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

July 2005

Banco de la República
ISSN - 1657 - 799X

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Bogotá, Colombia
1 August 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 Banco de la República, in accordance with Article 5 of Law 31/1992, submits this report to the Congress of the Republic of Colombia on macroeconomic performance during 2005 to date. Also discussed are the goals adopted by the Board of Directors for the current year and the outlook for the different macroeconomic variables. The last chapter contains an account of international reserves and the financial position forecast for Banco de la República.

Sincerely,

José Dario Uribe Escobar
General Manager

Introduction

Low inflation contributes to more an effective use of productive resources and encourages investment. It also avoids an arbitrary redistribution of income and wealth, which jeopardizes those who have fewer resources and cannot protect themselves against the negative effects of inflation, and promotes macroeconomic stability, which is a requirement for elevated and sustained growth.

The 1991 Constitution and Law 31/1992 order the Board of Directors of Banco de la República (BDBR) to stabilize prices, in coordination with the general macroeconomic policy. A flexible inflation targeting strategy was adopted as a result. This means the primary quantitative goal of the country's monetary policy is to keep inflation low, while attempting to stabilize the long-term trend in aggregate output. Accordingly, the Bank's objectives are price stability combined with maximum sustained growth in output and employment.

The monetary strategy adopted by BDBR is often misinterpreted. Some think the only purpose of BR policies is to control inflation, to the detriment of growth in output and employment or a better distribution of wealth and income. This is far from true. Low inflation contributes to more an effective use of productive resources and encourages investment. It also avoids an arbitrary redistribution of income and wealth, which jeopardizes those who have fewer resources and cannot protect themselves against the negative effects of inflation, and promotes macroeconomic stability, which is a requirement for elevated and sustained growth. In short, stable prices do much to improve the well being of all Colombians by raising income and reducing uncertainty and arbitrary distribution of income and wealth.

Taking advantage of the credibility of the inflation target, the Bank's policies have helped to soften the economic cycle by making the economy more resistant to negative external shocks and easing temporary fluctuations in the exchange rate.

The monetary policy also can make important short-term contributions. To the extent that inflation in Colombia remains near its long-term target, and inflationary expectations are consistent with the immediate quantitative targets, both monetary and exchange policy instruments have been used intensively, keeping real intervention interest rates low, supplying the necessary liquidity and allowing for active intervention in the exchange market, without jeopardizing the inflation target. In this way, and taking advantage of the credibility of the inflation target, BR policies have helped to soften the economic cycle by making the economy more resistant to negative external shocks and easing temporary fluctuations in the exchange

Banco de la República has kept intervention interest rates at levels that it believes are coherent with the targets for inflation and will boost short-term economic growth.

rate. Monetary policy credibility is, therefore, a tremendously valuable asset for the country, one the Bank and the government must preserve.

Banco de la República has kept intervention interest rates at levels that it believes are coherent with the targets for inflation and will boost short-term economic growth. These levels pertain to historically low real interest rates at which the Bank has supplied all the primary liquidity required by the financial system. This has been accomplished through repo operations, supplemented with large purchases of international reserves. In an atmosphere of increased confidence in the economy, this broad monetary policy stance has helped companies and households to recover financially and is behind the renewal in credit and domestic spending.

Private investment has been the most dynamic component of domestic demand since 2002, and investment as a share of gross domestic product (GDP) reached 19.3% in 2004. This surpasses the historic average for the last fifty years. Even more important is the fact that the force of private investment has remained steady during the course of 2005 to date, as illustrated by indicators such as the strong growth in imports of capital goods and the results of business surveys. The increase in investment has been accompanied by growth in productive capacity and improvements in the productivity and competitiveness of domestic production. Although the rise in household consumption was less that the increase in output, it is expected to improve in the coming quarters, as suggested by the rising volume of commercial sales, the growth in consumer credit and the better consumer confidence indicators announced by Fedesarrollo. By the same token, the strong economic recovery experienced by Venezuela in recent years, more growth in the United States and better terms of trade have allowed for a sharp increase in Colombian exports. Based on an analysis of these and other indicators, Banco de la República expects growth of the Colombian economy in 2005 to be similar to what is was in the last two years (around 4%).

The trend in consumer and producer prices is equally important. So far this year, inflation is in keeping with the target set by the Bank for 2005, which is between 4.5% and 5.5%. Annual consumer inflation went from 5.5% in December to 4.8% in June. The drop in non-food inflation was even more pronounced: from 5.5% to 4.3% during the same period. This was made possible by underused of productive capacity, peso appreciation, and growth in the monetary authority's credibility. The latter is reflected in declining expectations of inflation that are near in the target announced by the Bank. Therefore, the inflation target for 2005 is likely to be met and inflation should continue to decline during the remainder of the year.

In an atmosphere of increased confidence in the economy, this broad monetary policy stance has helped companies and households to recover financially and is behind the renewal in credit and domestic spending.

In short, private investment and exports are behind the growth in the Colombian economy (in spite of real peso appreciation during the last two years). Also, public investment is expected to improve in 2005, after last

year's slump. Labor productivity is increasing at a high rate and almost every sector of the economy is performing well, especially consumer durables and semi-durables. Consumption of non-durables does not appear to be growing as quickly, but is doing better. Inflation is on a downward course and moving gradually towards the long-term target. In other words, the basis for Colombia's economic growth is broad and sustainable.

Colombian needs consistently higher rates of economic growth if it is to lower unemployment and alleviate the poverty that affects broad sectors of the population.

However, this does not mean the economy is immune to changes in the external environment, particularly in capital flows and terms of trade. All emerging economies are vulnerable in this respect. Also, some productive sectors face legal and illegal competition from foreign goods. The spreads are much narrower than they were a decade ago, but are still high for certain kinds of credit. No less important are the macroeconomic risk factors to be addressed in due course. The most important is the fiscal situation, as reflected in the size of the government deficit and the levels of public borrowing. These have declined as a share of GDP but are still high.

Nevertheless, the Colombian economy is gaining force. International reserves have increased and the financial system is sounder. There are major differences with respect to the second half of the nineties. For example, the current account deficit in the balance of payments is 1.1% of GDP (as opposed to 5.4% in 1997). Single-digit inflation has been a fact of life for several years and is converging gradually with the desired long-term levels. Congress recently approved legislation to reduce the nation's pension liability and to eliminate special pension plans. This was an important step towards guaranteeing fiscal sustainability. These factors generate confidence in the economy, as illustrated by the increase in foreign investment flows.

A substantial improvement in the distribution of wealth and income is required if the most vulnerable sectors of society are to have more opportunities.

Colombian needs consistently higher rates of economic growth if it is to lower unemployment and alleviate the poverty that affects broad sectors of the population. A substantial improvement in the distribution of wealth and income is required if the most vulnerable sectors of society are to have more opportunities. Accomplishing these objectives demands more than macroeconomic policies; it necessitates additional mechanisms and policies as well. These include measures for security, stable rules of the game and respect for property rights, public spending targeted on high-risk groups, and more efficient use of the resources society has provided, at enormous sacrifice, to ensure education and health for all Colombians. Nevertheless, policies to promote development and equity cannot and must not go against macroeconomic stability.

Accomplishing these objectives demands more than macroeconomic policies; it necessitates additional mechanisms and policies as well.

The present report is divided into seven chapters. The first contains a summary of economic activity and employment during the course of the year to date, together with an analysis of prospects for the second half of 2005. The pattern and outlook for inflation are discussed in Chapter II; the trend in interest rates and monetary aggregates, in Chapter III, which also

contains an analysis of the developments in credit and the solvency indicators for the financial system. The same chapter includes three sections that explain the new liquidity supply scheme adopted by Banco de la República in May 2005, recent changes in interest rate spreads among credit institutions, and the credit channel and the policy interest rate transmission. In Chapter IV, there is an explanation of the exchange policy. Its coherence with the monetary policy is analyzed, and the principal results of the balance of payments for the first quarter are presented. A section on the recent trend in foreign direct investment flows is included as well. The change in public finances and the outlook in this respect for 2005 are analyzed in Chapter V. The balance of international reserves and the how they are managed is described in Chapter VI, while Chapter VII contains a review of the financial position of Banco de la República for the year to date and projected income for 2005.

I. Economic Activity and Employment

An analysis of figures for the first months of the year shows the pace of economic growth in 2005 probably will be similar to what it was during the last two years (around 4%).

A. Economic Activity

According to the National Bureau of Statistics (DANE), the Colombian economy grew by 3.6% in the first quarter of 2005 (Table 1). As illustrated in this section, an analysis of figures for the first months of the year shows the pace of economic growth in 2005 probably will be similar to what it was during the last two years (around 4%). Part of the momentum in recent months was due to the auspicious trend in terms of trade and the external demand for Colombian products, which continued to play an important role. Compared with the first quarter of 2004, foreign prices for coffee, oil and coal remained high, while growth of Colombia's major trading partners

Table 1

Gross Domestic Product by Type of Spending
(Annual Percentage Increase)

	2004	I Qtr. 2005
End Consumption	3.8	3.2
Household	4.0	3.2
Government	3.3	3.0
Gross Capital Formation	12.4	15.9
Fixed gross capital formation	13.2	16.9
FGCF without civil works	22.5	12.0
Civil works	(19.1)	45.0
Stock variations	6.4	6.7
Domestic Demand	5.3	5.4
Total Exports	10.2	13.1
Total Imports	16.7	22.2
Gross Domestic Product	4.1	3.6

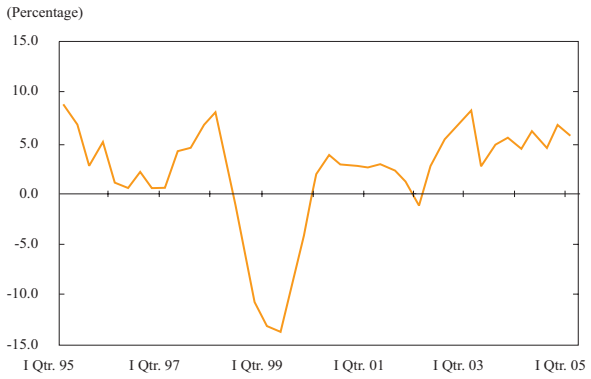
Source: DANE, Calculations by Banco de la República.

(United States, Ecuador and Venezuela) continued to favor foreign demand for our products.

Internal demand also increased at a good pace (Graph 1). The speed of investment, particularly during the first quarter of 2005, was akin to that of the two previous years (15.9%). However, there was a change in the composition of investment. Part of the expansion was due to civil works, which were up by 45% in the first quarter, following a drop of 19.1% in 2004. Excluding this item, gross capital formation rose by 11.9% in the first quarter of 2005, which is high but still not on par with the increase during 2004: 22.5% (Graph 2). This strong momentum in investment over the last three years has placed the investment rate (in relation to GDP) at 19% above its historical average (18.5%).

Graph 1

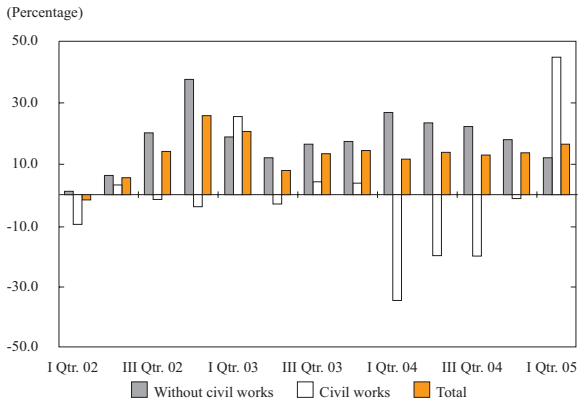
Annual Growth in Domestic Demand



Source: National Bureau of Statistics (DANE). Calculations by Banco de la República.

Graph 2

Real Annual Growth in Gross Fixed Capital Formation (GFCF)



Source: DANE, Calculations by Banco de la República.

A look at GRCF by sectors shows a substantial investment in machinery and equipment (34.1%), as well as in transport equipment (11.8%). This is indicative of an economy that is trying to increase its productivity and to reinforce its base for the sake of greater competitiveness in world markets. In contrast, investment in the home building sector was down by 2.3% in annual terms. This is explained by two factors. i) The first is a statistical situation brought about by a high base of comparison originating with the sharp rise in this item during the same period in 2004, when it was up by an annual rate of 156%. ii) The second is the weak demand for building permits at the end of 2004. This last factor could be temporary.

Household consumer spending was up by 3.2% in the first quarter of 2005, which is less than the growth in output and the value registered in 2004. A look at the components of this item shows consumption of non-durable goods increased 1.8% less than the other components of private consumption. In general, the other components of consumption, such as imports of durables and semi-durables, which are extremely sensitive to low interest rates and the exchange rate, accelerated or maintained the same growth rate observed in 2004 (Graph 3 and 4).

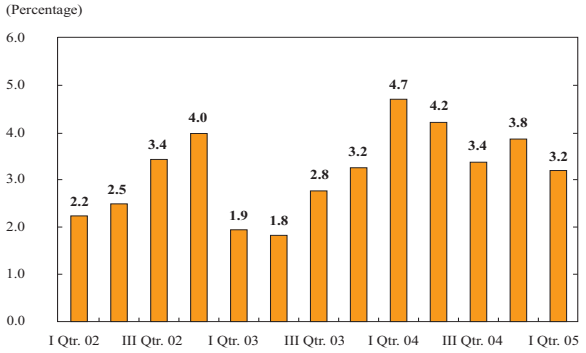
However, evidence points to continued recovery in consumption throughout the year. The April figures published by DANE for the monthly retail trade sample (MRTS) show dynamic trade in non-durable goods, with an increase of more than 6.0% in the food, beverage and tobacco sub-sector. This fact, coupled with the optimistic indicators of confidence, expectations and conditions for consumption reported by Fedesarrollo, plus the constant improvement in the job market and the fact that interest rates are still low, seem to set the stage for a positive reaction in household consumption.

In addition to investment and consumption of durable goods, exports continued to perform well during the first quarter of this year, with 13.1% real growth (Graph 5). This was due to an increase in foreign sales of both traditional and non-traditional goods (42.2% and 28.9%, respectively), favored by the rise in external prices and by foreign demand for Colombian products. As an example, coal exports were up in volume (18.6%) and in dollars (76.6%), as were coffee exports, which increased 18.6% in volume and 78.3% in dollars. Although oil exports rose in dollars (24.0%), their volume declined (2.2%). By March, non-traditional agricultural exports in dollars were up by 40.1% in annual terms, while industrial and non-traditional mining exports (excluding gold) had increased at respective rates of 25.7% and 48.8%.

There was strong import growth in the first quarter of 2005 (26.2%), stimulated by less cost due to real peso appreciation and the increase in investment. With respect to this particular point, many foreign purchases involve capital and intermediate goods (35.2% and 46.4% of total imports, respectively). Imported consumer goods also increased in the first quarter, especially durables (19.9%). This is consistent with the growth in household consumption of these types of goods.

Graph 3

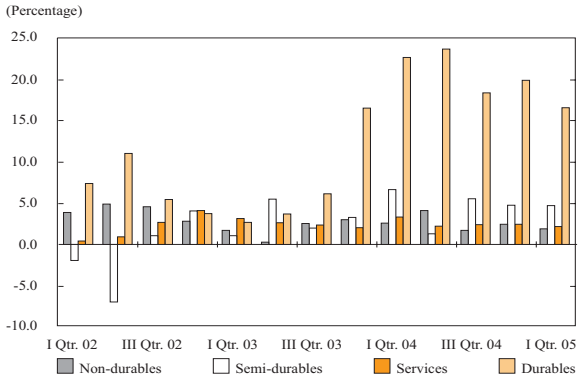
Real Annual Growth in Household Consumption



Source: DANE, Calculations by Banco de la República.

Graph 4

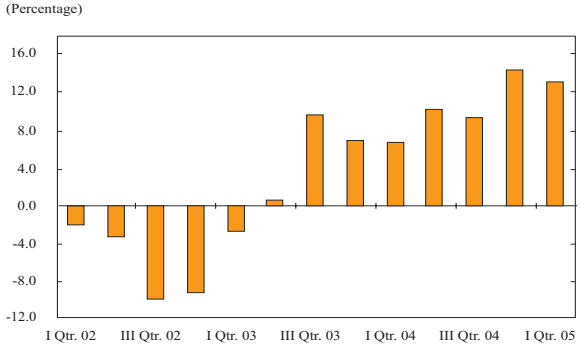
Real Annual Growth in Household Consumption, by Type of Goods



Source: DANE, Calculations by Banco de la República.

Graph 5

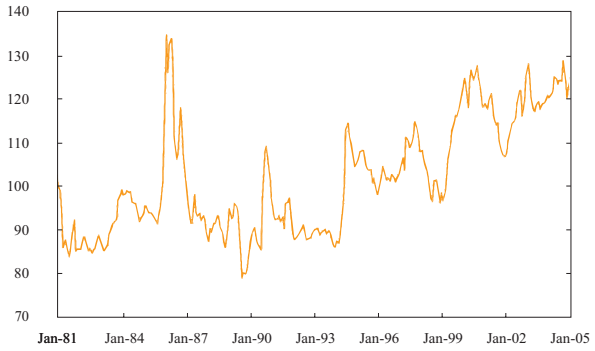
Real Annual Growth in Total Exports



Source: Calculations by Banco de la República.

GRAPH 6

TERMS OF TRADE
(MOVING WEIGHTED AVERAGES)



Source: DANE, Calculations by Banco de la República.

In dollars, first-quarter exports increased more than imports, largely because of better prices for exported goods. However, in real terms, the rise in imports was greater. This reflects the upward trend in terms of trade (Graph 6).

As to supply, some of the sectors that produce tradable goods (or export or compete with imports), such as agriculture, performed quite well. Coffee topped the list (8.1% growth), followed by other agricultural products (4.2%, not including illicit crops) and fishing (4.4%) (Table 2). Mining was up by 5.1% in the first quarter, thanks to a major expansion in coal mining (6.6%) and a positive variation in crude oil production (0.5%), which was the first real positive growth this sector has seen since 2002. This partly reflects the fact that high oil prices have made it more profitable to extract crude.

In the manufacturing industry, which is the other tradable sector, first-quarter performance was less encouraging. According to figures released by DANE, industrial manufacturing was down by 1.0% in the first quarter of 2005. This was to be expected, mainly because the first quarter had fewer working days compared with the same period in 2004. This

TABLE 2

GROSS DOMESTIC PRODUCT, BY SECTOR
(ANNUAL PERCENTAGE INCREASE)

	2004	I Qtr. 2005
Agriculture, livestock. hunting and fishing	2.6	3.4
Mining and quarries	2.9	5.1
Electricity, gas and water	3.0	0.4
Industrial manufacturing	4.8	(1.0)
Construction	9.7	10.6
Buildings	30.4	(2.3)
Civil works	(19.3)	43.6
Commerce, repair, restaurants and hotels	5.9	7.3
Transportation, storage and communication	5.1	3.5
Financial, insurance, real estate and company service establishments	4.3	(2.7)
Social, community and personal services	2.8	2.4
Financial brokerage services. measured indirectly	12.2	(14.1)
Gross domestic product	4.1	3.6

Source: DANE, Calculations by Banco de la República.

was due to the change in the date of Easter Week[1]. Taking into account the impact of working days, the DANE figures show industrial growth in the first quarter was 3.8%.

The slowdown in March was partially reversed in April (with 11% growth) due to the same difference in working days that caused the first-quarter decline. Considering the second quarter of 2005 has two more working days, plus the growth tendency component, the second quarter feasibly could see some recovery in industry. The figure on demand for unregulated energy at May would corroborate this production (Graph 7).

