeconomic goals set by the Bank, as well as to prevent any interruption in the flow of foreign currency or in payment of the country's external liabilities, reserves are invested in financial assets on a broad secondary market, while a portion are kept as working capital to guarantee immediate availability.

Pursuant to these guidelines, financial institutions outside the country are appointed to manage a portion of the portfolio in which Colombia invests its international reserves. These institutions are scrutinized carefully and selected according to their experience in the business, the size of the funds they manage, and the extent

TABLE 24

MAIN COMPONENTS OF INTERNATIONAL RESERVES
(MILLIONS OF DOLLARS)

Description	December 2003	Share %	June 2004	Share %	December 2004	Share %
Cash	77.9	0.7	78.3	0.7	16.4	0.1
Cash on hand	77.2	0.7	77.6	0.7	15.8	0.1
Demand deposits	0.7	0.0	0.7	0.0	0.5	0.0
Investments	9,770.5	89.5	10,452.8	89.5	12,336.3	91.1
Direct portfolio	4,519.3	41.4	5,207.4	41.4	6,947.5	51.3
Managed portfolio	5,251.2	48.1	5,245.4	48.1	5,388.8	39.8
Gold	136.4	1.2	128.7	1.2	143.2	1.1
On hand	0.0	0.0	0.0	0.0	0.0	0.0
In trust	136.4	1.2	128.7	1.2	143.2	1.1
International Monetary Fund	597.2	5.5	588.1	5.5	626.7	4.6
SDRs	172.5	1.6	169.0	1.6	182.9	1.4
Reserve position	424.7	3.9	419.0	3.9	443.9	3.3
Latin American Reserve Fund	333.3	3.1	340.2	3.1	340.2	2.5
Contributions	313.3	2.9	320.2	2.9	320.2	2.4
Andean pesos	20.0	0.2	20.0	0.2	20.0	0.1
International Agreements	6.0	0.1	3.4	0.1	77.1	0.6
Total Gross Reserves	10,921.4	100.1	11,591.4	100.1	13,539.9	100.0
Short-term Liabilities	5.8	0.1	3.6	0.1	4.1	0.0
International agreements	0.0	0.0	0.0	0.0	0.0	0.0
Foreign banks	0.0	0.0	0.0	0.0	0.0	0.0
Latin American Reserve Fund (FLAR)	0.0	0.0	0.0	0.0	0.0	0.0
Amounts payable for investment purchases	0.0	0.0	0.0	0.0	0.0	0.0
Interest accrued on liabilities	5.8	0.1	3.6	0.1	4.1	0.0
Total Net Reserves	**10,915.6**	**100.0**	**11,587.8**	**100.0**	**13,535.8**	**100.0**

Source: Banco de la República estimates.

of their capacity for management and risk control. As mentioned in previous reports, these institutions have improved the return on international reserves, thanks to specialized management (Box 3).

As to the investment portfolio as a whole, the Banco de la República of Colombia directly managed US$6,947.5 m (56.3% of the total investment tranche), including US$639.7 m in working capital. Specialized firms; namely, Barclays Global Investors, J.P. Morgan Investment Management Inc., Goldman Sachs Asset Management and Morgan Stanley Investments L.P., managed the other 43.7% (US$5,388.8 m).

In 2004, the reference index used to evaluate management of the portion of the country's international reserves[8] administered by Barclays Global Investors and J.P. Morgan Investment Management Inc. showed a return of 4.01%[9] as opposed to respective returns of 3.90% and 3.84% for these managers. The reference index[10] for the portfolio managed by Goldman Sachs Asset Management and Morgan Stanley Investment L.P. showed a return of 1.00% against 1.53% for the former and 1.03%% for the latter. The segment of the portfolio managed by the Banco de la República of Colombia, working capital not included, registered a return of 2.57% during 2004, in contrast with 2.61% for the reference index used to evaluate management of this portion [11]. The return on working capital was 1.30%.

The credit risk for the investment portfolio as a whole is concentrated mostly in the sovereign sector, including short and long-term holdings, with 54.5% of the portfolio. The rest distributed among the other sectors; namely, 30.9% in the banking sector, 8.2% in the corporate sector, 2.8% in the supranational sector, 0.8% with the Bank for International Settlements (BIS), and 2.8% in buy-back agreements at the New York Fed. At December 2004, distribution according to credit quality based on ratings by specialized agencies[12] was as follows: 42.8% "P-1" [13], 46.9% "AAA", 6.2% "AA", 0.5% "A", 0.8% in the BIS and 2.8% in buy-back agreements at the New York Fed. The way credit risk is distributed reflects the security with which international reserves are managed.

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8 Known as the «global mandate».

9 These are provisional figures subject to revision.

10 Known as the "rotation mandate in the United States". These are provisional figures subject to revision.

11 The reference portfolios used to gauge the performance of external managers are comprised of assets denominated in U.S. dollars, euros and yen. These assets are invested in a combination of money-market instruments and government bonds at one to five years. At 31 December 2004, average duration of the total investment tranche index was 1.07 years and the exchange composition was 85% U.S. dollars, 12% euros and 3% yen.

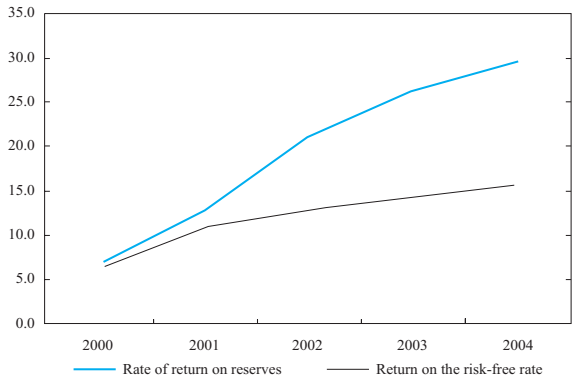
12 Santdard & Poor's, Moody's and Fitch ratings.

13 On the short-term rating scale, «P-1» is the best.

From 2000 to the end of 2003, the downward trend in interest rates in the developed economies spelled higher prices for fixed-income assets. Coupled with the appreciation of other currencies against the dollar, this benefited prices for the securities in which reserves are invested. The combination of these two effects translated into an unusually high return on international reserves during this period, well above what was forecast by the Bank and superior to the return on the risk-free rate in the United States[14]. Graph 35 shows the accumulated rate of return on reserves compared with the risk-free rate in dollars. Graph 36 contains a breakdown of the return on dollar reserves from accruals and valuations of their fixed-income instruments ("interest yield") and from the exchange differential against the U.S. dollar ("exchange yield differential").

Graph 35

Accumulated Rate of Return on Reserves vs. the Risk-free Rate in Dollars
(Percentage return)

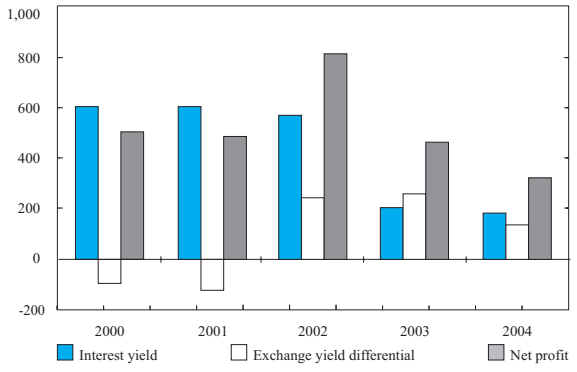


Source : Banco de la República.

Graph 36

Return on International Reserves
Monthly Flow

(Millions of Dollars)



Source : Banco de la República.

The criteria for managing international reserves; namely, security, liquidity and profitability, imply decisions in two particularly relevant dimensions. One is exposure to the risk of fluctuations in interest rates (market risk); the other is exposure to the risk of changes in the rate of exchange for different currencies with respect to the dollar (exchange risk).

The decision on the composition of the investment portfolio in terms of its exposure to market risk is basically financial. Anticipating a major rise in interest rates in the United States, with a subsequent drop in the price of fixed-income bonds, the Banco de la República gradually reduced the modified duration of its investments as of 2002, thereby gradually reducing its market-risk exposure as well[15].

In contrast, the decision on the exchange composition of the international reserve portfolio does not depend solely on financial considerations. It must reflect the denomination of the payments for which Colombians are liable

[14] With the risk-free rate, the investor assumes neither the market risk nor the credit risk. The three-month Treasury bill is used in the case of the United States.