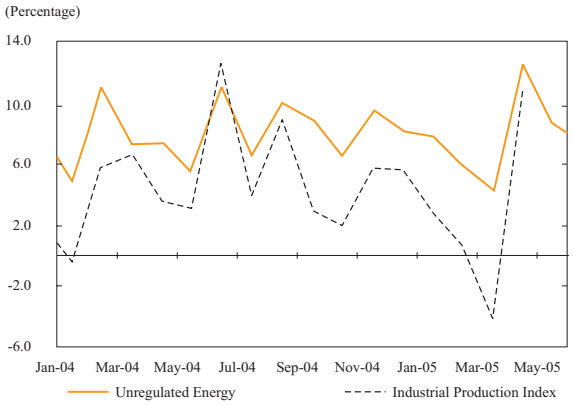
The first quarter of 2005 showed no uniform pattern in the sectors producing non-tradable goods and services. Home construction and financial brokerage services saw real reductions compared with the same period the year before. The drop in home construction was due primarily to slow growth in ongoing works. As mentioned earlier, these did little to improve the high base of comparison this sector witnessed in 2004. Furthermore, new works did not increase to the extent they had in previous quarters, although recent months have seen some recovery in building permits, which are a leading indicator of home construction (Graph 8).

Financial brokerage services in the first quarter possibly were affected by changes in the assets held by financial institutions. Despite good returns on the balance sheet, the sector experienced a real setback to the tune of 9.1%. This was because DANE includes the change in the price of treasury bonds (TES) when it measures economic activity and, at the end of March, the assets held by the

[1] Last year, Easter Week was in April. In 2005, it was celebrated in March, which meant two less working days this year for some industrial sectors. Also, there was one less working day in January, bringing the total to three working days less in the first quarter of 2005.

GRAPH 7

ANNUAL GROWTH IN DEMAND FOR UNREGULATED ENERGY AND INDUSTRIAL PRODUCTION

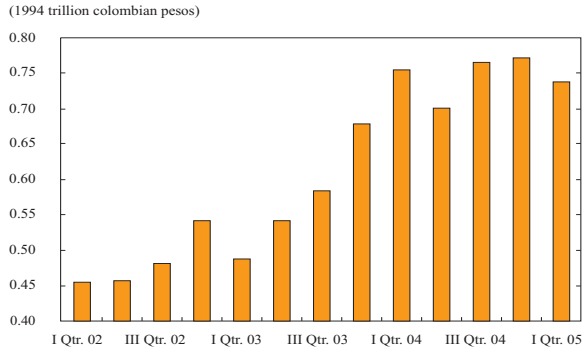


Source: DANE and ISA. Calculations by Banco de la República.

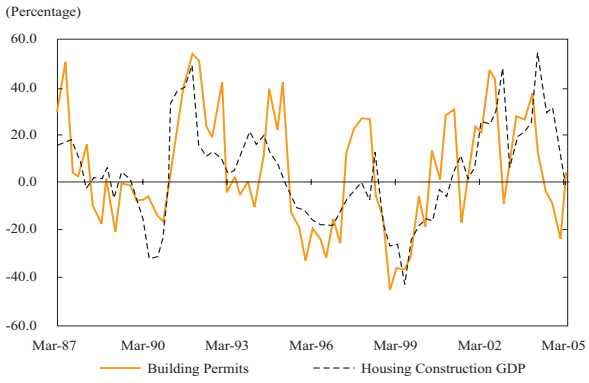
GRAPH 8

CONSTRUCTION INDICATORS

HOME AND BUILDING CONSTRUCTION GDP



ANNUAL INCREASE IN BUILDING PERMITS AND CONSTRUCTION GDP



Source: DANE. Calculations by Banco de la República.

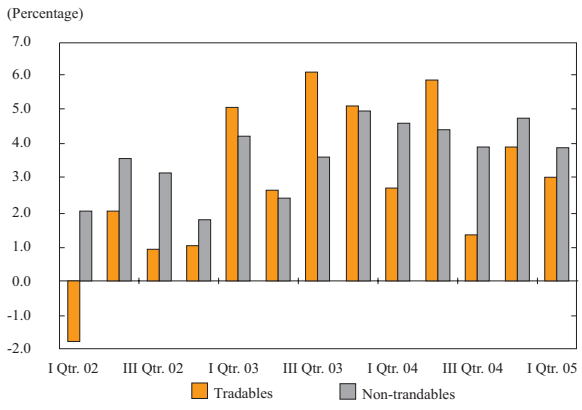
financial system lost value because of the drop in the price of these bonds. However, this was a short-term situation and its effect probably will be reversed during the remainder of the year.

Other non-tradable sectors performed well during the first quarter. Civil works are an example, having managed to recover this year after a sharp decline in 2004 (with 43.6% growth), as did trade (7.3% real growth in the first quarter) and, to a lesser extent, transport, which saw 3.5% annual growth based on the force of imports and exports.

The foregoing shows that, despite real appreciation of the peso, GDP growth in the first quarter of 2005 remained balanced between tradable and non-tradable economic activities (Graph 9).

GRAPH 9

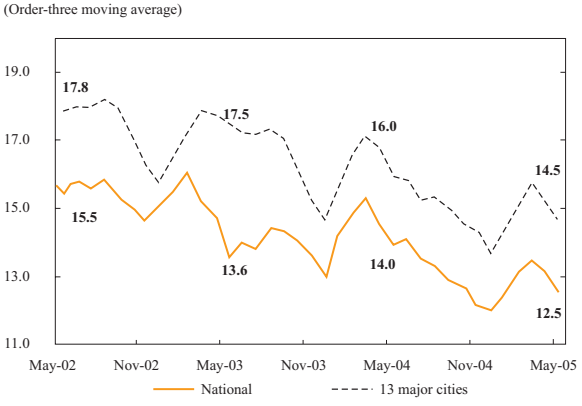
GDP GROWTH IN TRADABLE AND NON-TRADABLE SECTORS



Source: DANE. Calculations by Banco de la República.

GRAPH 10

UNEMPLOYMENT RATE



Source: DANE. Calculations by Banco de la República.

B. EMPLOYMENT AND UNEMPLOYMENT

The labor market continued to improve during the course of 2005 to date. The unemployment rate remained on a downward course and job creation recovered its momentum, following low total employment growth during the second half of 2004. Th period in question also saw a continuation of the tendency towards more formal employment.

The continued momentum of the economy has led to a significant drop in urban and national unemployment. Using three-month averages to avoid excessive volatility and lack of representativeness in the movement of the series, we see that unemployment in the three major cities went from 16.0% to 14.5% between May 2005 and May 2005. Total nationwide unemployment was down from 14.0% to 12.5% (Graph 10).

Urban and rural unemployment has declined for more than three years in a row, with reductions that add up to four percentage points (pp) or more since 2002. Nevertheless, the rate of unemployment is still high and the economy could increase

the pace at which jobs are created, without exerting additional inflationary pressures on the consumer price index (CPI) or wages.

A portion of the decline in unemployment this year is due to less growth in the labor supply (economically active population), which shrunk at an annual rate of 0.9% in the first five months of 2005, compared with 1.4% average annual growth during the same period in 2004 and 2.4% in 2003. However, in recent months, lower unemployment has been mostly the result of more jobs.

Employment began to recover in the early months of 2005 (even considering the quarterly averages). This contrasts with the situation in the second half of 2004, when the tendency in total job creation was at a standstill (although employment other than underemployment rose by 3.5%). By April and May 2005, the annual increase in employment was close to 250,000 jobs (for three months, on average) in the 13 major cities (Graph 11). Specifically in April, there were 437,000 more jobs, compared with April 2004 for the same group of cities.

The increase in the number of occupied individuals has been accompanied by a sharp change in the make up of the employed population. The creation of jobs akin to underemployment has been negative in the last 12 months, while the growth in better quality jobs has been steady and stable, and even accelerated in 2005 (Graph 11). Although formal employment has increased more in the last two months than underemployment, quarterly growth rates for underemployment have been positive (Graph 12).

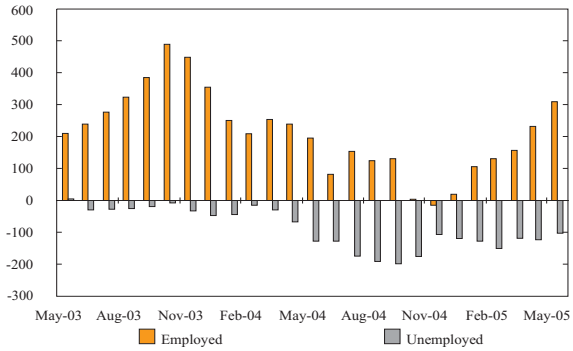
According to a more detailed analysis, the type of employment that is down or has not grown in the last three quarters to April 2005 involves the 12-to-17 age group or to people over age 56 who live in the big cities and regard their work as poorly paid and/or unsuited to their skills Graph 13).

The number of occupied individuals declined in the sectors where there are more informal jobs

GRAPH 11

JOB CREATION
(ORDER-THREE MOVING AVERAGE)

(Thousands of individuals in 13 cities)

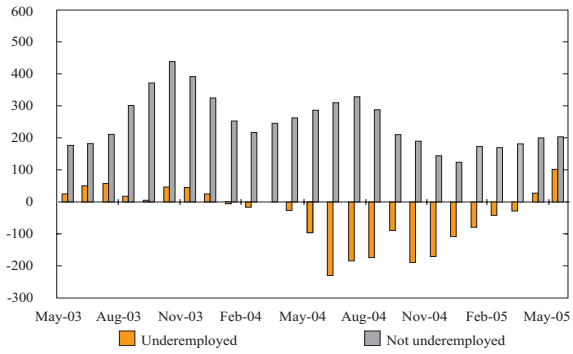


Note: "Job creation" refers to the absolute variation in the number of occupied individuals compared with the same period the year before.
Source: DANE. Calculations by Banco de República.

GRAPH 12

BREAKDOWN OF URBAN JOB CREATION
(ORDER-THREE MOVING AVERAGE)

(Thousands of individuals in 13 cities)

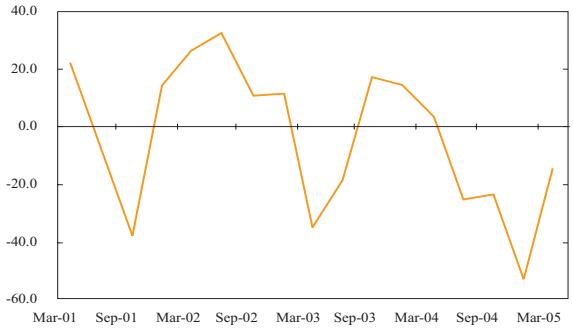


Source: DANE. Calculations by Banco de República.

GRAPH 13

JOB CREATION FOR INDIVIDUALS BETWEEN 12 AND 17 YEARS OF AGE (2.5% OF ALL OCCUPIED INDIVIDUALS)

(Annual variation: thousands of individuals)

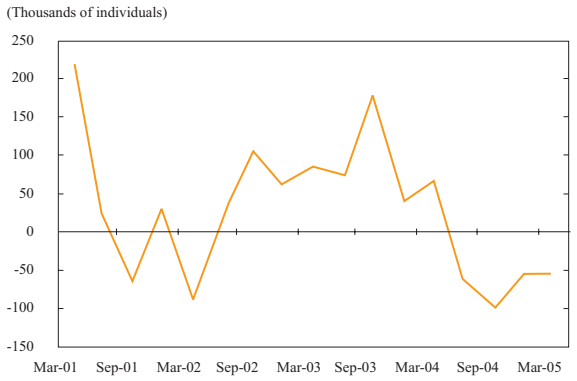


Source: DANE. Calculations by Banco de República.

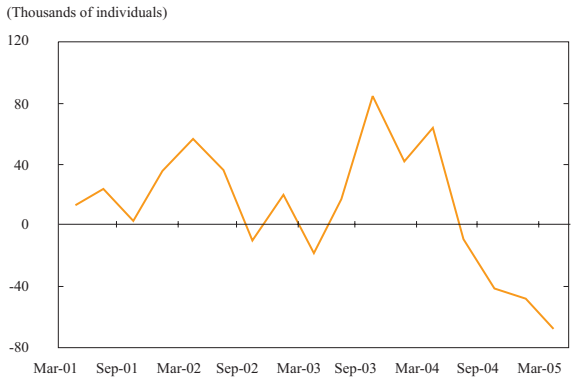
Graph 14

Job Creation

Self-employed Workers
(32.7% of all occupied individuals)



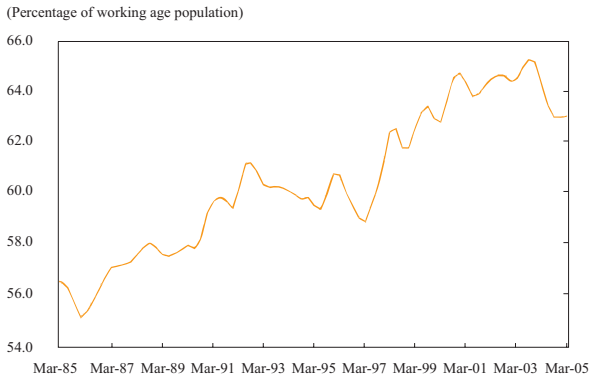
Unpaid Family Workers
(2.3% of all occupied individuals)



Source: DANE. Calculations by Banco de la República.

Graph 15

Global Participation Rate in Seven Cities
Combined Series of NHS and CHS Samples



Source: NHS and CHS, DANE. Calculations by Banco de la República.

(construction, community and personal social services and sales). This also was true among workers who are self-employed, unpaid family laborers and/or domestic employees (Graph 14). The trend in employment and unemployment reflects the steady momentum of the Colombian economy and particularly the growth in private productive activity, which is generating most of the demand for labor.

The decline in the global participation rate (GPR), from a quarterly average of 61.8% in April 2003 to 61.2% in April 2004, and 59.4% during the same month in 2005, also has helped the unemployment situation. This reduction may be associated with the economic cycle (Graph 16). Although the sample is small and the national and continuous household surveys conducted by DANE need to be combined, it is evident that the GPR also declined significantly during the last economic growth cycle (1992-1997). This indicator has exhibited secular growth ever since measurements began to be taken (1984), with several periods of slight retreat linked to periods of economic expansion. More family income and job stability is one hypothesis that could explain the decline in GPR since mid-2004. Information at May for the thirteen major cities, compared with 2004, shows household heads need one month less to find a job (almost 37 weeks as opposed to 42). Moreover, the jobs they find are more likely to be stable and less likely to be considered underemployment.

Accordingly, either the youngest family members and secondary workers (housewives, the elderly, etc.) are postponing their entry into the job market, or part of this population that was working may have become economically inactive. According to the DANE continuous household survey, a large portion of the newly inactive cited education as the activity that replaced their involvement in the labor market. A second group said they had left the job market to return to domestic chores.

II. Inflation in the First Six Months of 2005 and the Outlook for the Second Half of the Year

The course of inflation shows monetary policy is being implemented in a way that is consistent with the inflation targets and with long-term price stability, as stipulated in the Bank's constitutional mandate.

So far this year, prices have stayed within the target range for inflation set by Banco de la República for 2005; that is, between 4.5% and 5.5%. Most price indicators declined substantially in the first half of the year. Annual consumer inflation went from 5.5% in December to 4.8% in June. There was an even bigger drop in non-food inflation, which was down from 5.5% to 4.3% during the same period (Graph 16).

Core inflation declined in recent months, as it has since late 2003, making last year's target a reality. The average of the three indicators monitored by the Bank (non-food, nucleus and inflation without food and public utilities) was 4.25% in June, which is 105 basis points (bp) less than the average in December 2004 and below the mid-point in the target range.

There are several reasons for the downturn in inflation:

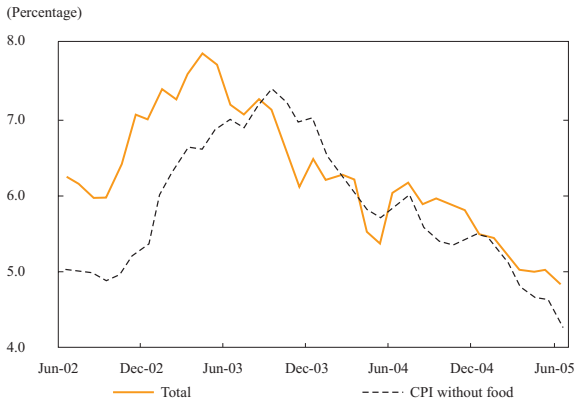
- *One is the decline in inflationary expectations, which are near the target announced by the Bank.* (Graph 18). Single-digit inflation for the past six years, with a decline since mid-2003, has boosted confidence in the country's monetary policy and lowered the extent of price and wage indexation (Graph 18).

  Wage agreements reached in 2004 and 2005 for this year and the next (Table 3) reflect less indexation in the past year. For example, 36.1% of the wage agreements reached in 2004 for that same year called for a 6.7% increase, while 64.4% of those for 2005 were based on a 5.6% increase throughout the year. On the other hand, 33.4% of the bargaining agreements in 2004 stipulated a wage increase for the following year equal to the CPI + 1, while 57.1% of those in 2005 established an increase for 2006 equal to the CPI.

Core inflation declined in recent months, as it has since late 2003, making last year's target a reality.

Graph16

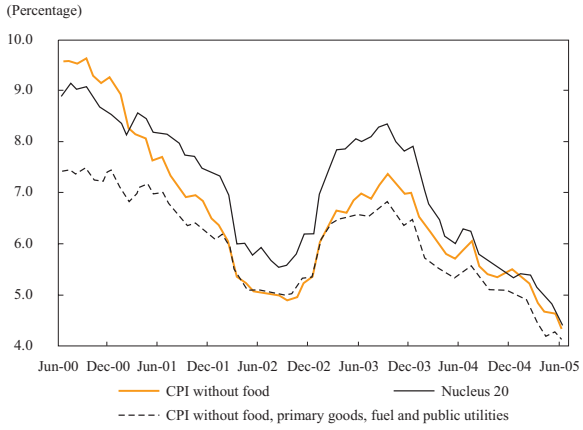
Annual Consumer Inflation



Source: DANE

Graph 17

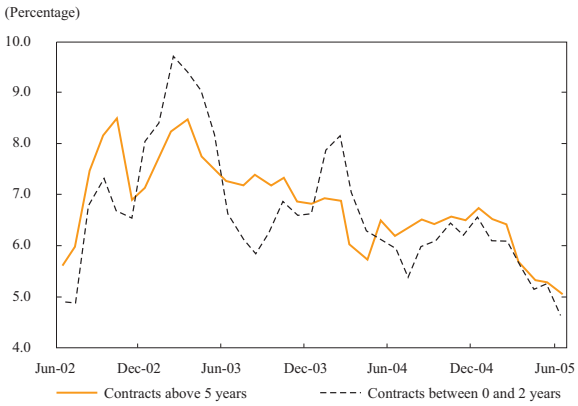
Core Inflation Indicators



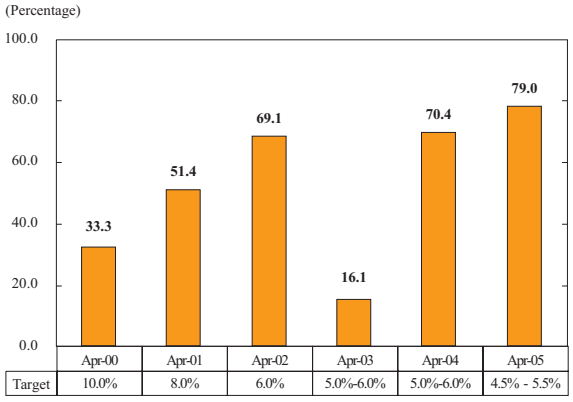
Source DANE. Calculations by Banco de la República.

Graph 18

Inflation Expectations Derived from Fixed Rate and Variable Rate Contracts for TES
(With figures at June 30)



Credibility of Annual Inflation Targets during the Years from 2001 to 2005
(Survey done every year in April)



Source: Banco de la República.