[15] The modified duration is an indicator or measure of the price sensitivity of fixed-income assets to interest rate movement in an economy. For a detailed explanation of the relationship between the price of an asset and the interest rate, see Box 3 in the *Report of the Board of Directors to the Congress of the Republic,* July 2004, pg. 65, which is available on the Internet at http://www.banrep.gov.co/junta/2004/CongresoJulio.pdf.

since, by definition, one of the functions of reserves is to serve as a source of foreign liquidity when access to capital markets is restricted. The Banco de la República has adopted several measures with this restriction in mind. To begin with, after revising the estimate on balance of payments outlays, the Bank modified the exchange composition of the international reserve portfolio on January 31, 2004 from 86% in dollars, 11% in euros and 3% in yen to 85%, 12% and 3%, respectively. The idea was to reflect more precisely the proportion of the currencies in which the country makes its payments. Moreover, to obtain a higher return by taking advantage of the fluctuations in interest rates, the external managers were authorized on January 31, 2004 to raise their asset positions in currency by up to 7.5 percentage points in relation to the neutral exchange composition of the investment portfolio. In other words, if considered appropriate as part of a balanced risk-return strategy, managers may raise their exposure to currencies like the euro, for example, from the neutral position of 12% to as much as 19.5%. However, this is at the expense of reducing their exposure to dollars from the 85% reference position to 77.5%.

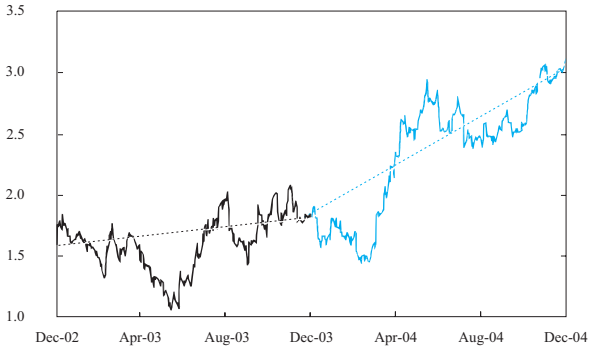
The return on the investment portfolio in 2004 reflects the tendency observed throughout most of the year, with rising interest rates (which imply falling prices) and devaluation of the dollar against the other currencies. In exchange terms, income was less than in 2003, mainly because the principal currencies in which reserves are invested appreciated less against the dollar (Graph 37). However, US$139.3 m in earnings were reported in 2004, thanks to the exchange difference with the dollar. US$8.8 m of these earnings originating with exchange positions taken by the managers and the Bank pursuant to what was authorized in January.

Net return obtained by the Bank and the delegated managers on the international reserve portfolio totaled US$324.5 m at December 31, 2004. Accrued interest came to US$253.9 m, and

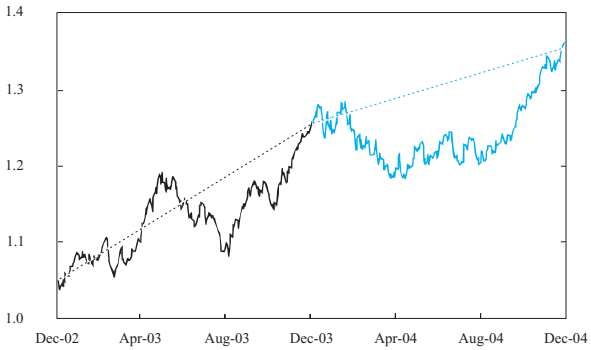
Graph 37

Trend in Interest Rates on U.S. Treasury Bonds and the Dollar against the Yen and the Euro

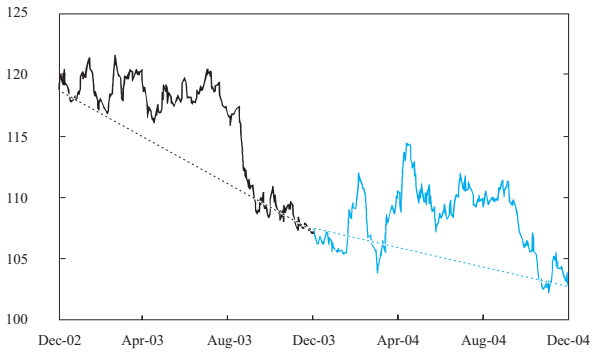
Rate of Return on Two-year U.S. Treasury Bonds: 2003-2004 1/



Euro vs. U.S. Dollar 2/



Yen vs. U.S. Dollar 3/



1/ The reverse relationship between price and rate of return means the price of a fixed-income asset decreases as the rate increases.
2/ The direct euro/dollar price means the euro loses value as it approaches zero.
3/ The inverse dollar/yen price means the yen loses value as it moves away from zero.
Source: Bloomberg L. P.