Table 3

Percentage of Beneficiaries by Level of Wage Increase
(Percentage)

Agreed for the current year	**<5**	**[5.6]**	**[6.7]**	**[7.8]**	**[8.9]**	**>9**
Agreed in 2004 (figures at November)	1.90	10.66	36.10	41.37	7.92	2.05
Agreed in 2005 (figures at May)	1.67	64.39	20.16	11.04	2.33	0.41
Agreed for the following year	**<7**	**>7**	**IPC**	**IPC +1**	**IPC +2**	**Otros**
Agreed in 2004 (figures at November)	10.53	10.84	25.27	33.35	2.52	17.50
Agreed in 2005 (figures at May)	8.08	0.00	57.11	13.89	6.36	14.56

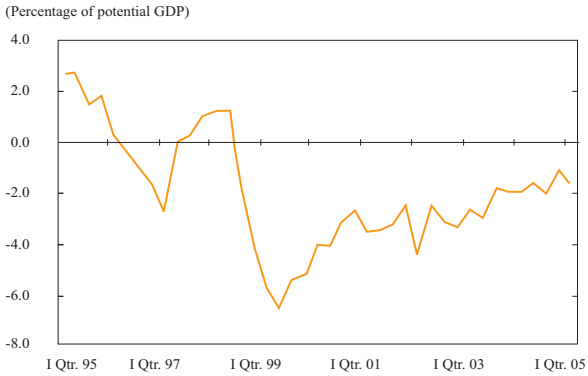
Source: Ministry for Social Protection. Calculations by Banco de la República.

- *Another reason is the surplus capacity still available in the economy.* This is reflected in the rate of underused productive resources. Although growth in the last two years has gradually reduced the output gap (the distance between actual and potential output), despite the uncertainty in measuring this variable, the indication is that more investment and gains in productivity have slowed its closure (Graph 19). In effect, the growth in productive capacity and productivity permit an increase in the potential for economic growth, without sparking significant inflationary pressure. Continued surplus capacity, coupled with more competition for the productive sector from increased imports, might be limiting companies' ability to fix prices, as is apparent in less demand-pulled inflationary pressure. For example, the decline in non-tradable inflation (without food) from 6.2% in December to 5.2% in June reflects limited demand-pulled pressures and declining expectations of inflation (Graph 20). This fact, coupled with growing trust in the monetary policy, has made it possible to maintain an expansive monetary policy in a time of declining inflation.

- *Accrued exchange appreciation is a third reason.* Although the bulk of appreciation occurred in late 2004 and in recent months, the exchange rate has remained stable. Because movement in the exchange rate does not immediately affect consumer inflation, it continues to decline. Accordingly, CPI tradable inflation (without food and regulated goods) went from 3.5% to 2.1% between December 2004 and June 2005. Its current level is the lowest of the various CPI components.

Graph 19

Output Gap

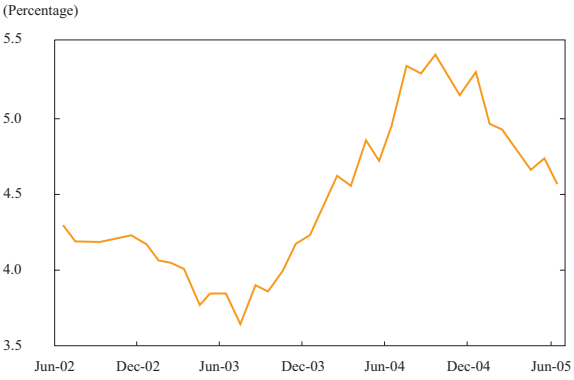


Source: Banco de la República.

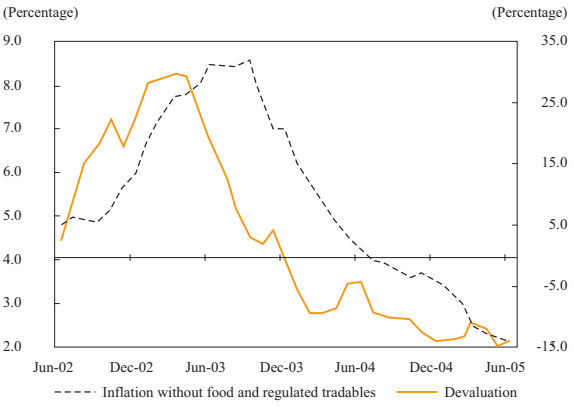
Graph 20

Annual Inflation

Non-tradables (without food and regulated goods and services)



Tradables (without food, regulated goods and services) and Devaluation



Source: DANE. Calculations by Banco de la República.

These factors offset the upward impact expected (directly or indirectly) from the hike in fuel prices (via higher fares for public transportation). Unexpectedly higher food prices, especially for perishables such as potatoes, vegetables and root crops due to circumstances related to their normal growing cycle, are another upward element, but with less influence.

The stability of the exchange rate during 2005 to date is a reliable sign that tradable inflation is likely to be low by the end of the year. Nor is it anticipated that expectations will generate upward pressure, considering (i) the monetary policy is regarded as extremely credible; (ii) the BDBR reiterated its commitment to the future target for inflation; (iii) inflation is moving towards the lower limit of the target range, and (iv) most price changes during 2005 were probably already in place by mid-year, as is traditional.

In terms of perishable food prices, additional increases in August cannot be ruled out, but probably will decline towards the end of the year and cause no major rise in inflation. Even though the rise in fuel prices is expected to continue, it will be less than in 2004 and at the beginning of this year.

Finally, with respect to the course of inflation during the remainder of this year and next, the extent of possible pressure from demand is the major cause of uncertainty. In principle, BR estimates suggest that, with 4% economic growth, the output gap will remain negative. This would imply continued surplus production capacity and a loose job market, which will keep major inflationary pressure at bay.

Although the calculations on the output gap are not precise, and it should continue to close during the course of the year, these pressures cannot be ruled out entirely. Banco de la República is keeping an eye on non-tradable inflation and other indicators that might signal sectoral bottlenecks, supply problems or any increase in company profit margins.

These factors, as a whole, suggest that inflation is very likely to be within the target range (4.5% to 5.5%). Moreover, according to the models developed by Banco de la República, non-food inflation could be near this range by the end of the year. Our analysis also suggests that inflation will continue to decline in 2006.

Inflation is very likely to be within the target range (4.5% to 5.5%).

The trend in inflation indicates that monetary policy management is consistent with the inflation targets and with long-term price stability, pursuant to the Bank's constitutional mandate. As explained in the

following Chapter, this has been accomplished in a context marked by a loose monetary policy (expressed in low BR intervention interest rates) and strong growth in monetary aggregates.

Our analysis also suggests that inflation will continue to decline in 2006.

III. Monetary Policy

Monetary aggregates and credit are growing at a fast pace, while real borrowing and lending rates in the banking system have remained at historically low levels.

Monetary policy in Colombia is part of an inflation targeting strategy and focuses on maximum GDP growth consistent with the targets set for inflation. Inasmuch as inflation and expectations of inflation are aligned with the targets, and because economic activity is below potential and unemployment remains high, there has been substantial monetary stimulus in the economy throughout the year. This contrasts with the situation in other Latin American countries.

The BDBR has been coherent in using its two major monetary instruments. On the one hand, it lowered the intervention interest rate (repo rate) in December. On the other, the Bank remained actively involved in the exchange market through direct purchases of foreign currency. In this context, monetary aggregates and credit have grown at a high rate, while real rates on borrowing and lending in the banking system are historically low. This monetary stance, coupled with improved confidence and better external conditions, allows for a reasonable expectation of 4% GDP growth, which is similar to the rate in 2004 and 2003. The inflation target for 2005 is likely to be met and inflation should continue to decline in 2006.

A. Interest Rates and Monetary Aggregates

1. Interest Rates

The latest change in intervention interest rate (a reduction of 25 bp) was ruled by the BDBR on December 17, 2004.

a. Banco de la República Intervention Rates

The latest change in intervention interest rates (a reduction of 25 bp) was ruled by the BDBR on December 17, 2004. This placed the expansion

auction and window rates at 6.5% and 10.25% effective annually, and contraction rates at 5.5% and 4.5%, in that order. Later, on December 22, the BDBR suspended the contraction window and contraction auctions entirely (Table 4).

b. Market Interest Rates

In the first six months of 2005, the nominal interbank interest rate (IIR) averaged 6.36%, which is 71 bp less than during the same period in 2004 (Graph 21). This was due to a 75 bp reduction in BR intervention rates

TABLE 4

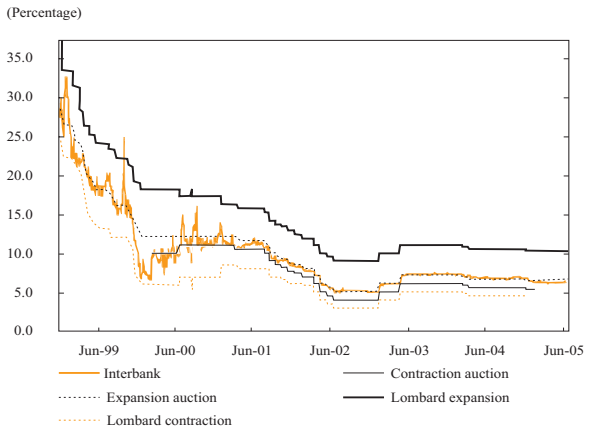
BANCO DE LA REPÚBLICA INTERVENTION RATE
(PERCENTAGE)

Effective Dates		Contraction Minimum (Lombard)	Contraction Auction Maximum	Expansion Auction Minimum	Expansion Maximum (Lombard) for the Period	Interbank Rate		
From	To					Average	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 **(*)**	Jun-30-05	-	-	6.50	10.25	6.38	6.35	1.29

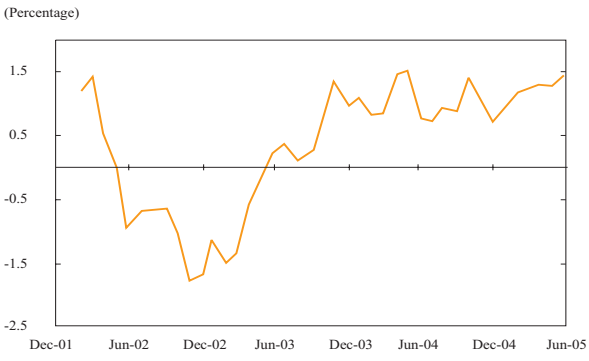
(*) Banco de la República closed the deposit window (auction and Lombard) on December 22, 2004.
Source: Banco de la República and the Banking Superintendent (interbank rate).

GRAPH 21

BANCO DE LA REPÚBLICA INTERBANK AND INTERVENTION RATE (*)



REAL INTERBANK RATE

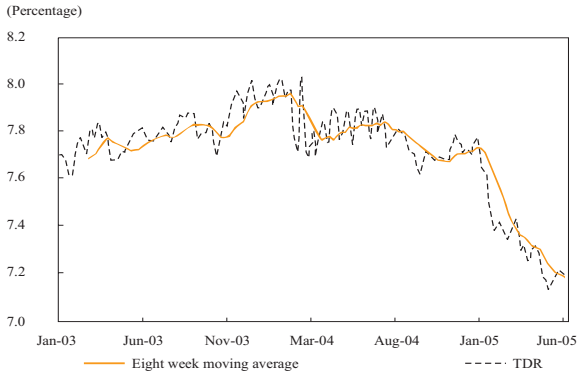


(*) Banco de la República closed the contraction window (auction and Lombard) on December 22, 2004.
Source: Banco de la República.

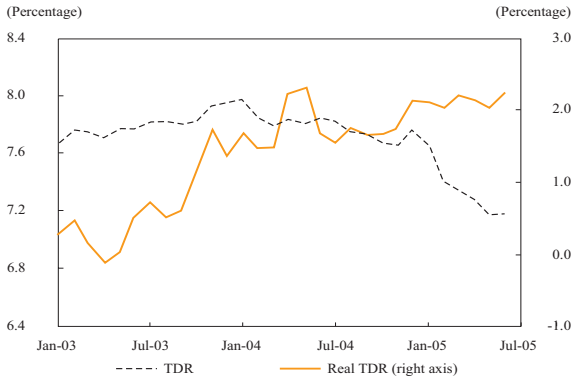
GRAPH 22

INTEREST RATE

TDR (TERM DEPOSIT RATE)



NOMINAL AND REAL TDR (*)



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

during 2004 and to changes in liquidity management. In real terms, the IIR averaged 1.22% between January and June 2005, down 15 bp from the average in 2004.

As Graph 22 illustrates, the reduction in BR interest rates also affected the nominal TDR rate[2] . Its average for the first six months of 2005 was 7.39%. This is 45 bp below the figure for January-June 2004. However, the average TDR rate for same period in 2005 was 2.14%, which is equivalent to a 33 bp increase compared with the average registered in the first five months of 2004.

Nominal interest on credit (by economic use) also declined, registering the following averages at June 2005: 24.30% for consumer credit, 16.68% for regular loans, 10.38% for preferential credit, and 8.86% for treasury loans. These averages were 174 bp, 102 bp, 39 bp and 76 bp less than those observed during the same period in 2004, in that order (Graph 23). In real terms, these rates averaged 18.57%, 11.30%, 5.29% and 3.84% during the same period in 2005 (Table 5).

c. Interest Rates on Government Bonds

During the first half of the year, the domestic market for government bonds was characterized by a high volume of trading and a downward trend in interest rates on the primary and secondary market, which reached historic lows. This pattern was interrupted temporarily at the end of March because of uncertainty over how the U.S. Federal Reserve Bank (the Fed) would continue to manage interest rates.

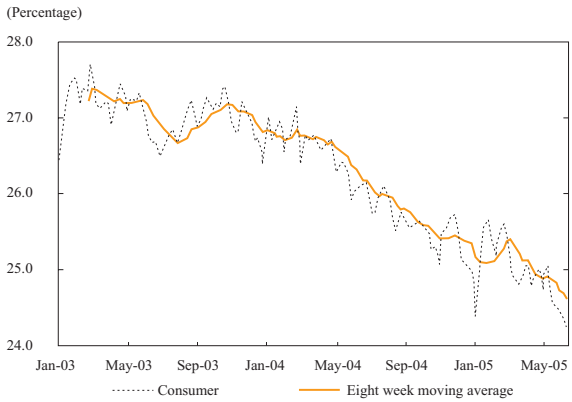
On March 22, the Fed raised the rate on federal funds by 25 bp, as the market had predicted. However, in publicizing this increase, it stated that inflationary pressures in the United States economy had increased in recent months. The tendency of the world market changed in the wake of that

[2] Calculated as the average rate on 90-day term deposits.

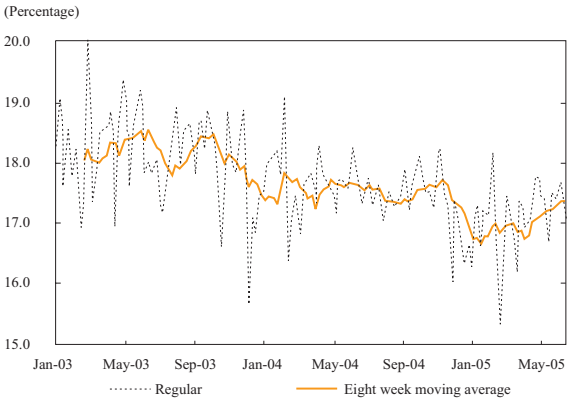
Graph 23

Interest Rates, by Type of Credit

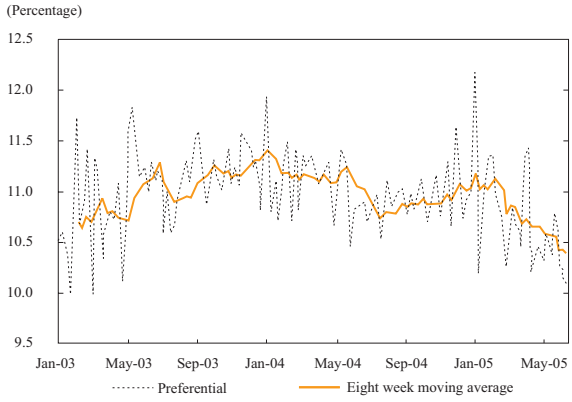
Consumer



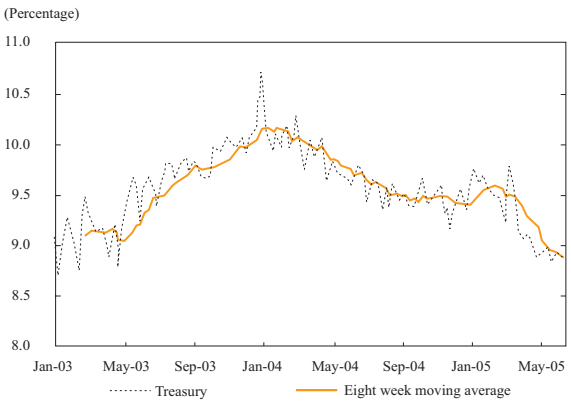
Regular



Preferential



Treasury



Source: Calculations by Banco de la República.

Table 5

Lending Rates (*)

Year	Consumer		Regular		Preferential		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
Jun-04	26.04	18.84	17.70	10.97	10.77	4.44	9.62	3.35
Jun-05	24.30	18.57	16.68	11.30	10.38	5.29	8.86	3.84

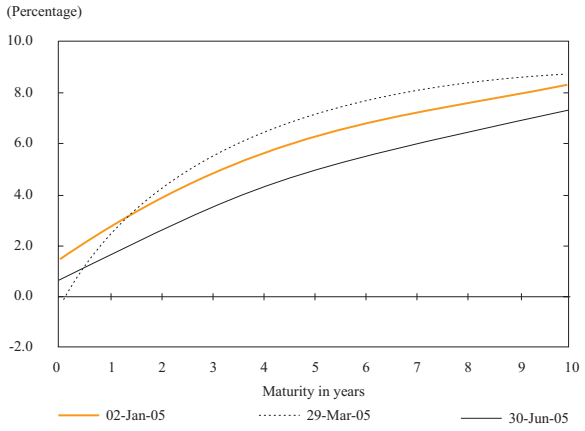
(*) End of period figures.
Source: Banco de la República.

announcement, initially with a rise in interest rates on U.S. Treasury Bonds, followed by broader spreads on the region's external debt instruments and, in the Colombian case, an increase in the exchange rate and the domestic debt curve. The exchange rate went from Col$2,338 to Col$2,400 per dollar, and the zero-coupon curve on fixed-rate TES rose by 71 bp, on average, between March 11 and 29[3].

Colombian agents began to monitor U.S. Treasury bonds to gauge how the Fed would handle interest rates in the future. This exercise revealed an important correlation between these bonds and TES in the two months thereafter. The TES market experienced another downturn after the market rates on U.S. Treasury bonds declined (an increase in prices) and the spreads on the region's debt instruments dropped[4]. Likewise, the trend in the exchange rate was towards revaluation, having declined by Col$60 between March 29 an April 12.

GRAPH 24

FIXED-RATE TES SPOT CURVE, 2005



Source: Colombian Stock Exchange (BVC). Calculations by Banco de la República.

The drop in TES interest rates during the rest of the semester was due to the end demand expressed by agents who perceived a favorable pattern for inflation and high levels of liquidity in the financial system. The decline in market rates has been particularly true for medium and long-term bonds, which ended the semester at levels below those registered in March. In other words, they reached historic lows in both nominal and real terms. The zero-coupon curve is shown in Graph 24, minus inflation in the last 12 months.

2. Monetary Aggregates and the Financial Portfolio in the Productive Sector

Monetary aggregates, the financial portfolio of the productive sector, and holdings continued to grow at rates above nominal GDP. During the course of the year to June, base money and M3 rose at average annual nominal rates of 18.4% and 17.8%, respectively. This is equivalent to 12.7% and 11.9% real growth, in that order (Graphs 25 and 26). A look at the trend in

[3] Each point on the zero-coupon curve reflects the interest rate on a flow payable at that particular point in time. In other words, the six-month due date on the zero-coupon curve reflects the flow yield payable six months from today. This curve is different from a yield curve where the points reflect the domestic rate of return on bonds with that maturity, but their flow payments can be made at different times. If the bonds had no coupon payments and only principle, the zero-coupon curve and the yield curve would be exactly the same.

[4] For example, the Colombian EMBI registered historic lows.

M3 as a share of GDP shows the financial depth of the economy is less than it was in the second half of the nineties. The financial portfolio in the productive sector grew at an average annual rate of 17.5% between January and April 2005, mainly because of more TES holdings in the private sector (34.3%). On the other hand, the increase in the net portfolio[5] during the last six months came to 13.8%. The adjusted net portfolio, which includes securitization, grew by 16.1%[6]. However, in terms of GDP, the portfolio remains at historically low levels (21% of GDP), despite a slight recovery in June (Graph 27).

The acceleration in the growth of monetary aggregates and the portfolio in domestic currency is largely due to the fact that agents have insisted on more assets in Colombian pesos and less of an external component to their portfolios. Low external interest rates, high international liquidity and a

[5] The net portfolio is equal to the gross portfolio minus provisions. It does not include leasing operations. The information is reported to the Banking Superintendent by credit institutions and is preliminary. It is not taken from the balance sheets in the system.

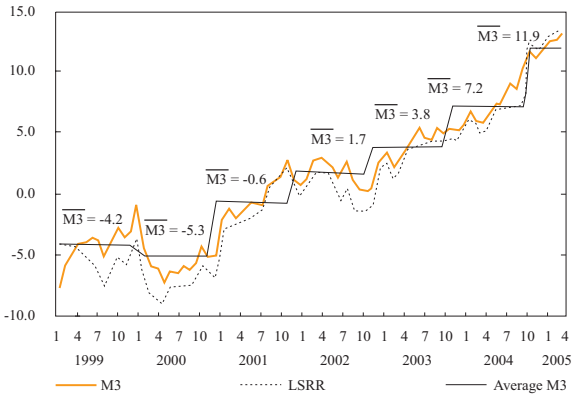
[6] The adjusted portfolio adds to the figures of the Banking Superintendent the holdings that have been removed from bank balance sheets through securitization and are valid.

GRAPH 26

M3

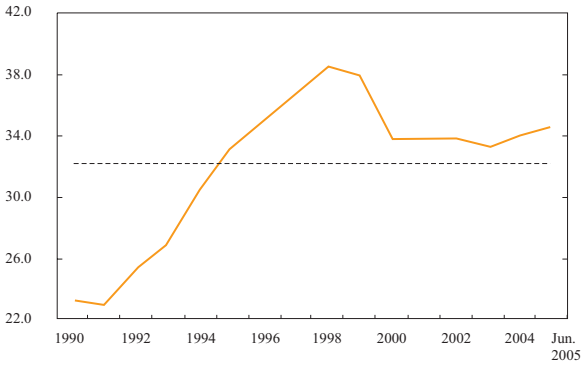
REAL M3

(% annual variation)



M3 AS A PORTION OF GDP

(Percentage)

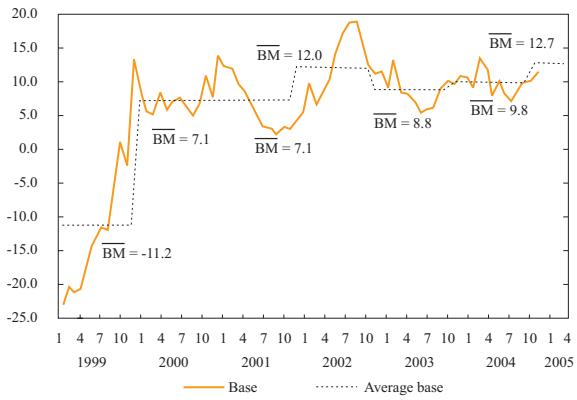


Source: Banco de la República.

GRAPH 25

REAL BASE MONEY

(% annual variation)

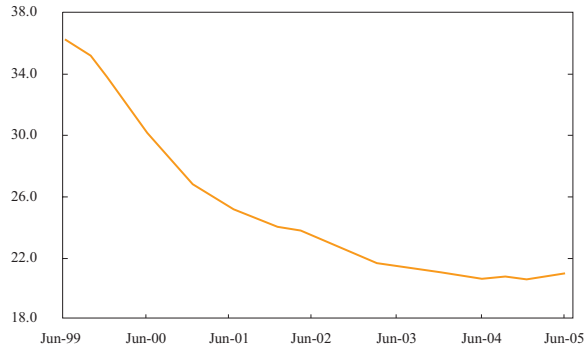


Source: Banco de la República.

GRAPH 27

NET PORTFOLIO AS A PERCENTAGE OF GDP (*)

(Percentage)



(*) Nominal GDP is calculated as the sum of quarterly flows from the end of June 2004 and nominal GDP projected for the same month in 2005. The net portfolio is the annual average of weekly figures in total currency, without FEN.
Source: Banco de la República.

The financial depth of the economic is less than it was in the second half of the nineties.

more favorable perception of the country's risk might be some of the factors behind this change.

The increased demand for deposits in the financial system was reflected in the growth in liabilities subject to reserve requirements (LSRR), with a nominal average annual variation of 18.4% between January and June 2005. This is superior to the respective growth in the economy and 7.0% more than the change registered for the same period in 2004. Quasimoney, which includes savings accounts and term-deposit certificates (CDs), was responsible for the largest increase in LSRR, thanks to respective average annual variations of 27.5% and 12.8%. The increase in the average value of bonds issued by credit establishments (34.3% average annual growth) also was a factor.

Sectoral figures show 18.3% annual growth in private LSRR by May 2005. Deposits from the public sector increased at an annual rate of 21.5%, despite a 17.8% decline in repo operations between the financial system and the public sector, particularly the National Treasury (Table 6). The latter is the effect of the change in the liquidity supply system agreed on by the government and Banco de la República (Box 1).

The increase in the level and recomposition of LSRR, coupled with historically high excess reserve rates, prompted considerable growth in the demand for bank reserves during the same period. During the course of

TABLE 6

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

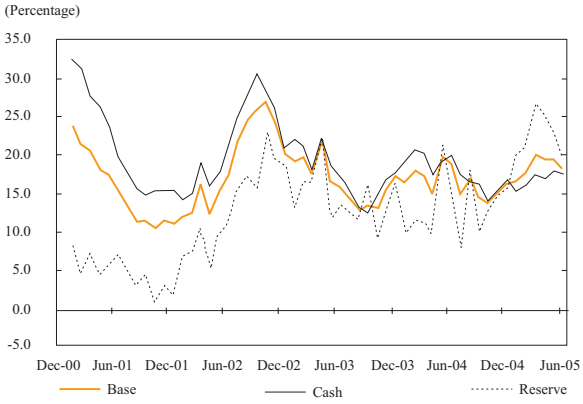
	March			June			September			Diecember			Mayo		
	2003	2004	%	2003	2004	%	2003	2004	%	2003	2004	%	2004	2005	%
Private M3	60,279	66,554	10.41	61,461	69,495	13.07	61,955	69,475	12.14	66,941	78,048	16.59	66,982	79,127	18.13
Cash	8,780	10,383	18.27	9,338	10,750	15.12	9,215	10,547	14.45	12,070	13,832	14.60	10,496	12,311	17.29
LSRR	51,500	56,170	9.07	52,123	58,745	12.70	52,741	58,928	11.73	54,871	64,215	17.03	56,486	66,816	18.29
Current accounts	6,484	7,796	20.24	6,893	8,086	17.31	7,069	7,582	7.26	8,880	10,236	15.28	7,361	8,786	19.35
CD	21,970	23,159	5.42	21,733	23,803	9.52	22,291	24,471	9.78	21,890	24,422	11.56	23,181	25,812	11.35
Savings	19,154	20,530	7.18	19,608	21,672	10.52	19,700	21,613	9.71	20,317	24,428	20.24	21,138	26,342	24.62
Others	3,892	4,685	20.36	3,888	5,184	33.32	3,681	5,262	42.93	3,784	5,129	35.55	4,806	5,876	22.26
Public M3	13,814	17,145	24.11	15,478	16,621	7.38	15,427	18,474	19.75	15,450	19,068	23.42	17,172	20,860	21.48
Current accounts	3,528	3,790	7.42	3,577	3,666	2.48	3,266	3,780	15.71	4,240	5,055	19.24	3,579	4,254	18.87
CD	1,846	1,566	(15.15)	2,137	2,064	(3.42)	1,967	2,614	32.89	1,649	2,272	37.78	1,958	2,349	19.95
Savings	4,567	6,542	43.24	4,726	7,255	53.52	5,055	7,870	55.69	5,233	8,209	56.86	7,633	10,328	35.32
Repos	2,235	3,405	52.38	3,316	1,589	(52.09)	3,506	2,265	(35.40)	2,328	1,194	(48.71)	2,061	1,694	(17.81)
Others	1,638	1,842	12.42	1,722	2,047	18.84	1,633	1,945	19.12	1,999	2,337	16.91	1,942	2,235	15.11
Total M3	74,093	83,699	12.96	76,939	86,115	11.93	77,383	87,949	13.65	82,390	97,116	17.87	84,155	99,987	18.81

(*) Annual variation
Source: Banco de la República.

the year to June, the average value of bank reserves was up by an annual rate of 22.4%. This is 9.0 pp more that the increase reported for the same period in 2004. The demand for cash remained high, as it has since the tax on financial transactions was instituted, and registered an average annual increase of 16.7% during the first six months of the year (Graph 28). These factors led to a strong increase in the demand for primary liquidity. During the first part of the year, this was evident in an average annual increase of 18.4% in base money.

Graph 28

Base Money and its Use
Annual Rate of Growth in the Monthly Average



Source: Banco de la República.

In keeping with the *inflation targeting strategy*, the monetary authorities reacted to this situation by satisfying the increased demand for liquidity at the interest rates established by the BDBR, based on the *Inflation Report.* Accordingly, the period between June 2004 and June 2005 saw an increase of CoL$2,670 billion (b), in base money. Its sources were slightly different from those in previous years, due to the Bank's intervention in the exchange market. The expansionary impact of net foreign exchange purchased by the Bank on the exchange market came to Col$4,676 b[7], followed by the growth in net repos, which was Col$2,350 b during the period. The foregoing was offset, in part by the net decline generated by the increase in national government deposits with Banco de la República (Col$6.432 b) (Table 7). This contrasts with previous years when net operations with the government had an expansionary effect. The contractionary monetary effect produced by the sale of reserves to the government is another point to bear in mind and was offset entirely by TES purchases.

As illustrated in Table 8, TES holdings in the productive sector had grown at an annual rate of 23.3% by April 2005[8]. This is more than the increase in M3. Consequently, the importance of the TES share of in the productive sector's financial portfolio in domestic currency continued to grow and accounted for 30.0% by April 2005.

An increase in monetary aggregates as a result of demand-related factors should not be a source of inflationary pressure. However, if there are changes in international liquidity, in external interest rates or in expectations of devaluation that alter decisions concerning the demand for liquidity on the part of agents, the result could be a supply surplus and, therefore, the risk of inflationary pressures the Bank would have to deal with.

An increase in monetary aggregates as a result of demand-related factors should not be a source of inflationary pressure.

[7] This is the monetary effect of US$3,719 m in gross foreign reserve purchases, minus US$1,650 m sold to the government.

[8] Figures on the sector's portfolio are only to April 2005.

TABLE 7

SOURCES OF BASE MONEY

		2001	2002	2003	2004	Jun-04			Jun-05		
						Full year	Year to date	Monthly	Full year	Year to date	Monthly
I.	**Government**	1,537	1,296	914	(236)	(362)	(360)	252	(5,978)	(6,101)	(2,286)
	Profits transferred	1,453	1,226	830	803	803	803	0	454	454	0
	Pesos	1,453	1,226	1,481	803	803	803	0			
	Dollars	0		(651)	0	0	0	0	454	454	
	Deposits with the Central Bank	84	70	83	(1,039)	(1,165)	(1,163)	252	(6,432)	(6,555)	(2,286)
II.	**TES Regulation**	(954)	150	568	(2,524)	(342)	(1,102)	(351)	1,291	2,713	(0)
	Definitive purchases	160	1,208	893	1,017	1,178	285	0	3,671	2,933	0
	Definitive sales				(2,967)	(983)	(983)	(272)	(1,989)	0	0
	Maturity	(1,113)	(1,058)	(325)	(575)	(537)	(404)	(79)	(391)	(221)	(0)
III.	**Repos**	(1,250)	1,349	1,492	(1,058)	716	(1,904)	242	2,350	1,504	2,115
	Expansion **1/**	(1,109)	1,322	1,386	(1,086)	461	(1,790)	352	2,208	1,504	2,115
	Contraction	(141)	28	106	28	254	(115)	(110)	143	0	0
IV.	**Foreign Currency**	1,445	(517)	(703)	6,194	2,209	1,909	545	4,676	392	656
	Put options	1,445	(517)	(703)	4,183	2,485	2,185	545	1,997		
	Discretional intervention				3,264	0	0	0	7,043	3,779	656
	Foreign currency sold to the government **2/**				(1,252)	(276)	(276)	0	(4,364)	(3,387)	
V.	**Others 3/**	159	178	239	272	354	87	(39)	330	145	25
Total change in base money		937	2,457	2,510	2,647	2,575	(1,370)	650	2,670	(1,348)	509
Base money position		11,648	14,105	16,615	19,262	15,244	15,244	15,244	17,914	17,914	17,914

1/ Includes one-day, overnight and medium-term repos.
2/ Includes the contractionary effect to neutralize the transfer of US$195.9 m (Col$454 b) in profits to the government.
3/ Includes the monetary impact of the BR income statement, TES A maturities, and BR investments.
Source: Banco de la República.

B. HOLDINGS IN THE FINANCIAL SYSTEM AND ASSET QUALITY

The financial system has seen accelerated growth in the main items on its balance sheet since mid-2004. This positive momentum involves the two largest components of assets (portfolio and investments) and is backed by a similar trend in deposits from brokers and financial agents. The accumulation of funds is, therefore, not likely to threaten growth of the system in the medium term (Boxes 2 and 3).

On the asset side, with the figures at May 2005[9], the portfolio registered 13.1% real annual growth (15% if corrected for securitization)[10], one of the highest increases since the crisis in the late nineties (Graph 29). This is

[9] This section contains figures up to May 2005, which is the latest information available from balances in the financial system. The portfolio figures in this section include leasing operations.

[10] The past year saw Col$1,290 b in portfolio withdrawals from balances sheets in the financial system, due to securitization; 90% pertained to the mortgage portfolio.

TABLE 8

FINANCIAL PORTFOLIO OF THE PRODUCTIVE SECTOR
(BILLIONS OF PESOS)

	Total Productive Sector								
	Total			Public Sector			Private Sector (.)		
	M3	TES	M3 + TES	M3	TES	Total	M3	TES	Total
Balances									
2003	82,390	31,613	**114,003**	15,450	16,612	**32,061**	66,941	15,001	**81,942**
2004	97,116	36,408	**133,524**	19,068	16,869	**35,937**	78,048	19,539	**97,587**
2005 January	96,037	38,018	**134,055**	19,477	16,887	**36,364**	76,560	21,131	**97,691**
February	95,948	40,622	**136,570**	20,040	17,514	**37,554**	75,908	23,108	**99,016**
March	96,915	40,671	**137,586**	18,939	18,029	**36,968**	77,976	22,643	**100,618**
April	98,672	42,340	**141,011**	20,146	18,524	**38,669**	78,526	23,816	**102,342**
Absolute annual change									
2003	9,318	2,754	**12,072**	3,145	-529	**2,616**	6,172	3,283	**9,456**
2004	14,725	4,795	**19,521**	3,619	257	**3,875**	11,107	4,539	**15,645**
2005 January	13,560	5,524	**19,084**	4,093	193	**4,286**	9,467	5,331	**14,798**
February	13,207	7,149	**20,356**	3,975	908	**4,883**	9,232	6,242	**15,474**
March	13,216	6,351	**19,567**	1,794	1,254	**3,049**	11,422	5,097	**16,519**
April	14,956	8,011	**22,967**	3,733	1,547	**5,279**	11,223	6,465	**17,688**
Annual percentage change									
2003	12.8	9.5	11.8	25.6	(3.1)	8.9	10.2	28.0	13.0
2004	17.9	15.2	17.1	23.4	1.5	12.1	16.6	30.3	19.1
2005 January	16.4	17.0	16.6	26.6	1.2	13.4	14.1	33.7	17.9
February	16.0	21.4	17.5	24.7	5.5	14.9	13.8	37.0	18.5
March	15.8	18.5	16.6	10.5	7.5	9.0	17.2	29.0	19.6
April	17.9	23.3	19.5	22.7	9.1	15.8	16.7	37.3	20.9

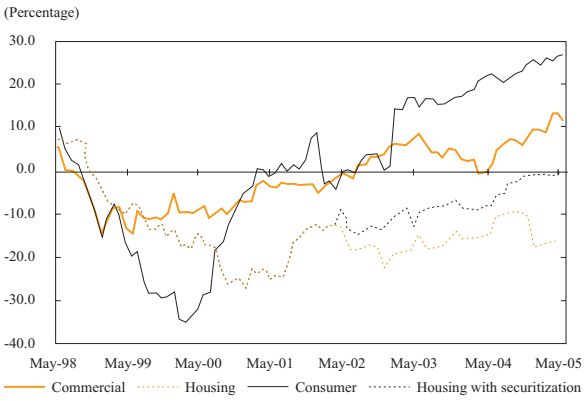
(*) Does not include TES in the financial sector
Source: Banco de la República.

explained by good performance for commercial and consumer loan portfolios, which saw respective increases of 12% and 27% and offset the downward trend in the mortgage portfolio. The latter dropped 16% in real annual terms (-1% if corrected to include securitization).

The share of company assets represented by investments (primarily in TES) continued to expand and, by May 2005, had increased at a real annual rate of 20%. The only exception was in March 2005, when tension on the government bond market lowered the value of the portfolio.

GRAPH 29

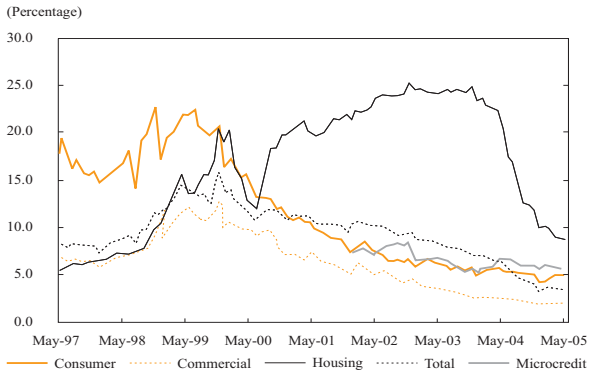
NET PORTFOLIO, BY TYPE OF CREDIT
REAL ANNUAL CHANGE



Source: Banking Superintendent. Calculations by Banco de la República

GRAPH 30

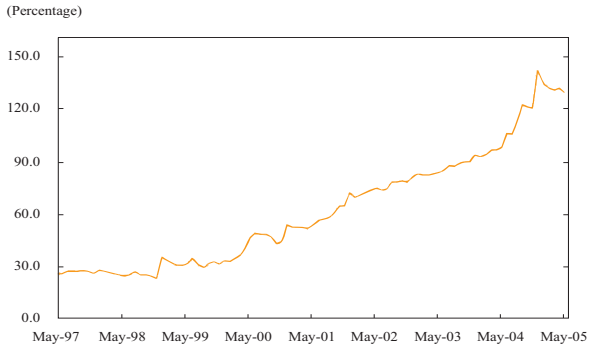
PORTFOLIO QUALITY, BY TYPE OF CREDIT



(*) The portfolio quality index is calculated as the overdue portion of the gross portfolio.
Source: Banking Superintendent. Calculations by Banco de la República.