US$70.6 m in profits were derived from valuation of the country's international reserves at market prices. The valuation profit originated with the trend in the euro, the yen and SDRs against the dollar (US$139.3 m), bond investment devaluation (US$-75.5 m) and the increase in the price of gold (US$6.8m)[16].

In conclusion, the international reserve investment policy designed and implemented by the Banco de la República during the period from 2000 to 2004 generated 85% more than the return on the risk-free rate in dollars in the same years. The result was excess profits on the order of US$1,240 m. Most of these excess returns came from the valuation of fixed-income assets and the interest earned on these investments. As illustrated in Graph 36, the return on interest rates between 2000 and 2004 came to approximately US$600 m a year, while income from the exchange differential was not a major part of total returns. In 2003, because of low interest rates worldwide, the return on this item dropped to a third of what it was in earlier years, while the appreciation of different currencies against the U.S. dollar, especially the euro and the yen, helped to offset the loss in interest rate earnings. The return on reserves in 2004 was moderate. This was due to the rise in external interest rates that year, as well as the exchange differential, since currencies did not appreciate as much against the dollar as in 2003.

[16] The Good Delivery gold price (99.5% purity) on the international market (FIX A. MILLION. London) rose from US$417.25 per once on December 31, 2003 to US$438 on December 31, 2004.

International Reserves and the External Reserve Management Program

The Banco de la República of Colombia has had an external reserve management program since 1994. The objective is to give added value to the international reserve portfolio by using strategies and assets the Bank cannot take full advantage of internally. External managers have the facilities and the experience to handle investments of this type, as well as access to information on the specific features of these markets.

A portion of net international reserves (NIR) is delegated to external managers under a clear set of rules established by the Banco de la República, specifying the type of investments managers are allowed to make and the maximum amounts. The Bank also defines a risk budget for each of the managers and a reference index (theoretical portfolio) to measure their performance.

The Banco de la República of Colombia is not the only institution with a program of this type. A number of major Banco de la Repúblicas around the world have similar programs. According to a study by the Union of Swiss Banks (UBS), which polled a group of Banco de la Repúblicas that account for 78% of the world's international reserves, 70% of those interviewed say they have an external reserve management program. The 38% that do not are thinking about contracting one in the near future.

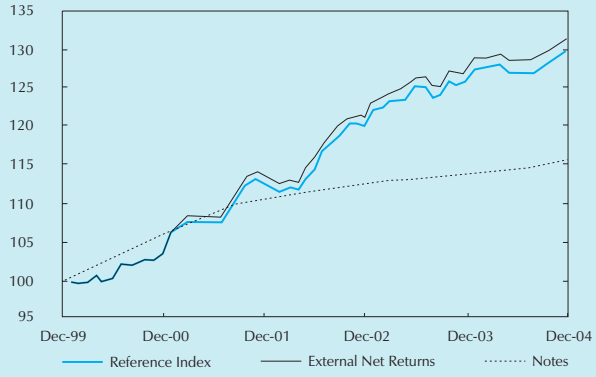
The Banco de la República has engaged the services of J.P. Morgan Fleming Asset Management (initially J.P. Morgan Investment Management) and Barclays Global Investors (initially Barclays de Zoete Wedd) since June 1994. In 1999, a third manager, Goldman Sachs Asset Management, was added to the program, and a fourth, Morgan Stanley Investment Management, was contracted in November 2002. All these firms are market leaders in the field.

In addition to the intangible benefits, such as a transfer of know-how and technology to the Banco de la República, the program has improved the return on international reserves. These profits are then transferred to the national government. According to an approximate estimate, the returns secured by the managers since June 1994 exceed the reference index by US$67.1 m; that is, is a third of the profits expected this year from international reserves. Taking into account the commissions paid for these services, the return in excess of the reference index has been US$38.4 m since June 1994.

As to the annual rate, having external managers has meant an improvement of 0.20% a year in returns for the country since 1994, or 0.08% a year after commissions. The Banco de la República is using its experience in managing a program of this type to launch a new phase of fund delegation by modifying the structure to make it more effective. Between October 2002 and January 2005, returns have improved an annual rate of 0.28%, or 0.19% after commissions. Were it not for this program, the country would have earned US$21.4 m less m as of October 2002.

The following graph shows the accumulated returns on three-month U.S. Treasury bills since 2000 in relation to the return on the reference index for externally managed portfolios and the net return on externally managed portfolios minus commissions. It is evident that the use of external managers has added value to the country's international reserves.

Graph B3.1
Accumulated Net Returns Obtained by External Managers



Source: Banco de la República.

VIII. Financial Position of the Banco de la República

The Banco de la República (Central Bank of Colombia) listed Col$827.8 b in profits on its income statement for 2004. Last February, Col$454 b of this amount was transferred to the national government, once the reserves stipulated in the by-laws of the institution had been established.

A. Earnings in 2004

The income statement for 2004 showed Col$827.8 b in profits (Table 25), the result of Col$1,569 b in income and Col$741.3 b in outlays. As specified later in this report, Col$454 b of these profits were transferred to the national government in February 2005, once the reserves stipulated in the by-laws of the Bank had been established.

Most of these earnings came from the return on international reserves (Col$834.9 b or US$324.5 m). Other sources include revaluation of the TES portfolio (Col$322.0 b), commissions on services rendered by the Banco de la República to the financial sector in performance of its role as the banker for banks (Col$135.8 b), and the return on the transitory purchase of securities (Col$131.3 b).

The main items with respect to expenditure were Col$184.5 b in remuneration on deposit accounts[17], Col$193.2 b in exchange difference[18], Col$165.7 b in personnel costs, Col$70.8 b in currency issue costs, and Col$43.6 b in general expenses.

The return on international reserves was less in 2004 than in 2003. Several factors were responsible for this outcome; namely, i) devaluation of the portfolio as a result of the rise in external interest rates; ii) fewer exchange rate earnings because of less euro appreciation (7.79%) than in 2003 (19.86%), and iii) revaluation of the peso against the dollar, which lowered the peso value of the return on international reserves.

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17 This includes remuneration on bank reserves and national government deposits.

18 Refers to devaluation of assets denominated in F/C that do not affect international reserves, inasmuch as the peso had revalued 14.1% against the dollar by the end of the period.

TABLE 25

BANCO DE LA REPÚBLICA INCOME STATEMENT, 2003 - 2005
(BILLIONS OF PESOS)
FIGURES UP TO MARCH 11 AND ALL GOVERNMENT TRANSACTIONS (*)

		Performance		Actual annual change (Percentage)	Projection 2005	Estimated annual change (Percentage)
		2003	2004			
I.	**Total income**	2,031.8	1,569.0	(22.8)	1,114.7	(29.0)
	1. Operating income	1,990.7	1,551.7	(22.1)	1,109.1	(28.5)
	Interest and returns	1,802.9	1,303.2	(27.7)	931.4	(28.5)
	International reserves	1,326.9	834.9	(37.1)	541.9	(35.1)
	External lines	4.5	0.6	(87.0)	0.2	(73.5)
	TES -A valuation at market prices	7.7	0.0	(100.0)		
	TES val, through monetary expansion operations	340.8	322.0	(5.5)	356.7	10.8
	Val, of public bank capit, bonds and TES. L, 546	8.2	7.0	(14.8)	4.8	(31.2)
	Transitory purchase of securities and quotas	105.6	131.3	24.3	23.4	(82.2)
	Others	9.3	7.5	(18.5)	4.5	(39.8)
	Commissions	121.9	135.8	11.4	94.6	(30.3)
	Banking services and trust business	91.0	101.9	12.0	94.6	(7.1)
	Foreign currency management	27.4	24.1	(11.8)		(100.0)
	Others	3.5	9.8	177.2		(100.0)
	Exchange differences	22.3	49.3	121.0	2.2	(95.5)
	Coin issue and precious metals	21.3	38.3	79.4	58.7	53.4
	Others	22.3	25.1	12.8	22.2	(11.5)
	2. Non-operational income	41.1	17.3	(57.8)	5.6	(67.9)
II.	**Total expenses**	584.3	741.3	26.9	897.9	21.1
	Interest and returns	152.3	225.4	48.0	251.9	11.8
	Deposit accounts	103.9	184.5	77.4	223.3	21.1
	Transitory sale of securities	9.8	9.3	(4.5)		(100.0)
	External lines. exchangeable instruments and others	9.1	5.4	(40.7)		(100.0)
	Expenses for international reserve management	29.4	26.2		28.6	9.2
	Commissions and fees	3.0	3.5	18.3	2.0	(44.6)
	Exchange differences	42.2	193.2	358.3	19.5	(89.9)
	International organizations	18.8	191.1	917.2	18.2	(90.5)
	External lines	20.2	2.1	(89.5)		(100.0)
	Others	3.2		(100.0)	1.3	
	Cost of issuing notes and coins	89.6	70.8	(20.9)	179.9	154.1
	Employee expenses	156.9	165.7	5.6	179.7	8.4
	Retirement pensions	28.2	(23.3)	(182.8)	137.6	
	General expenses	48.0	43.6	(9.1)	46.6	6.9
	Taxes	5.0	6.1	21.7	6.3	3.6
	Insurance	10.5	9.2	(12.6)	10.1	10.1
	Contributions	2.9	4.2	46.2	4.6	8.8
	Cultural costs	6.6	6.6	(1.3)	7.6	16.4
	Provisions. depreciation and amortization	28.1	27.7	(1.1)	40.6	46.4
	Operational and non-operational outlays	11.1	8.5	(23.2)	11.4	33.7
III.	**Profits or losses in the period. including depreciation**	1,447.4	827.8	(42.8)	216.7	(73.8)