GRAPH 31

COVERAGE: PROVISIONS /DELINQUENT PORTFOLIO



Source: Banking Superintendent. Calculations by Banco de la República.

1. Quality and Coverage

Besides good performance for the principal items on the balance sheet, there was less credit risk to the financial system. In May 2005, the overdue/gross portfolio ratio was at one of its lowest levels (3.4%) (Graph 30). This downturn in the portfolio quality indicator applied to all types of credit, but particularly to the mortgage portfolio, partly because the overdue portfolio is less after much of the questionable balance was sold, written-off and securitized in the second half of 2004.

This process has been accompanied by an increase in provisions to cover the overdue portfolio (Graph 31). As a result, the credit risk to institutions appears to be at historically low levels.

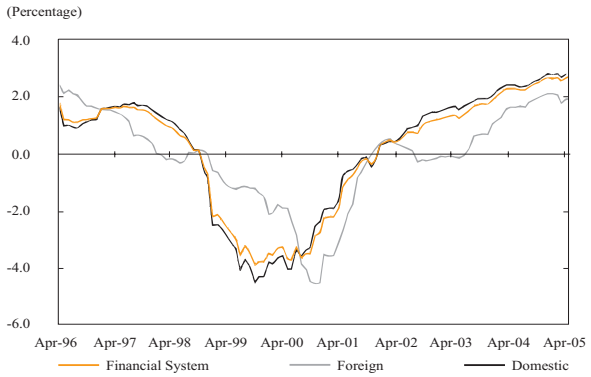
2. Profitability and Asset Soundness

The profitability of credit company assets has been above 2% since mid-2004 and was 2.8% in May 2005 (Graph 32), which is equivalent to Col$3 b in annualized profits. Most of the main brokers were in line with this tendency, except foreign institutions, which reported lower levels of profitability than the others (1.9%). Even public

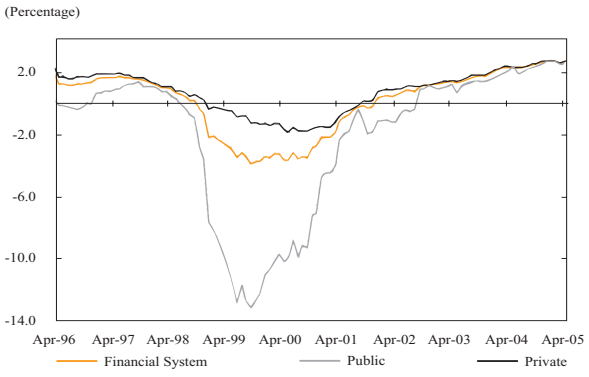
GRAPH 32

ASSET PROFITABILITY, BY TYPE OF ENTITY IN THE FINANCIAL SYSTEM

FOREIGN AND DOMESTIC



PUBLIC AND PRIVATE



Source: Banking Superintendent. Calculations by Banco de la República.

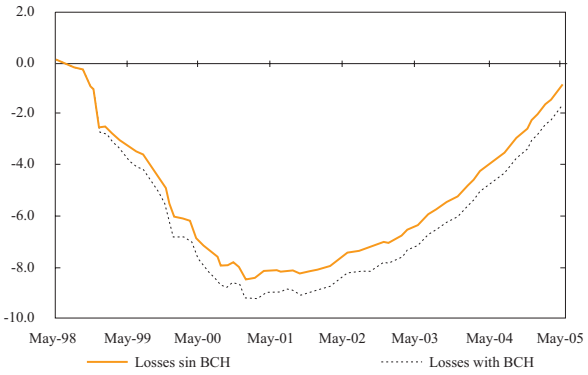
institutions, which were characterized by major losses during the crisis, reported returns on assets similar to those in the rest of the system (2.7%).

However, despite good performance in terms of profits, when taking into account the cumulative results as of January 1998, the outcome at May 2005 was still negative (by Col$900 b) (Graph 33). The solvency ratio for financial intermediaries (technical equity/risk-weighted assets) was above 14% in the early months of 2005, which is five points above the minimum required by the Banking Superintendent.

GRAPH 33

ACCUMULATED LOSSES IN THE FINANCIAL SYSTEM SINCE 1998

(Billions of March 2005 pesos)

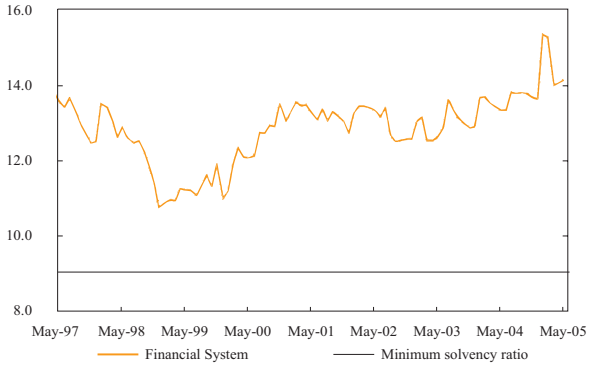


Source: Banking Superintendent. Calculations by Banco de la República.

GRAPH 34

SOLVENCY RATIO (*)

(Percentage)



(*) The solvency ratio is calculated as technical equity divided by risk-weighted assets
Source: Banking Superintendent. Calculations by Banco de la República.

Box 1

The New Liquidity Supply Scheme

In its session on June 3, 2005, the Board of Directors approved a new liquidity supply scheme whereby the Bank manages all surplus government liquidity. The new scheme is the result of a joint effort by the General Office of Public Credit and the National Treasury (DGCPTN), with the support of missions sent by World Bank and First Initiative, which collected comments from financial institutions[1] .

The new scheme has a variety of benefits for the capital market, the national government and Banco de la República. Its primary objective is to improve the way liquidity is distributed in the market, to further development of the money and government-debt market, and to reduce the operational and credit risk DGCPTN faces when investing at market rates.

Under the new scheme, which took effect on 22 June 2005, DGCPTN deposits all its resources with Banco de la República, which distributes them on the market pursuant to its monetary projections. The new scheme combines the best of the old arrangement with several changes aimed at making liquidity distribution more efficient.

The Bank holds two repo auctions daily, in accordance with monetary projections. This is different from the old scheme, where there was only one auction. The first auction is held between 9:00 a.m. and 9:15 a.m. and the second, between 1:00 a.m. and 1:15 p.m. The amount of the first auction and the minimum quota for the second are announced daily, always one day in advance. The quota for the second auction is either the remnant of the first auction or the minimum quota of the second, whichever is larger. The new daily auction replaces the early liquidity distributed previously by DGCPTN. With the minimum liquidity quota for the second auction, a certain amount of resources are always available in the afternoon, regardless of the outcome of the first auction. The traditional auction time was changed to coincide with closure of the government-debt and foreign exchange markets, thereby reducing unforeseeable liquidity needs to comply with transactions on those markets.

To the extent that monetary scheduling permits, the Bank will auction seven-day repos every Wednesday between 12:45 p.m. and 1:00 p.m. This replaces the term repos with DGCPTN and will allow the money market to better schedule its needs at term.

The limits on the number of repo requests (bids) per agent and on the total amount of resources taken to the Bank are now less restrictive. Normally, there will be no limit on the number of bids an agent can is allowed to tender at an auction, unlike the earlier scheme in which only three bids were accepted. The individual quota for credit institutions is as much as 35% of their liabilities subject to reserve requirements. Under the previous scheme, the proportion was 15%.

---

[1] First Initiative is an organization that finances activities and intervention in the public sector, primarily through funding for technical assistance to policy makers and regulatory bodies.

This limit far exceeds the maximum institutions had in repos with the Bank and DGCPTN in the past. Table B1.1 summarizes the operational changes inherent in the new scheme.

Table B1.1
Liquidity Supply Scheme

	Previous Scheme	New Scheme
No. of daily one-day repo auctions	One auction	Two auctions
Repo term	One day	One day and 7 days, if monetary scheduling permits
One-day auction schedule	11:30 a.m. - 12:00 a.m.	1st auction:9:15 a.m. -9:30 a.m. 2nd auction:1:00 p.m. -1:15 p.m.
Seven-day auction schedule		Wednesday: 12:30 p.m. - 12:45 p.m.
Announcement of auction quotas	The auction quota for the following day was announced daily, one day in advance	The amount of the first auction and the minimum quota for the second are announced daily, one day in advance. The amount not awarded in the first auction is added to the minimum value of the second.
No. of bids per agent in each repo auction	Three bids	No limit on bids
Increase in the individual quota for credit institutions	15% of liabilities subject to reserve requirements (LSRR)	35% of LSRR

Source: Banco de la República.

By depositing resources with Banco de la República, DGCPTN reduces the risk and cost of its investments and receives interest rates that are closer to those on the market. The rate on one-day interest-earning deposits made by DGCPTN with the Bank is the minimum expansion rate minus 5 bp; the next rate is the closing rate of the primary short-term TES B auction. At one year, the weekly average of the 365-day spot curve rate is used. A linear interpolation is done for the other specified dates[2] (Table B1.2).

The new scheme implies a number of benefits for markets. The following are some examples.

- There will be only one reference rate of interest for the repo market, and a further reduction in the volatility of the interbank interest rate might be possible.

[2] The remuneration scheme will be calculated weekly, on Thursday, or on the next working day thereafter if Thursday is a holiday, using the data available at that moment.

Cuadro R1.2
Remuneración a los depósitos de la DGCPTN en el Banco de la República

Deposit term	Previous Rates Rate +Margin (*)	Current Rates
First working day	Contraction + 60 bp	Expansion - 5 bp
Seven days	Contraction + 80 bp	
15 days	Contraction + 100 bp	
91 days	Contraction + 160 bp	
122 days	Contraction + 200 bp	Short-term TES B auction
182 days	Contraction + 250 bp	
365 days	Contraction + 325 bp	Weekly spot curve average

(*) This system was in effect until June 6, 2005.
Source: Banco de la República.

- The Bank will have better information on DGCPTN flows. This will help to make monetary projections more precise.
- Monetary policy transmission will improve, as there will be just one reference rate of interest and liquidity will be distributed more evenly[3].
- By being the primary supplier of liquidity, the Bank is in a position to distribute liquidity more evenly at times of market stress. This reduces systemic risk[4].
- Knowing the Bank's quotas gives the money market a measure of certainty about available liquidity. With the previous scheme, there was a great deal of uncertainty about what portion of its resources DGCPTN would deposit directly in the market and what portion would be taken directly or indirectly to the Bank.
- The new one-day repo auction and the change in the traditional auction time will help institutions to manage their liquidity during the day. They will continue to have early access to liquidity and, at 1:00 p.m., when they know the effect of their operations on the public debt and foreign exchange markets, they can adjust their liquidity again.
- By offering repos for more than one day (if monetary planning permits), the Bank will lend added stability to the liquidity positions of companies, thereby helping them to

[3] During 2005 to date, DGCPTN has conducted repo operations with 17 institutions and the Bank, with 69.

[4] During the TES B crisis in 2002, DGCPTN concentrated its surplus liquidity in a few institutions, which reduced their participation in the interbank market from 40% to 20%, and in the repo market from 58% to 30%.

manage their liquidity. Agents will participate in a market that is more standardized and deeper because of a single method for valuing securities and haircuts[5].

- DGCPTN will face less credit risk by investing at market rates, as well as less operational cost and risk in its investment process.

- Finally, a greater quantity of securities will be accepted as security for monetary expansion operations. Banco de la República receives 14 different government securities; DGCPTN received only six.

[5] A discount percentage applied to the price of the security to ensure coverage if the price drops.

Box 2

The Recent Trend in Spreads

The trend in spreads has become a recurrent topic in recent months. A description of this situation over the last few years is provided in this section to supplement the lack of discerning measurements in this respect and to lend specific and quantifiable elements to the discussion.

I. How to measure the spread.

Two approximations are normally used to measure the spread. The first is known as the ex *ante spread*. It is the result of a comparison between the implicit interest credit companies charge for new loans (lending rates) and what they pay on new deposits (deposit rate). The advantage to this measurement is that it reflects the approximate cost to the user, derived from financial brokerage. However, as several studies indicate[1], it does have certain limitations. i) It does not consider the difficulties involved in recovering all loans (credit risk). ii) The lending and deposit rates are constructed as simple averages of transactions involving very different terms and amounts, or with rates for just one type of activity.

The ex *post spread* is the second measurement. It is an approximation of the margin appropriated by the financial system itself, through the brokerage process, and uses information from the balance sheets of financial institutions. Implicit interest rates are constructed, both lending and deposit, to reflect the income and average cost of brokerage transactions. The advantage to this

[1] Jana, M. *et. al.* «Mediación y evolución de los márgenes de intervediación financiera para el caso colombiano 1996-2001,» in *Borradores de Economía, Banco de la República,* No. 182, 2001; Urrutia, M., «El margen de intermediación y la importancias de su medición,» in *Revista del Banco de la República,* Vol. 73, No. 870, pp. 5-17, 2000.

method is that it represents an average measure of all brokerage activity (and not just merely that of the operations in the spread). However, since there is no consensus on the definition of financial brokerage, its calculation will depend on the scope of the definition being used.

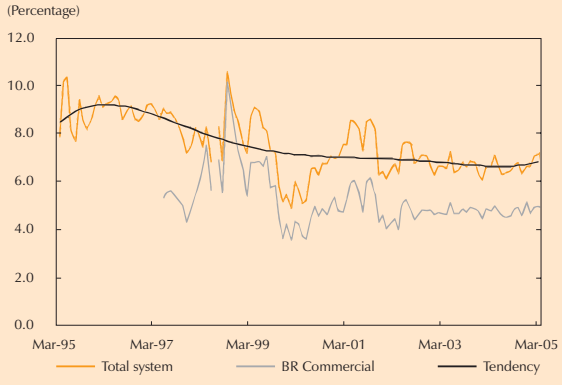
II. Recent trends in the spread

A. Ex ante spread

Graphs B2.1 and B2.2 show the trend in the real *ex ante* spread in interest rates on different financial activities (consumer rate, commercial rate, microcredit rate, credit card rate and total lending rate[2]), constructed with two different deposit rate indicators. Graph B2.1 uses the CD rate as the deposit rate, while Graph B2.2 uses a deposit rate that includes the weighted average of different types of deposits in the financial system[3].

Graph B2.1
Spread (*ex ante*) Using the CD Rate

Total System and Commercial



Consumer, Microcredit and Credit Card

Source: Banking Superintendent. Calculations by Banco de la República.

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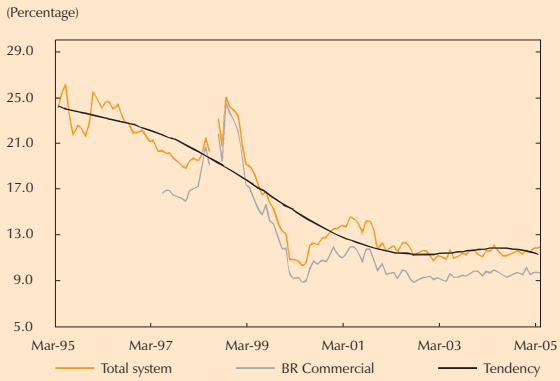
[2] Calculated as the weighted average of the sum of credit rates (consumer, preferential, regular and treasury) for the working days of the month. Given the high turnover in treasury credit, it was weighted as a fifth of its daily disbursement.

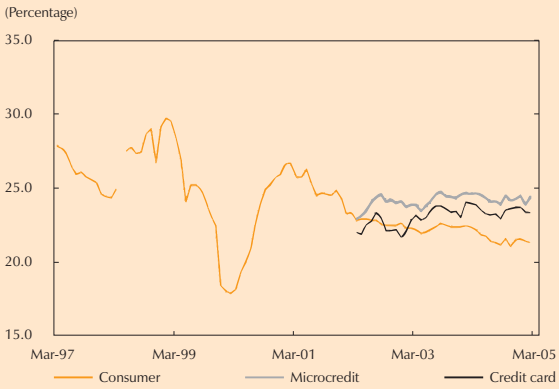
[3] This deposit rate was calculated as the weighted average interest rate (per share of the deposit stock) on CDs paid out each period, the savings account rate and the checking rate (assumed to be 0%).

Graph B2.2
Spread Using the *Ex ante* Rate

Total System and Commercial



Consumer, Microcredit and Credit Card



Source: Banking Superintendent. Calculations by Banco de la República.

As illustrated in Graph B2.1, with the first measurement, the spread is two percentage points lower than it was a decade ago (except in 1999-2000[4]). With the second measurement (Graph B2.2), the difference in rates is almost half of what was being charged at the time. The behavior of the deposit rate explains the differences in these findings. With the second measurement, the deposit rate is much lower (and creates a higher spread), since it includes other deposits that do not cost as much. By the same token, the reduction in the spread is due to a greater share of low-costs deposits as part of the total, which is consistent with low-inflation scenarios.

Generally speaking, the average spread for the entire system is now the lowest it has been in the last ten years, except in 1999 and 2000. Much of this reduction is due to the gradual elimination of regulated charges levied on the financial system during the nineties, such as reserve requirements and forced investments. Another factor is the reduction in inflation. This downward trend also is evident in the specific spread on consumer and commercial credit.

The spread on consumer loans, credit cards and microcredit is much higher than the spread on regular loans. This is because the interest on these loans is higher, since most of them are not backed by collateral and have a higher overdue rate (credit risk). Also, as in many countries around the world, loans of this type are more costly to manage.

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[4] The figures for 1999 and early 2000 are biased by the rate control imposed at that time. Credit supply rationing was a reflection of this situation and meant that loans were given only to people who posed a very low credit risk. This explains the low spreads during the period, without it implying any improvement in social well being.

This trend shows the margin, measured with marginal rates, is not uncommonly high. Accordingly, the cost to the average person who deposits a sum of money in the bank, then asks for a loan, not only represents a surplus with respect to the historic trend, but also is one of the lowest in the last decade.

B. Ex post spread

As mentioned earlier, measuring the spread with *ex post* rates is sensitive to whatever definition of financial brokerage is applied. For example, assuming that banks are dedicated solely to receiving deposits, then using the money to generate credit (a limited definition of brokerage), produces spreads very different from those when the assumption is that banks use a broader basket of liabilities, not only to fund loans but also to purchase financial investments and other assets (broader definition).

The best approximation to this calculation is obtained by constructing various *ex post* spreads based on different views of a bank's business in terms of borrowing and lending. Table B2.1 contains a summary of the various definitions used[5], ranging from the narrowest explanation of financial brokerage to broader and more general concepts.

TABLE B2.1
METHODS FOR CALCULATING THE IMPLICIT OR *EX POST* INTEREST RATE SPREAD

	Lending Rate	Deposit Rate
Spread A	Portfolio earnings/performing portfolio	Outlays for interest/cost liabilities
Spread B	Portfolio earnings/total gross portfolio	Outlays for interest/cost liabilities
Spread C	Financial earnings/productive assets	Egresos financieros/pasivos con costo
Spread D	(Financial earnings-financial outlays)/ productive assets	
Spread E	(Financial earnings-financial outlays)/total assets	

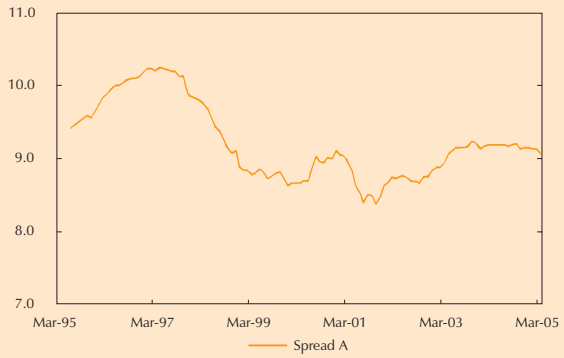
Source: Janna *et al.* (2001).