(*) Includes the sale of US$1,250 in foreign exchange to the government and the purchase of TES for the equivalent in pesos.
Source: Banco de la República.

As to expenses, net outlays for retirement pensions were down by Col$51.1 b compared with 2003. This decline originated with (i) fewer expenses (Col$36.1 b) because of the reduction in actuarial provisions[19], and (ii) la larger return on the portfolio of resources pertaining to the actuarial calculation (Col$15.4 b), thanks to portfolio valuation because of lower interest rates. It is important to note the 5.6% decline in personnel costs compared with 2003. General expenses for the year were down by 9.1%.

B. Provisioning Reserves and Profit Sharing

Pursuant to the by-laws of the Banco de la República, the CBBD distributed Col$840.1 b in 2004, including Col$827.8 b in profits obtained during the period and a portion of reserves (Col$12.3 b) used to protect assets. As noted earlier, Col$454 b were transferred to the national government, once all legal and statutory reserves had been established.

Table 26 contains a breakdown of profit sharing and the use of reserves in 2004.

Equity capital reserves include: (i) Col$1,768.0 b reserved for currency fluctuations[20], (ii) Col$93.1 b to protect assets, and (iii) Col$6.6 b from exchange rate earnings. According to the by-laws, no provision was made for monetary and exchange stabilization, inasmuch as no losses are forecast for the next two years.

C. Balance Sheet

The Banco de la República reported Col$41,846.0 b in total assets, with an annual reduction of Col$1,861.7 b (4.3%) (Table 27). This reduction originated primarily with (i) the liquidation of investments (Col$2,217.4 b), which declined from Col$3,201.4 b in 2003 to Col$984.0 b in 2004 owing to the sale of TES and current maturities for coupons and principal; (ii) less demand for repos (Col$1,086.1 b) on the part of the financial system, and (iii) depreciation in contributions to international organizations because of peso appreciation against the dollar (Col$246.8 b). Most of the increase in assets

Table 26

Distribution of 2004 Profits and Use of Banco de la República Reserves
(Billions of pesos)

I.	**Funds for Distribution**	**840.1**
	a) 2003 profits	827.8
	b) Use of reserves to protect assets	12.3
II.	**Allocation**	**840.1**
	a) National government	454.0
	b) Reserve for currency fluctuation	349.4
	c) Net investment in goods and services for cultural activities	30.2
	d) Exchange earnings	6.6

Source: Banco de la República.

[19] Pursuant to Constitutional Court Ruling C-75 handed down in August 2004, which declared Article 4 of Law 860/2003 unconstitutional. The article in question concerns the transition regime defined in Law 100/1993.

[20] Funds used to cover eventual losses due to fluctuation in the dollar exchange rate against the other currencies that make up the country's international reserves.

TABLE 27

BALANCE SHEET - BANCO DE LA REPÚBLICA OF COLOMBIA - EARNINGS 2003-2004
(BILLIONS OF PESOS)

	December Balances	2003 Share (%)	December Balances	2004 Share (%)
Assets	43,707.7	100.0	41,846.0	100.0
Gross international reserves	30,658.4	70.1	32,356.9	77.3
Contributions to international organizations	3,253.9	7.4	3,007.1	7.2
Investments	3,201.4	7.3	984.0	2.4
Consolidated public-sector debt	81.4	0.2		0.0
Public sector monetary regulation	3,061.0	7.0	928.0	2.2
Capitalization bonds: pubic banks and others	59.1	0.1	56.1	0.1
Loans	85.1	0.2	4.1	0.0
Public sector-National government	2.8	0.0	2.4	0.0
Banks	0.1	0.0		0.0
Financial corporations	5.1	0.0	2.8	0.0
Savings and home loan associations	0.0	0.0	0.0	0.0
Rest of the financial system	79.2	0.2		0.0
Other loans	0.0	0.0	0.0	0.0
Provision	(2.0)		(1.1)	(0.0)
Resale agreements - Temporary liquidity support	3,597.9	8.2	2,511.8	6.0
Accounts receivable	104.4	0.2	47.5	0.1
Other net assets	2,806.5	6.4	2,934.5	7.0
Liabilities and Equity	**43,707.7**	**100.0**	**41,846.0**	**100.0**
Liabilities	**20,762.8**	**47.5**	**23,823.6**	**56.9**
Foreign currency liabilities affecting international reserves	16.2	0.0	9.8	0.0
Base money	16,614.6	38.0	19,261.6	46.0
Currency in circulation	14,398.3	32.9	16,278.6	38.9
Coins	372.4	0.9	409.5	1.0
Deposits for bank reserves	1,694.1	3.9	2,379.7	5.7
Current account deposits - Rest of financial sector	149.8	0.3	193.8	0.5
Other deposits	72.2	0.2	49.0	0.1
National government - National Treasury	46.0	0.1	1,062.0	2.5
Obligations with international organizations	2,643.5	6.0	2,482.6	5.9
Liabilities for external lines	184.1	0.4		0.0
Instruments for monetary and exchange regulation	28.5	0.1	0.3	0.0
Contraction repos	28.0	0.1		0.0
Exchange certificates	0.0	0.0	0.0	0.0
Foreign-currency securities for financing and reserve deposit, 5/97 B.D.	0.4	0.0	0.3	0.0
Others	0.1	0.0	0.0	0.0
Accounts payable	42.6	0.1	48.6	0.1
Other liabilities	1,115.1	2.6	909.7	2.2
Total Equity	**22,944.9**	**52.5**	**18,022.3**	**43.1**
Capital	12.7	0.0	12.7	0.0
Reserves	893.2	2.0	1,524.1	3.6
Equity surplus	19,553.4	44.7	14,623.9	34.9
CEC Liquidation	453.5	1.0	453.5	1.1
Exchange adjustment 1993 and thereafter, plus surplus	19,054.9	43.6	14,111.8	33.7
Others	45.0	0.1	58.7	0.1
Property appraisal (art, culture and real estate)	1,038.2	2.4	1,033.8	2.5
Profit or loss	1,447.4	3.3	827.8	2.0
Previous profits and/or losses	0.0	0.0	0.0	0.0
Profits and/or losses for the period	1,447.4	3.3	827.8	2.0

Source: Banco de la República.

originated with (a) international reserves (Col$1,698.5 b) and (b) other net assets (Col$128.0 b). The change in international reserves was due to the combined effect of gross reserve accumulation (US$2,617.4 b) and a decline in peso value (Col$4,943.1 b) as a result of appreciation against the dollar.

Liabilities amounted to Col$23,823.6 b, with an annual increase of Col$3,060.8 b due to growth in base money (Col$2,647.0 b or 15.9%) and in government deposits (Col$1,016.0 b). On the other hand, liabilities for external lines were paid off in full (Col$184.1 b) and obligations with international organizations were down by Col$160.9 b due to peso appreciation.

Equity capital came to Col$18,022.3 b, down Col$4,922.6 b for the year. However, given the extent of profits and the reserves that have been established, this reduction may be paradoxical. Peso appreciation against the dollar is the main reason for this outcome and lowered reserve assets in pesos by Col$4,943.1 b. The counterpart to this item is the reduction in the surplus because of the exchange adjustment in equity capital [21].