As with *ex ante* spreads, those of implicit rates are lower than they were between 1995 and 1998, although slightly higher than in 1999-2001. At that time, spreads were narrow, but treasury loans were the only credit being extended. And, there was a sharp decline in loans with high rates, such as consumer credit (Graph B2.3).

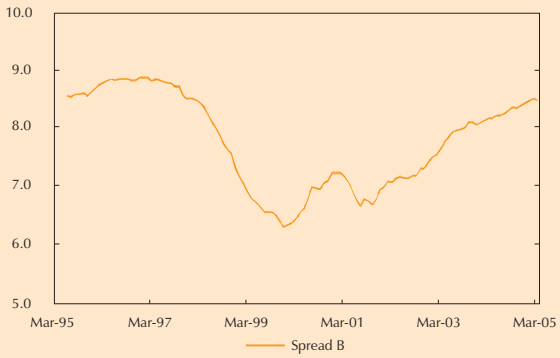
[5] These definitions were selected on the basis of Janna *et. al.* (2001). The monthly flows were deflated with the CPI for each month; the monthly inventory was deflated with the average CPI for the month in question and the one thereafter.

Graph R2.3
Ex Post Spreads according to Different Definitions of Brokering

(Interest Earnings /Performing Portfolio) - (Outlays for Interest/ Cost Liabilities)

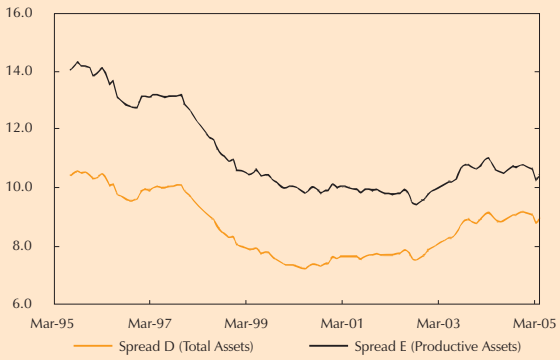


(Interest Earnings/Total Gross Portfolio) - (Outlays for Interest/ Cost Liabilities)



(Financial Earnings/Productive Assets) - (Financial Outlays / Cost Liabilities)

(Financial Earnings - Financial Outlays)/ Total Assets (Productive)



Source: Banking Superintendent. Calculations by Banco de la República.

The increase as of 2001 is due not only to regulatory changes, but also to a recomposition of the liabilities and assets held by credit institutions. In effect, low-cost deposits, such as savings accounts and checkable savings accounts, represent larger share of liabilities since mid-2001, to the detriment of more costly liabilities such as CDs and bonds (Graph B2.4). This has reduced the average cost incurred by these establishments to accumulate funds.

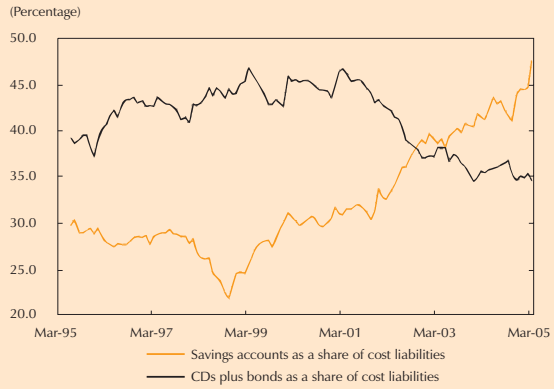
As of late 2002, consumer credit, which was down from the onset of the crisis, began to grow as a share of the total loan portfolio. This recomposition of assets was at the expense of other types of credit, such as mortgage and commercial loans. It means more earnings from interest on the loans now being extended, which have higher rates[6] (Graph B2.5). Aside from this effect,

the recent improvement in the performing portfolio (the part that generates income from interest) as a share of the total portfolio[7] has raised the lending rate calculated with the total gross portfolio (Spread B), thereby widening the spread measured this way.

III. Conclusions

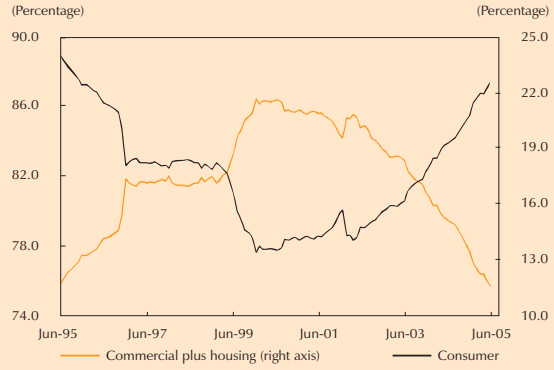
As illustrated, there is no single measurement to gauge spreads. Probably the best way is to consider a variety of indicators that measure the cost of brokerage from different standpoints.

Graph B2.4
Recomposition of the Liabilities Held by Credit Institutions



Source: Banking Superintendent. Calculations by Banco de la República.

Graph B2.5
Types of Credit as a Share of the Total Gross Portfolio



Source: Banking Superintendent. Calculations by Banco de la República.

6 This is because interest on consumer credit is higher, since most loans of this type are not backed by collateral and usually have a higher default rate (credit risk).

7 As a result of reorganization and clean-up in the banking sector after the crisis.

A study of this type shows that brokerage spreads in Colombia, in general, dwindled throughout the past decade to an historic average, and even much lower in some cases. The bulk of this trend is due to important progress in reducing regulatory burdens.

The high spreads for certain types of credit, such as the case of consumer credit summarized earlier, are characteristic of all economies and are not unique to the Colombian case. According to the measurements, the cost for users has declined and, and the same time, the reduction in the overdue portfolio, coupled with increased efficiency, has enabled banks to regain a measure of profitability.

Box 3

The Credit Channel and the Relationship between BR Intervention Rates and Market Rates

Bank credit is one of the channels for monetary policy transmission. Therefore, increases (decreases) in BR intervention rates are transferred to market rates for identical or longer maturities (on deposits and lending). This lowers (raises) the demand for credit. As a result, the beneficiaries reduce (increase) their consumption and investment, thereby creating a drop (rise) in aggregate demand and in inflation.

This mechanism is based on two assumptions. i) Deposits with credit establishments (CE)[1] should be used primarily for loans, which are an imperfect substitute for all other assets. ii) Agents rely on bank loans as their main source of financing, inasmuch as other types of funding imply higher costs. To the extent that these assumptions are not born out, transmission of the BR intervention rate to market rates is less, and the credit channel can be weakened.

As will be illustrated, there was a growing trend in Colombia between 2000 and 2004 towards substituting the loan portfolio for investment in government bonds. This detracts from the first assumption. Bank loans remained the primary source of company financing, but gains have been made through other means (e.g., plowing back profits, suppliers and bonds).

Even though these assumptions have lost ground, studies done by Banco de la República show that changes in intervention interest rates still are being transmitted to CE lending and deposit rates. The findings of these studies are outlined in the last section of this box.

[1] Commercial banks, finance corporations and commercial finance companies.

I. Sources of CE Financing

Liabilities subject to reserve requirements (LSRR)[2] were the main source of CE funding during the period under study. They accounted for 71.8% of all sources, on average, showing growth in excess of nominal GDP only as of 2004. There has been a sustained increase in the share of public LSRR, with annual variations well above nominal growth in the economy, particularly the increases in savings and current accounts. Although private LSRR still represent the largest share, they have not grown as quickly as nominal GDP, except in 2004 (Table B3.1).

TABLE B3.1
PRINCIPAL SOURCES OF CE RESOURCES IN DOMESTIC AND FOREIGN CURRENCY (*)

	Balance in Billions of					Pesos Share (%)					Annual variation (%)			
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2001	2002	2003	2004
Total Sources	74.6	79.6	85.8	96.1	113.2	100.0	100.0	100.0	100.0	100.0	6.8	7.7	12.1	17.8
LSRR	53.7	58.2	61.5	68.3	80.9	72.0	73.0	71.8	71.0	71.5	8.3	5.8	11.0	18.5
Public LSRR	7.1	9.6	12.8	16.0	19.7	9.5	12.0	14.9	16.6	17.4	34.9	33.4	25.2	23.4
Savings	1.1	1.7	3.8	5.2	8.2	1.5	2.1	4.4	5.4	7.3	48.6	129.0	37.3	56.9
Current accounts	2.4	3.3	3.9	4.2	5.1	3.2	4.1	4.5	4.4	4.5	39.1	18.3	9.0	19.2
CDs	1.1	1.6	1.7	1.6	2.3	1.4	2.0	2.0	1.7	2.0	50.2	8.1	(5.5)	37.8
Collections	1.1	1.1	1.4	1.6	1.9	1.5	1.4	1.6	1.6	1.7	0.4	19.5	15.3	21.5
Repos	0.9	1.2	1.1	2.3	1.2	1.2	1.5	1.3	2.4	1.1	31.7	(9.7)	113.2	(48.7)
Demand deposits	0.5	0.7	0.9	1.0	1.1	0.6	0.8	1.0	1.0	1.0	36.3	33.3	11.0	13.0
Private LSRR	46.6	48.6	48.7	52.3	61.2	62.5	61.0	56.8	54.4	54.1	4.2	0.4	7.2	17.0
Savings	15.7	17.5	19.1	20.3	24.4	21.1	21.9	22.2	21.1	21.6	11.1	9.2	6.6	20.2
Current accounts	7.1	7.1	7.7	8.9	10.2	9.5	8.9	9.0	9.2	9.0	0.6	8.5	15.0	15.3
CDs	20.4	20.8	18.8	19.8	22.1	27.3	26.1	22.0	20.6	19.5	1.8	(9.2)	5.3	11.2
Bonds	2.5	2.3	2.3	2.2	3.3	3.4	2.9	2.7	2.3	2.9	(7.4)	(1.4)	(5.6)	52.1
Demand deposits	0.8	0.7	0.6	0.7	0.7	1.0	0.9	0.7	0.7	0.6	(6.0)	(12.3)	10.9	(1.2)
Others	0.1	0.2	0.2	0.3	0.4	0.2	0.2	0.2	0.4	0.4	39.9	(3.7)	106.8	25.4
Banco de la República Repos	1.6	1.0	2.0	3.3	2.4	2.1	1.3	2.3	3.5	2.1	(35.8)	94.5	69.5	(29.2)
EFE Liabilities	5.4	5.5	5.7	6.6	7.3	7.2	6.9	6.7	6.9	6.5	1.9	4.5	15.5	10.7
Foreign Banks	3.4	3.0	3.4	2.4	3.5	4.6	3.8	4.0	2.5	3.1	(11.1)	12.8	(29.5)	46.7
Equity Accounts	5.2	5.6	6.4	7.7	9.4	7.0	7.1	7.4	8.0	8.3	7.9	13.0	21.2	21.8
Others	5.3	6.3	6.7	7.7	9.6	7.0	7.9	7.8	8.0	8.5	19.8	6.6	14.9	24.4

(*) Does not include IFI or special official financial entities (EFE).
Source: Banco de la República.

II. Principal CE Assets (Uses)

The 51.8% increase in CE assets between 2000 and 2004 is explained largely by more investments (107.8%) and, to a lesser extent, by growth in the portfolio (37.0%) and other assets (29.5%). (Table B3.2).

[2] The principal LSRR are listed in Table B3.1.

TABLE B3.2
PRINCIPAL USES OF CREDIT ESTABLISHMENT RESOURCES IN DOMESTIC AND FOREIGN CURRENCY 1/

	Year End Balances in Billions of Pesos					Share (%)					Annual variation (%)			
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2001	2002	2003	2004
Total Assets (Gross)	74.6	79.6	85.8	96.1	113.2	100.0	100.0	100.0	100.0	100.0	6.8	7.7	12.1	17.8
Investments	16.7	21.6	24.0	27.9	34.7	22.4	27.1	27.9	29.0	30.6	29.6	10.9	16.5	24.2
Government	6.8	10.2	13.4	17.3	23.5	9.1	12.9	15.7	18.0	20.7	50.7	31.1	28.7	35.8
Others	9.9	11.4	10.5	10.6	11.2	13.2	14.3	12.3	11.1	9.9	15.1	(7.3)	1.0	5.3
TM Portfolio 2/	46.7	47.6	51.4	56.3	64.0	62.7	59.8	59.9	58.6	56.5	1.9	7.9	9.7	13.6
DC Portfolio 3/	43.4	44.7	48.2	54.2	60.6	58.2	56.1	56.2	56.4	53.5	3.0	7.9	12.3	11.9
FC Portfolio 4/	3.3	2.9	3.1	2.2	3.4	4.5	3.6	3.7	2.3	3.0	(13.0)	8.2	(30.6)	56.1
TM Commercial	27.1	27.7	31.1	34.7	40.0	36.4	34.7	36.2	36.1	35.3	1.9	12.3	11.6	15.2
DC Commercial	23.9	24.9	28.0	32.5	36.6	32.0	31.2	32.6	33.9	32.3	4.0	12.6	16.3	12.5
FC Commercial	3.3	2.8	3.1	2.1	3.4	4.4	3.5	3.6	2.2	3.0	(14.0)	10.2	(30.9)	57.2
TM Consumer	6.7	7.5	8.0	9.9	13.0	9.0	9.5	9.3	10.3	11.5	11.8	6.2	23.8	31.2
DC Consumer	6.7	7.4	7.9	9.9	12.9	8.9	9.3	9.3	10.3	11.4	11.5	6.9	24.0	31.4
FC Consumer	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0	37.5	(48.8)	(10.6)	(2.5)
TM Mortgage 5/	12.9	12.4	11.9	11.2	10.2	17.2	15.6	13.9	11.7	9.0	(3.3)	(4.1)	(6.0)	(8.8)
TM Microcredit	0.0	0.0	0.4	0.6	0.8	0.0	0.0	0.5	0.6	0.7	0.0	0.0	46.1	48.1
Available	4.1	4.0	4.7	5.5	6.3	5.5	5.0	5.4	5.7	5.6	(3.4)	17.9	17.4	15.0
Leasing	1.6	1.7	2.0	2.7	4.3	2.1	2.1	2.3	2.9	3.8	6.7	18.4	38.8	57.6
Repos and Interbank funds	1.1	1.0	0.7	0.7	0.9	1.5	1.3	0.8	0.8	0.8	(7.8)	(30.7)	0.4	18.2
Accounts Payable	4.4	3.7	3.1	2.9	3.0	5.8	4.7	3.6	3.0	2.7	(14.2)	(18.0)	(5.5)	4.6

1/ Does not include IFI or special official financial entities (EFE).
2/ Total money; that is, domestic and foreign currency.
3/ Transactions in domestic currency
4/ Transactions in foreign currency, re-expressed in domestic currency using the exchange rate at the end of the period
5/ Includes securitization.
Source: Banco de la República.

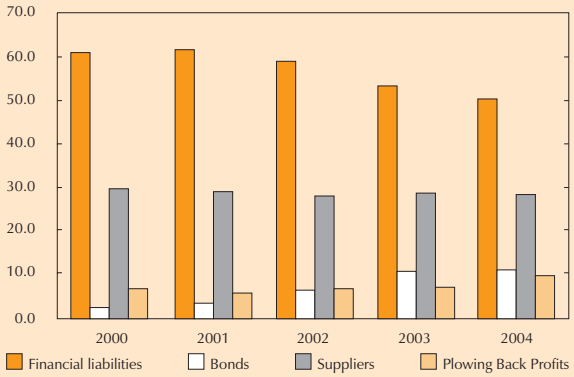
Between 2000 and 2004, there was a clear tendency among CE towards substituting the loan portfolio with investments in government bonds. The total CE portfolio as a share of total assets declined during that period (-6.2 pp), while investments in government bonds rose (11.6 pp). This was particularly true of entities that specialize in mortgage loans; the share of their portfolios represented by mortgages declined. As for the others, the reduction involved all types of credit. Yet, in both cases, the drop was offset by the increase in government bond investments.

III. Company Financing

A sample of 3,585 companies that were active during 2000-2004 and reported their balances to the Business Superintendent was used to analyze the funding sources used by the non-financial private sector. The following are the main ones, on average: bank loans (56.8%), suppliers (28.9%), plowing back profits (7.4%) and bonds (6.9%) (Graph B3.1). However, the share of liabilities with the banking sector was down during this period (-10.1 pp), offset by an increase in bond sales (8.3 pp) and the amount of profits being plowed back into companies (3.1 pp)[3]. In

[3] The increase in bond sales was due primarily to one institution. If it is excluded, the proportions are as follows: bank loans

GRAPH B3.1
PRINCIPAL SOURCES OF FINANCING FOR THE NON-FINANCIAL PRIVATE SECTOR AS A PERCENTAGE OF THE AGGREGATE OF THE THREE SOURCES



Source: Business Superintendent.

conclusion, the sample showed bank loans continue to be the main source of company financing, despite the growing importance of other mechanisms, such as suppliers, plowing back profits and bonds.

IV. Relation between BR Intervention Rates and Market Rates

The intervention rates Banco de la República charges or receives on its one-day repo transactions reflect the stance of monetary policy. The BDBR sets these rates based on an analysis of the *Inflation Report* and at a level consistent with the target for inflation. Credit entities turn to the Bank every day for a quota to satisfy their short-term liquidity needs. A change in BR intervention rates implies a change in the cost of short-term funding for CEs, as it affects the interest they are charged for loans (one-day interbank rate-IIR) and the rates on long-term financing. The 90-day TDR rate is an example. CEs transfer these changes in their financing costs to the interest they charge on loans made to customers.

Huertas *et. al.*(2005)[4] estimated this effect for the period from February 2000 to April 2004. According to their findings, if Banco de la República raises the one-day repo rate by one percentage point, 93% of this change is transferred to the IIR during the following week and 26%, to the TDR. After that, the entire change is transferred to the IIR, and by nearly half of one percentage point, to the TDR.

(57.4%), suppliers (31.6%), plowed-back profits (7.7%) and bonds (3.3%). In this case loans with CEs also were down (-9.6 pp), offset largely by an increase in plowed-back profits (5.3 pp), suppliers (2.5 pp) and, less so, by more bond sales (1.8 pp).

4 Huertas, Carlos; Jalil, Munir; Olarte, Sergio; Romero, José V. "Algunas consideraciones sobre el canal de crédito y la transmisión de tasas de interés en Colombia," Internal Background Paper, Banco de la República, 2005.

The reaction of lending rates to changes in the deposit rate was analyzed as well. According to the findings, i) an increase of 1 pp in the IIR raises treasury and prime rates by 0.21 pp and 0.19 pp, respectively; and ii) the consumer rate goes up by 0.42 pp with increases of 1 pp in the TDR[5] . This study was done with aggregate information from all the CEs. Nevertheless, a bank-by-bank analysis of the information shows differences in the deposit rate, largely depending on the risk implied for each institution. As to lending rates, the CEs tend to specialize in certain types of loans. Each and every one of these factors can make a difference in the way a CE reacts to changes in the interest rates outlined in monetary policy.

Amaya (2005)[6] examined IIR transmission to borrowing and lending rates, using monthly figures for 1996-2004. He found long-term connections between these variables for each financial institution[7] . If the estimated long-term coefficient was less than 0.5, Amaya placed the institution in the low-transmission bracket. Between 0.5 and 0.75 was indicative of medium transmission, while 0.75 to 1 signaled high transmission. Despite the variation in results from one institution to another, they all suggest that transmission is fast and consequential. In other words, when banks see movement in the IIR, they quickly change their rates (lending or deposit) in the same direction. The classification of banks according to their degree of transmission shows 90% are in the medium-high bracket for deposit rates, while 93% are medium-high for lending rates. The lending and deposit rates of these banks react during the same month to IIR movement, and the maximum response observed was between four to six months.