D. Projected Income and Expenses for 2005

The estimate for the year includes Col$1,114.7 b in total income and Col$897.9 b in outlays, for a projected profit of Col$216.7 b. Interest and the return on international reserves (Col$541.9 b) will be a major source of income, as will appreciation of the TES portfolio purchased by the Banco de la República (Col$356.7 b) and commissions received (Col$94.6 b). There are two reasons why the return on international reserves is expected to be less than in earlier periods. One is the anticipated rise in interest rates on the international market during 2005, which would devalue the reserve portfolio, even despite the reduction in portfolio duration described in Chapter VIII. The other is the fact that the possible impact of a change in the exchange rates for the currencies in the reserve portfolio has not been taken into account[22]. Income from the international reserve account is uncertain, as there is no way of knowing how the exchange rate for the dollar will hold up against the euro and the yen.

Projected income is Col$897.9 b, up 21.1% (Col$156.6 b) compared with 2004. The following are the main items in this respect:

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21 Pursuant to Article 26 of Law 317/1992 and Article 62, Section 4 of the by-laws, international reserves are entered on the books at market prices and the exchange adjustment originating with devaluation of the peso exchange rate against the U.S. dollar is recorded as an equity surplus. The exchange adjustment due to revaluation will be applied to that surplus.

22 In 2004, devaluation of the dollar against other currencies added US$139.3 m to the return on international reserves, which was calculated with information available at January 31, 2005.

1. Col$223.3 b in remuneration on deposit accounts, up 21.1% given the need for monetary contraction to partially offset past purchases of international reserves. A good portion of these outlays are to reimburse the deposit account of the National Treasury.

2. The cost of currency issue (Col$179.9 b), with 154% growth as per the currency issue program for the year. This estimate includes Col$70 b from the destruction of currency, which will be offset at the time of profit sharing, inasmuch as the asset protection reserve created by the CBBD in past years to defray this expense is used automatically.

3. Col$179.7 b in personnel costs, with a projected increase of 8.4% that mirrors the commitments in the collective bargaining agreement. As in the past, the end of the year is expected to see this item fall short of the projection because of the number of people who opt for a pension. Another factor in this respect is the austerity policy adopted by the Bank, which has led to staff reductions.

4. Col$137.6 b in spending for retirement pensions, including an increase of Col$160.9 b compared with the year before. This is due to Col$85.8 b in provisions projected for 2005, as opposed to those registered in 2004 (Col$1 b)[2 3], and Col$126.3 b in estimated returns on the pension portfolio compared the year before (Col$181.0 b). The lower return comes from having projected valuation of the pension portfolio with the interest rates at which securities were negotiated at the close of 2004, without including portfolio valuation due to the change in interest rates, which helped to explain the return in 2004.

5. Col$46.6 b in general expenses, with a 6.9% increase due to the cost associated with relocating and beginning to operate the new mint.

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[23] As noted earlier, the size provisions was low in 2004 due to Constitutional Court Ruling C-75 of August 2004 , which involves the transition regimes.

Trillions	t
Term deposit certificates	CD
Special drawing right	SDR
Estimate	e
Central government of Colombia	CGC
Value added tax	VAT
Real exchange rate index	RERI
Consumer price index	CPI
Producer price index	PPI
Foreign direct investment	FDI
Billions	b
Millions	m
Not applicable	n.a.
Liabilities subject to reserve requirements	LSRR
Economically active population	EAP
Working age population	WAP
Preliminary	pr
Gross domestic product	GDP
Projection	proj
Basis points	bp
Net international reserves	NIR
Real exchange rate	RER
Nominal exchange rate	NER
Term deposit rate	TDR
Interbank interest rate	IIR
Global participation rate	GPR

Acronyms

Inter-American Development Bank	IDB
Bank for International Settlements	BIS
Colombian Stock Exchange	BVC
Council on Fiscal Policy	CONFIS
National Bureau of Statistics	DANE
Bureau of Internal Revenue and Customs	DIAN
National Energy Finance Corporation	FEN
Territorial Pension Fund	FONPET
Latin American Reserve Fund	LARF
International Monetary Fund	IMF
Social Security Institute	ISS
Banco de la República Board of Directors	CBBD
United States Federal Reserve Bank	Fed
Union of Swiss Banks	UBS