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5 According to an estimate with a VAR model, a change of one pp in the TDR is transferred entirely to the interest rates on ordinary loans. However, the high degree of uncertainty is a problem and makes it difficult to draw conclusions with this parameter.

6 Amaya, Carlos A. "La fijación de tasas de interés y los mecanismos de transmisión de la política monetaria".Internal Background Paper, Banco de la República, 2005.

7 Given the high correlation between BR intervention rates and the IIR, the latter was used as a proxy of the former. Information from 16 CEs was used to analyze lending rates and from 21 CEs for deposit rates. At December 2004, these institutions held 55% of the portfolio stock and 81% of the CD stock. siguientes: créditos bancarios: 57,4%; proveedores: 31,6%, reinversión de utilidades: 7,7%; y bonos: 3,3%. En este caso también se observa una caída de los préstamos con los EC (-9,6 pp), que se compensó en su mayor parte con un incremento en la reinversión de utilidades (5,3 pp) y proveedores (2,5 pp); y, en menor medida, con un aumento en la colocación de bonos (1,8 pp).

IV. The Exchange Policy and Balance of Payments

Exchange policy is not independent of monetary policy. Monetary policy decisions (e.g. changes in interest rates) affect the exchange rate, while exchange policy measures (e.g. purchase or sale of international reserves) can influence money supply and interest rates.

Exchange policy is not independent of monetary policy. Monetary policy decisions (e.g. changes in interest rates) affect the exchange rate, while exchange policy measures (e.g. purchase or sale of international reserves) can influence money supply and interest rates. Therefore, in terms of their objectives, the exchange policy must be consistent with the monetary policy. According to experience in Colombia and other countries, sharp and prolonged deviations in the exchange rate with respect to its long-term tendency are associated with excessive current account imbalances (increased vulnerability of the economy to external shocks). They also can affect the competitiveness of sectors that produce tradable goods and services (exportable or importable). A subsequent correction can have a negative impact on economic activity, prices and financial stability. BR intervention in the exchange market can help to avoid these deviations, provided it does not jeopardize the long term goals for inflation or go against the long-term tendency in the real exchange rate.

The exchange policy must adhere to strict limits, if coherence between the targets for inflation and exchange is to be maintained. If the projected rate of inflation is below target, the inflation targeting strategy would suggest a less restrictive monetary policy. If projected inflation is above target, the inflation targeting strategy would suggest a tighter monetary policy.

The exchange policy must adhere to strict limits, if coherence between the targets for inflation and exchange is to be maintained. If the projected rate of inflation is below target, the *inflation targeting strategy* would suggest a less restrictive monetary policy. This is compatible with purchases of foreign exchange by the central bank to reduce appreciation. In this case, the exchange and monetary policies are consistent with one another and should have no negative impact on expectations of inflation. If projected inflation is above target, *the inflation targeting strategy* would suggest a tighter monetary policy. This could be incompatible with a foreign exchange purchase program for the central bank and could influence inflationary expectations, if the public senses a conflict between the objectives for inflation and foreign exchange. A conflict of this type can prompt the central bank to intervene in the exchange market and, at the same time, to offset the resulting expansion with monetary contraction operations. This

is called *sterilized intervention* and its effectiveness is the subject of debate in economic science. Sterilized intervention implies quasi-fiscal costs that are not insignificant

The present chapter offers a detailed look at these topics, starting with developments in the real and nominal exchange rate, and the factors that have caused the exchange rate to appreciate. An analysis of recent exchange market interventions by Banco de la República and the coherence of these episodes with the monetary policy adopted as part of the *inflation targeting strategy* is included as well.

A. The Trend in Nominal and Real Exchange Rates

The average nominal exchange rate for the Colombian peso remained stable throughout the first half of 2005, averaging Col$2,346.36 per dollar. Although this is 13.17% below the average observed during the same period in 2004, the tendency towards appreciation has slackened since the end of last year (Graph 35). Compared to a basket of currencies pertaining to other countries that trade with Colombia, real appreciation was 4.36% during the course of the year to June, when deflated with the producer price index (RERI-PPI). It was 6.69% when deflated with the consumer price index (RERI-CPI) (Graph 36). The competitiveness index (RERI-C) appreciated by 3.83% in the first six months of the year[11].

As explained in the March 2005 report to Congress, appreciation has been a factor in Colombia since the end of 2003. This is somewhat later than in other Latin American countries. Appreciation has affected developed economies such as Japan and the Euro zone, as well as some of the emerging Asian countries (Graph 37). The main reasons are: i) external and fiscal imbalances in the United States economy; ii) broad liquidity on international markets, as indicated by low international

GRAPH 35

Nominal Exchange Rate

Representative Market Rate

Annual Nominal Depreciation

Source: Banking Superintendent. Calculations by Banco de la República.

[11] The RERI-C measures the trend in the competitiveness of four Colombian products sold on the United States market (bananas, coffee, flowers and textiles). It is calculated by comparing the Colombian CPI and that of 24 of its leading direct competitors on the United States market for these goods, based on a common currency.

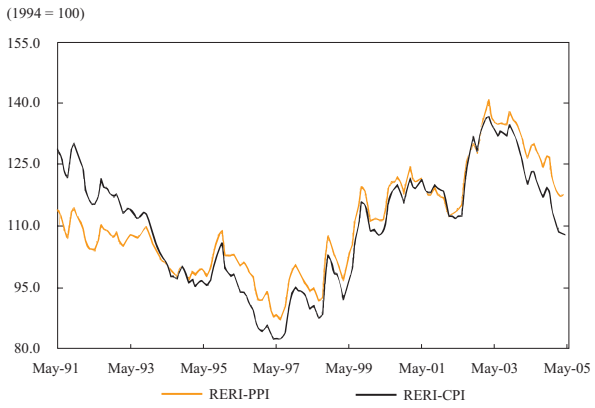
interest rates; iii) lower risk premiums for the emerging economies, and iv) the tremendous momentum of the Chinese and United States economies, which fueled world growth and the rise in commodity prices. This affected terms of trade and heightened the demand for exports.

Appreciation in Colombia can be traced to the same external context; that is, to better terms of trade, more of a demand for our exports, particularly in the United States and Venezuela, and capital inflows for direct and portfolio investments, as shown in the 2004 balance of payments (Table 9).

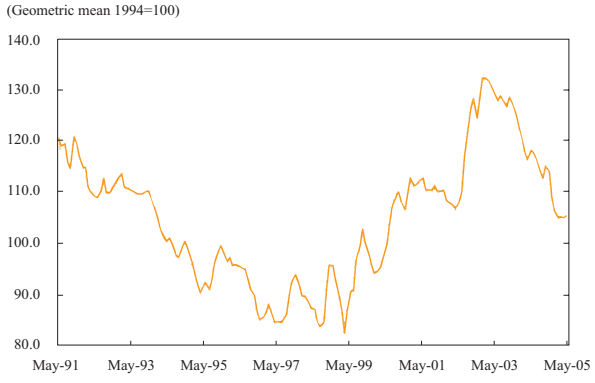
Graph 36

Real Exchange Rate

Real Exchange Rate Index



Real Exchange Rate with Third Countries (*)

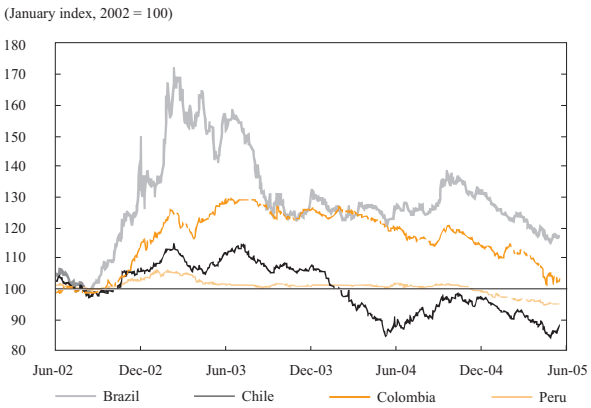


(*) Products: coffee, bananas, flowers and textiles on the U.S. market.
Source: Banco de la República.

Graph 37

U. S. Dollar Exchange Rate for Different Currencies

Latin American Currencies



Euro and yen

Source: Datastream.

Summarized Balance of Payments - Colombia
(U.S. Millions)

	2002 (pr)	2003 (pr)	2004 (pr)	Difference 2004 - 2003
I. Current account (A + B + C)	**(1,332)**	**(969)**	**(952)**	**17**
Income	17,903	19,840	24,062	4,222
Outlays	19,235	20,809	25,014	4,205
A. Non-factor goods and services	**(1,188)**	**(855)**	**(405)**	**450**
1. Goods	239	567	1,368	801
2. Non-factor services	(1,427)	(1,423)	(1,773)	(351)
B. Factor income	**(2,848)**	**(3,446)**	**(4,193)**	**(747)**
C. Transfers	**2,704**	**3,333**	**3,647**	**314**
II. Capital and Financial (A + B)	**1,279**	**746**	**3,198**	**2,451**
A. Financial account (1 + 2)	**1,279**	**746**	**3,198**	**2,451**
1. Long-term financial flows (b + c - a)	(1,416)	1,009	2,044	1,035
a. Assets	**851**	**932**	**136**	**(795)**
i. Colombian direct investment abroad	857	938	142	(795)
ii. Loans, commercial credit and other assets	(6)	(6)	(6)	(0)
b. Liabilities	**(535)**	**1,970**	**2,232**	**261**
i. Foreign direct investment in Colombia	1,084	1,905	3,748	1,843
Direct	2,115	1,801	3,005	1,204
Portfolio	(1,031)	104	743	639
ii. Loans, commercial credit, leasing and other liabilities	(1,618)	65	(1,516)	(1,581)
c. Other long-term financial movement	**(30)**	**(30)**	**(51)**	**(22)**
2. Short-term financial flows (b - a)	2,695	(263)	1,154	1,416
a. Assets	**(2,335)**	**83**	**1,017**	**934**
i. Portfolio investment	(2,030)	1,753	1,565	(189)
ii. Commercial credit and loans	(126)	(615)	(76)	539
iii. Other assets	(179)	(1,055)	(472)	583
b. Liabilities	**360**	**(179)**	**2,170**	**2,350**
i. Portfolio investment	16	(20)	380	400
ii. Commercial credit and loans	370	(127)	1,976	2,103
iii. Other liabilities	(26)	(33)	(186)	(153)
B. Special capital flows	**0**	**0**	**0**	
III. Net Errors and Omissions	**191**	**38**	**295**	**257**
IV. Variation in Gross International Reserves 1/ (Pursuant to the balance of payments method)	**138**	**(184)**	**2,541**	**2,725**
V. Gross International Reserve Position 2/	**10,841**	**10,918**	**13,536**	

(pr) Preliminary.
1/ The variation in international reserves was calculated according to IMF Manual V (1993), which recommends that appreciation in prices and the exchange rate not be included.
2/ The international reserve position is valued at market prices. Accordingly, it includes all variations in reserves due to changes in the price or exchange rate for assets.
Source: Banco de la República.

Some of the trends in capital flow have increased in 2005 as opposed to the same period the year before. Exchange transactions in the productive sector during the course of the year to June are shown in Table 10. Also included is a comparison between this period and the first six months in 2004, showing considerable growth in reimbursements for merchandise exports and, to a lesser extent, in net income from transfers and sales of foreign exchange on the free market. However, these increases were offset by a sizeable rise in remittances for imports, and by the increase in payments for financial and non-financial services. The sum of these factors meant that net movement

To some degree, the international environment and BR policy decisions may have helped to ease the tendency towards appreciation.

in foreign exchange from current transactions was similar to what it was the year before. On the one hand, there was a major increase in foreign exchange from associate capital transactions, primarily because of foreign direct investment (FDI), particularly in coal and oil. On the other, there have been no sizeable net short-term capital inflows, and the private sector has sent money out of the country to pay foreign debts and to increase current accounts.

The figures from the exchange balance pertain to cash transactions. The balance of payments provides the most complete information on Colombia's transactions with the rest of the world. This is an important point to remember. Balance of payment figures for the first quarter are included in Chapter IV and lend support to the information found in the exchange balance.

To some degree, the international environment and BR policy decisions may have helped to ease the tendency towards appreciation. On the one hand, the country-risk indicator for both Colombia and the emerging

TABLE 10

EXCHANGE FLOWS IN THE PRODUCTIVE SECTOR (*)
(U.S. MILLIONS)

	Accumulation 2004	Annual Accumulation to		Annual Cumulative Variation
		June 04	June 05	
Exchange Flows in the Real Sector	**3,189**	**1,123**	**2,185**	**1,062**
Current Account	**2,584**	**1,060**	**1,013**	**(47)**
A. Trade balance	**(2,587)**	**(1,385)**	**(1,396)**	**(12)**
Reimbursements for merchandise exports	3,954	1,669	2,275	606
Draws for merchandise imports	6,541	3,054	3,671	617
B. Net services and transfers	**5,171**	**2,445**	**2,409**	**(36)**
Net financial services	(301)	(149)	(297)	(148)
Net non-financial services	864	463	324	(138)
Net transfers	3,296	1,505	1,659	154
Net purchases from professional foreign exchange dealers	1,376	655	758	103
Net others	(64)	(29)	(36)	(7)
Capital Account	**605**	**62**	**1,172**	**1,110**
A. Private sector	**747**	**97**	**1,166**	**1,070**
Net loans	**(617)**	**(245)**	**(577)**	**(332)**
Disbursements	1,650	320	1,667	1,347
Amortization	2,266	565	2,244	1,679
Foreign Investment in Colombia	**2,520**	**1,117**	**1,880**	**762**
Direct investment + supplementary	2,140	1,033	1,851	818
Portfolio investment	380	85	29	(56)
Colombian direct investment abroad	**(79)**	**(194)**	**2**	**196**
Direct investment	(51)	(25)	(23)	2
Portfolio investment	(28)	(169)	25	194
Net Current Accounts	**(1,076)**	**(581)**	**(138)**	**443**
B. Public sector	**(142)**	**(34)**	**6**	**40**

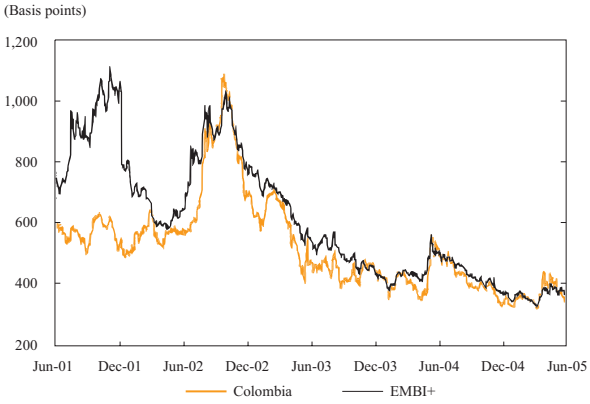
(*) Excludes TGN and Banco de la República transactions.
Source: Exchange Balance, Banco de la República.

economies has stopped falling and is stabilizing (Graph 38). At the same time, interest rates set by the United States Federal Reserve Bank (Fed) continued to increase, as reflected in the rising profitability of investments abroad and the increase in the cost of the external debt. This factor, coupled with better indicators of economic performance in the United States, helps to explain some of the decline in portfolio capital inflows during 2005 to date and the decline in net external borrowing by the private sector.

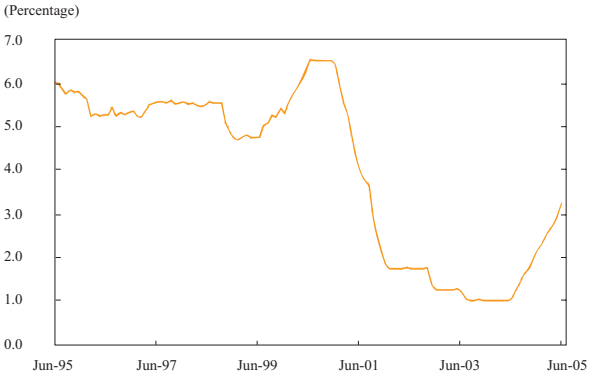
The combination of BR measures adopted in December 2004, including the reduction in intervention interest rates and the suspension of contraction transactions, together with increased discretional intervention in the exchange market this year, might have helped to ease appreciation of the Colombian peso. By June 2005, Banco de la República had exercised discretional intervention in the exchange market through purchases of US$1,615 million in foreign exchange (Table 11). It also sold US$1,250 m to the government during the first quarter. Since September 2004, when the Bank decided to intervene in the exchange market on a discretional basis, it has acquired US$2,930 m.

GRAPH 38

COUNTRY-RISK PREMIUM
EMBI+ LATIN AMERICAN COUNTRIES



FED INTEREST RATE



Source: Datastream.

TABLE 11

BR FOREIGN CURRENCY PURCHASE-SALE TRANSACTIONS
(U.S. MILLIONS)

	2004	2005						
		January	February	March	April	May	June	Accumulated Jan-Jun
Purchases	**2,904.9**	**267.9**	**335.5**	**170.4**	**407.7**	**151.3**	**282.4**	**1,615.0**
Put options	**1,579.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
To accumulate international reserves	1,399.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
To control volatility	179.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discretional intervention	**1,325.3**	**267.9**	**335.5**	**170.4**	**407.7**	**151.3**	**282.4**	**1,615.0**
Sales	**500.0**	**0.0**	**250.0**	**1,000.0**	**0.0**	**0.0**	**0.0**	**1,250.0**
National government	500.0	0.0	250.0	1,000.0	0.0	0.0	0.0	1,250.0
Net Purchases	**2,404.9**	**267.9**	**85.5**	**(829.6)**	**407.7**	**151.3**	**282.4**	**365.0**

Source: Banco de la República.

After the exchange band had become a thing of the past, Banco de la República focused its exchange-market intervention on accumulating international reserves and, to a lesser extent, on avoiding excess short-term volatility in the exchange rate. With this system, there was no attempt to affect the exchange rate, which fluctuated freely, according to market forces. However, on two occasions, the Bank did try to influence the exchange rate.

The role of exchange intervention as part of the *inflation targeting strategy* is evaluated in the next section, as is the effectiveness of the monetary policy.

B. Exchange Intervention and Monetary Policy

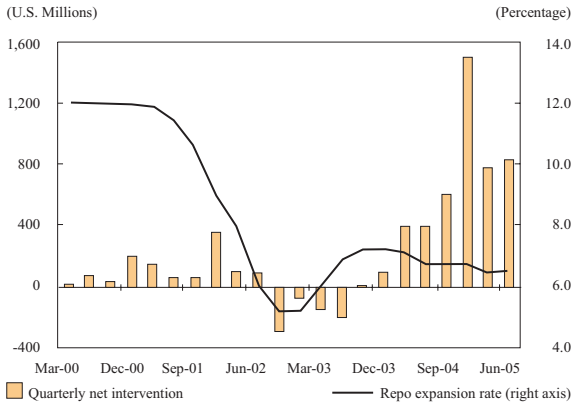
In countries with a floating exchange rate, intervention in the exchange market is not crucial to supporting the exchange rate. However, there are instances, even with floating systems, when the central bank may consider it necessary to intervene in the market. Literature on the subject mentions the following as the specific objectives of intervention: i) control over excess short-term volatility; ii) accumulation of international reserves, which helps to make the economy less vulnerable to eventual crisis situations[12]; iii) control over excessive and temporary deviations in the exchange rate that do not reflect a change in its fundamental determinants; and iv) avoidance of exchange market dysfunction in response to major shocks[13].

From another perspective, "managed floating" as an efficient monetary policy strategy (see Bofinger and Wollmersh, 2003[14]) has been justified as a way to soften fluctuations in output and inflation. The connection between the interest rate and the exchange rate is not predictable, and little is known about the variance or persistence of the shocks that affect this relationship. Using the interest rate as the only monetary policy instrument could lead, in this case, to high variations in inflation and output that are inefficient. On the other hand, using international reserves as a complementary instrument can reduce that inefficiency.

After the exchange band had become a thing of the past, Banco de la República focused its exchange-market intervention on accumulating international reserves and, to a lesser extent, on avoiding excess short-term volatility in the exchange rate (Graph 39). With this system, there was no attempt to affect the exchange rate, which fluctuated freely, according to market forces. However, on two

Graph 39

Quarterly Net Intervention and the Repo Expansion Rate



Source: Banco de la República.

12 Relatively high government borrowing (and the external debt in particular), coupled with the volatility of international markets, suggests the convenience of having a sufficiently broad supply of international reserves.

13 Recent literature on the microstructure of the international exchange market suggests that even a free-floating currency market can collapse. Major shocks that cannot be absorbed by the market can be transmitted and even amplified, and the pressure could bring parts of the market to a halt.

14 Bofinger, Peter and Wollmersh, Timo. "Managed Floating as a Monetary Policy Strategy" in *Economics of Planning*, Vol. 36, No. 2, 2003, pp. 81-109.

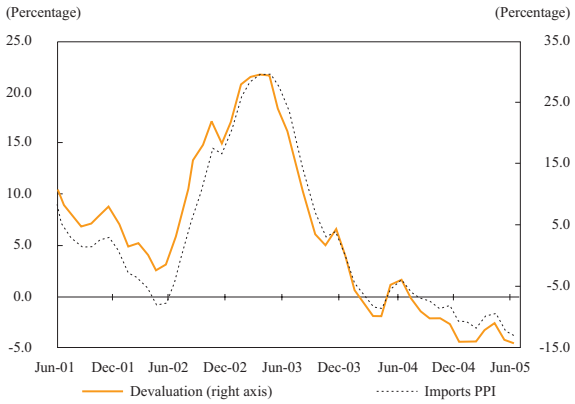
occasions, the Bank did try to influence the exchange rate. These two episodes are described in the following section, as are the intervention policies applied by the Bank and the results.

1. Depreciation During 2002-2003

Colombia and other countries in the region suffered the effects of political uncertainty in Brazil, as of June 2002, followed by corporate scandals in the United States. The country-risk coefficient of Colombia's sovereign debt reached 1,050 bp and the exchange rate depreciated by 30% between April 2002 and February 2003. The price of imported goods increased, as did inflation in tradables and total inflation (Graph 40). Also, beginning in 2002, non-traditional exports to Venezuela slumped because of the crisis in that country.

GRAPH 40

ANNUAL NOMINAL DEVALUATION AND PPI INFLATION FOR IMPORTS



Source: DANE and Banco de la República.

This situation coincided with a period when output continued to grow below its potential, ruling out any talk of demand-pulled pressures. There were supply shocks as well, such as the rise in food prices, which also helped to boost total inflation. The accelerated increases in inflation heightened expectations of inflation to an extent that threatened the possibility of meeting the targets proposed for 2003.

BR policy responded to these shocks in several ways. On the exchange front, call options were activated automatically by mid-2002, with US$414 m in sales. However, the exchange rate continued to depreciate and, in February, the Bank announced it would rundown as much as US$1 billion in reserves to offset the tendency towards depreciation[15]. The BDBR raised intervention rates in January 2003 by 100 bp and again in April, by the same amount. This combination of policies helped to ease peso depreciation and to minimize the deviation in inflation with respect to the top of the target range for that year (between 5% and 6%).

2. Appreciation During 2004-2005

As of January 2004, the exchange rate began to experience negative annual variations, reaching a low of -15% in December 2004. At June

[15] The actual sale came to US$345 m.

2005, annual depreciation was -12.9%. The primary reasons for the tendency towards appreciation were, as mentioned earlier, i) the substantial growth in total exports, especially to Venezuela; ii) the improvement in terms of trade; iii) the rise in foreign direct investment, especially in coal and oil; and iv) the presence of low external interest rates and low country-risk coefficients. The latter attracted a certain amount of short-term capital, mostly in 2004.

A negative output gap, a downward trend in inflation, and a continued decline in inflationary expectations characterized the macroeconomic situation at the start of 2004. Tradable inflation and import prices were reduced by appreciation, making it possible to apply a more relaxed monetary policy. The BDBR lowered intervention interest rates by 25 bp in February 2004 and again in March of that year. At the same time, the Bank reactivated put options to accumulate international reserves, since the stock was down after the interventions in 2002 and 2003.

The Bank announced its intention to purchase up to US$700 m between April and July of that year, through put options. These purchases came at a time when the exchange rate was still appreciating. Even so, the forecasts for inflation were above the halfway mark of the target announced for 2004 and 2005, ruling out the possibility of additional interest rate reductions. Tradable inflation declined slowly with respect to appreciation, and non-tradable inflation was up (Graph 20), suggesting the output gap was closing at a faster pace. For these reasons, and to keep interest rates stable, exchange intervention was sterilized through TES sales and by reducing the quota on expansion repos.

In September 2004, the Bank decided to opt for discretional intervention in the exchange market and announced it was willing to purchase up to US$1 billion during the next three months, based on this arrangement. This decision was taken because it was felt the real exchange rate was not at its long-term level. Put options were deactivated temporarily[16]. Discretional intervention proved to be effective in the beginning, but as the market learned and managed to estimate the actual extent of BR intervention, the exchange rate appreciated even more, while BR purchased all the reserves it said it would.

During the course of 2005 to date, the exchange rate has stabilized and BR intervention in the exchange market has been substantial (US$1,615 m between January and June 2005).

While this was happening, inflation was moving towards the 2004 target and expectations were declining in the direction of levels consistent with the target for 2005. Non-tradable inflation had stabilized and even had begun

[16] When option holders anticipate sharp appreciation, they delay exercising their options. This limits the power of intervention to tone down appreciation.

to drop, indicating the output gap probably was not closing as fast as had been estimated. On the other hand, the inflation forecasts suggested that a more relaxed monetary policy stance would be consistent with the 2005 target for inflation and with a downward trend in inflation as of 2006. Based on these factors, the BDBR reduced the reference rates by 25 bp in December 2004, closed repo contraction operations indefinitely, and announced it would continue its discretional intervention in the exchange market. This time, however, it did not announce a deadline or a limit on the amount of intervention.

A necessary part of the inflation targeting strategy is to determine if exchange intervention is consistent with efforts to meet the inflation targets. It also is important to determine if the policy on intervention is consistent with the operational scheme of an inflation targeting strategy.

Discretional intervention by the Bank in the fourth quarter of 2004 came to US$1,232 m, as opposed to US$2.905 m in total purchases throughout the year. As a result of this intervention and the sale of US$500 m to the government, net international reserves rose by nearly 24% in 2004, one of the highest rates in the world.

During the course of 2005 to date, the exchange rate has stabilized and BR intervention in the exchange market has been substantial (US$1,615 b between January and June 2005). The monetary expansion resulting from this intervention was offset by government deposits with Banco de la República and by the reduction in quotas on expansion repos.

C. Coherence between Inflation Targeting and Exchange Intervention

As indicated in previous reports to Congress, a necessary part of the *inflation targeting* strategy is to determine if exchange intervention is consistent with efforts to meet the inflation targets[17]. It also is important to determine if the policy on intervention is consistent with the operational scheme of an *inflation targeting strategy*. The following are the criteria for consistency in this respect[18].

- Interest rates are the principal monetary policy instrument. Accordingly, they must move in a direction consistent with the targets for inflation (that is, by relaxing/tightening monetary conditions when the inflation forecasts are below/above the inflation target and/or when the output gap is negative/positive).

- Intervention in the foreign exchange market must not go in a direction contrary to the policy on interest rates. Insofar as is possible, exchange

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17 Holub, Tomas. "Official Intervention in the Foreign Exchange Market: Elements of Best Practice," in *IMF Working Papers*, July 22004. In this document, the author refers to "consistency of objectives".

18 Op. cit. These aspects are called "regime consistency".

intervention should be used solely as a complementary tool, and only in exceptional circumstances (high volatility, huge misalignments in the exchange rate and/ or disrupted conditions on the market).

As illustrated in Table 12, foreign exchange intervention in Colombia has been consistent with the movement in BR interest rates. Also, in most of the episodes, the changes in monetary policy were produced first through modifications in interest rates and later through intervention in the foreign exchange market. For example, intervention to rundown international reserves in 2003 occurred in cases where the forecasts for inflation were

TABLE 12

CONSISTENCY OF FOREIGN EXCHANGE MARKET INTERVENTION

	Month forecast:	Projected year	Deviation from target (*)	Ex post deviation (*)	Output gap (Percentage)	Change in interest rate	Consistency
			(Basis points)				
Intervention for volatility reasons:							
	Jul/02	2002	(24)	100	(3.2)	Stable	No
		2003	(174)	100	(2.8)		
	Oct/02	2002	11	100	(2.8)	Stable	Yes
		2003	65	100	(3.0)		
Intervention to rundown international reserves:							
	Mar/03	2003	150	100	(2.8)	High	Yes
		2004	(108)	0	(1.8)		
	May/03	2003	115	100	(2.7)	Stable	Yes
		2004	(158)	0	(1.6)		
Interventions to accumulate international reserves:							
	Oct/03	2003	(65)	100	(1.6)	Stable	Yes
		2004	(37)	0			
	Dec/03	2004	(61)	0	(1.2)	Low	Yes
		2005	(37)		(0.7)		
	Jan/04	2004	(77)	0	(1.1)	Stable	Yes
		2005	(16)		0.5		
	Apr/04	2004	15	0	(1.5)	Low	?
		2005	(10)		(0.9)		
	May/04 - Jun/04	2004	15	0	(1.5)	Stable	?
		2005	(10)		(0.7)		
	Jul/04 - Aug/04	2004	50	0	(1.6)	Stable	?
		2005	(9)		(0.9)		
	Sep/04 - Oct/04	2004	20	0	(1.6)	Stable	?
		2005	(43)		(1.2)		
	Nov/04 - Dec/04	2004	26	0	(1.6)	Stable	?
		2005	1		(1.5)	Low	
	Jan/05 - Feb/05	2005	0		(1.8)	Stable	Yes
		2006	(45)		(1.2)		
	Mar/05	2005	0		(1.8)	Stable	Yes
		2006	(45)		(1.2)		
	Apr/05	2005	(25)		(1.5)	Stable	Yes
		2006	(40)		(0.7)		

(*) With respect to the halfway point in the target range.
Source: Banco de la República.

above the target and inflationary expectations were on the rise. These interventions were accompanied or preceded by hikes in policy interest rates.

In practice, central banks often use discretional and secret intervention. The study by Canales-Kriljenko et. al.(2003) shows that only 25% of these institutions announce the volume of their interventions.

Another pertinent aspect is what Holub (2004)[19] calls "consistency of procedures". Because transparency and the communication strategies are so important in an *inflation targeting system*, it is crucial to determine if BR intervention in the foreign exchange market (secret or open intervention, based on rules or on discretional decisions, etc.) is consistent with this arrangement. In this respect, and unlike intervention in the money market, there are no elements of "best practice" applicable in all circumstances. There are reasons for intervention through open transactions on the exchange market, but secret intervention can be justified as well (See, for example, Canales-Kriljenko[20], *et. al.,* 2003).

In cases where monetary authorities want to alter the trend in the exchange rate, secret intervention can be a necessary strategy. There are three main advantages to this type of intervention. First, it minimizes damage to the central bank's credibility if intervention fails because it is inconsistent with the fundamental determinants of the exchange rate, or with the macroeconomic policy. Secondly, it prevents agents from betting against the positions adopted by monetary authorities. Third, it might be preferable if it is felt that announcing intervention could aggravate market risk and volatility while agents respond to the new information.

In practice, central banks often use discretional and secret intervention. The study by Canales-Kriljenko *et. al.* (2003) shows that only 25% of these institutions announce the volume of their interventions. In the Colombian case, intervention through options is largely the result of discretional decisions. However, once Banco de la República decides to intervene, its does so in a transparent way and pursuant to previously announced rules. It does not try to surprise the market with its intervention. As indicated earlier, the primary objective has been to accumulate international reserves, or to send a message on the current and future stance of monetary policy. To a lesser extent, intervention also has been used to control excessive volatility on the foreign exchange market. Beginning in September 2004, the BDBR decided to opt for the possibility of discretional intervention announced *ex post* (15 days after the end of the month), and temporarily suspended intervention through options. This is a common practice among central banks, and only a few publish the results of intervention in real time. From

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19 *Op. cit.*

20 Canales-Kriljenko, J.I.; Guimaraes, R.; Karacadag C. "Official Intervention in the Foreign Exchange Market: Elements of Best Practice," in *IMF Working Papers,* July 2003.

From this standpoint, the method normally used by Banco de la República to intervene in the exchange market has been more transparent than that of many other economies with a flexible exchange rate.

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D. First-Quarter Balance of Payments: 2005

The balance of payments during the first quarter of 2005 showed deficits in the current account (US$517 m, -2.0% of quarterly GDP) and in the capital account (US$227 m, -0.8% of quarterly GDP). These were financed with the rundown in international reserves (US$593 m) and with US$151 m in other income (errors and omissions). Gross international reserves came to US$12,784 m at March (Table 13). When comparing the balance of payments for the first quarter of 2005 to the balance for the same period in 2004, several aspects stand out.

1. The current account deficit was down by US$180 m with respect to the first quarter of 2004, mainly due to a better trade balance (US$295 m) and an increase in net income from transfers (US$86 m). These items were offset, in part, by net payments for non-financial services and by factor income (US$200 m).

2. The trend in capital flows changed:

   - The capital and financial account registered US$227 m in net outlays, as opposed to US$845 m in income during the same period the year before.

   - The composition of capital flows (excluding FDI) changed in favor of short-term transactions to the detriment of long-term transactions.

The balance of payments during the first quarter of 2005 showed deficits in the current account (US$517 m, -2.0% of quarterly GDP) and in the capital account (US$227 m, -0.8% of quarterly GDP). These were financed with the rundown in international reserves (US$593 m) and with US$151 m in other income (errors and omissions).

1. Current Account

The improvement in the balance of payments compared with the first quarter of 2004 was the result of more export growth (US$1,198 m, 34% annual) as opposed to imports (US$903 m, 26% annual). Among other factors, this reflects the further improvement in terms of trade, due to the hefty increases in export commodity prices during the last two years, as explained earlier (See Graph 6). At the same time, recovery of the world economy has spurred foreign demand for Colombian goods, particularly on the Venezuelan, United States and Ecuadorian markets.

SUMMARIZED BALANCE OF PAYMENTS - COLOMBIA
(MILLIONS OF DOLLARS)

	2004 Jan-Mar (pr)	2005 Jan-Mar (pr)	Variation
I. Current account (a + b + c)	**(697)**	**(517)**	**180**
Income	4,974	6,389	1,415
Outlays	5,672	6,906	1,235
A. Non-factor goods and services	**(271)**	**(87)**	**184**
Income	3,999	5,257	1,258
Outlays	4,270	5,345	1,075
1. Goods	116	411	295
Income	3,540	4,739	1,198
Outlays	3,424	4,327	903
2. Non-factor services	(387)	(499)	(111)
Income	459	519	60
Outlays	846	1,017	171
B. Factor income	**(1,213)**	**(1,303)**	**(89)**
Income	125	210	84
Outlays	1,338	1,512	174
C. Transfers	**787**	**873**	**86**
Income	850	923	72
Worker remittances	709	752	43
Other transfers	141	171	29
Outlays	63	50	(14)
II. Capital and Financial Account (a + b)	**845**	**(227)**	**(1,072)**
A. Financial account (1 + 2)	**845**	**(227)**	**(1,072)**
1. *Long-term financial flows (b + c - a)*	228	617	389
a. Assets	**47**	**38**	**(9)**
i. Colombian direct investment abroad	49	40	(9)
Direct	49	40	(9)
Portfolio			
ii. Loans	(1)	(1)	
iii. Commercial credit			
iv. Other assets			
b. Liabilities	**276**	**655**	**380**
i. Foreign direct investment in Colombia	685	1,255	570
Direct	620	822	202
Portfolio	65	433	368
ii. Loans	(342)	(637)	(295)
iii. Commercial credit	(14)	6	20
iv. Leasing	(54)	31	85
v. Other liabilities			
c. Other long-term financial movement			
2. *Short-term financial flows (b - a)*	**616**	**(844)**	**(1,461)**
a. Assets	**(424)**	**853**	**1,277**
i. Portfolio investment	(158)	1,014	1,172
ii. Commercial credit	(103)	(130)	(26)
iii. Loans	28	258	230
iv. Other assets	(191)	(289)	(99)
b. Liabilities	**192**	**9**	**(184)**
i. Portfolio investment	94	(7)	(101)
ii. Commercial credit	79	101	22
iii. Loans	63	(50)	(113)
iv. Other liabilities	(44)	(36)	7
B. Special capital flows	**-**	**-**	**-**
III. Net Errors and Omissions	**273**	**151**	
IV. Variation in Gross International Reserves 1/	**420**	**(593)**	
V. Gross International Reserve Position 2/	**11,332**	**12,784**	
Number of times the outstanding short-term external debt	**3**	**2**	
VI. Net International Reserve Position 2/	**11,330**	**12,780**	
VII. Variation in Net International Reserves 1/	**424**	**(593)**	

1/ The variation in international reserves was calculated according to IMF Manual V (1993), which recommends that appreciation in the exchange rate and prices not be included.
2/ The international reserve position is valued at market prices. Therefore, it includes all variations in reserves due to changes in price or in the exchange rate for assets.
(pr) Preliminary
Source: Banco de la República.

There was an increase of 42.2% (US$680 m) in traditional exports, mainly due to the higher value of coal, oil, petroleum by-products and coffee exports (Table 14). Coal exports registered an annual variation of 77% during the first quarter of 2005, thanks to an increase in the export price of this item (44%), which went from US$32.4 per ton in 2004 to US$46.8 per ton in 2005. The volume of coal exports was up as well (by 20%). Coffee exports totaled US$414 m, with an annual increase of 78% due to better international prices (32%, US$1.00 per pound in 2005 as opposed to US$0.76 in 2004). The volume of coffee exports also increased (17%).

Exports of petroleum and petroleum by-products between January and March 2005 totaled US$1,101 m. This comes to an annual increase of 24% and was due to soaring export prices for crude oil (34%). These rose from US$33.1 per barrel (bl) in the first quarter of 2004 to US$44.s per bl in the first quarter of 2005[21]. Compared with 2004, there was no change in the amount sold (203,000 barrels/day). Ferronickel exports totaled US$202 m, with an annual variation of 21%. This is

[21] This price is the average at which Colombian crude oil is exported (both light and heavy). On average, it was nearly US$6 below the reference price for West Texas Intermediate (WTI), which is a high quality crude. The only oil in Colombia that matches WTI quality is from Cusiana. However, reserves of light crude are being depleted and the country has begun to export heavy crude, which commands a lower price because it is not as high in quality.

TABLE 14

EXPORTS (FOB), BY LEADING PRODUCTS AND ECONOMIC SECTORS (PR)
(MILLIONS OF DOLLARS)

	January-march		Variation	
	2004	2005	Absolut	Percentage
Traditional exports	1,613	2,293	680	42.2
Coffee	232	414	182	78.3
Coal	326	576	250	76.6
Ferronickel	167	202	35	21.0
Petroleum and petroleum by-products	887	1,101	213	24.0
Non-traditional exports 1/	1,794	2,311	518	28.9
Agricultural sector	330	463	132	40.1
Industrial sector	1,306	1,642	336	25.7
Mining sector 2/	157	206	49	31.4
Total exports	3,406	4,604	1,198	35.2

(pr) Preliminary.
1/ Does not include temporary exports, re-exports and others. Includes adjustments in the balance of payments.
2/ Includes gold and emeralds.
Source: DANE and Banco de la República.

explained by the increase in shipped volume (27%), as there were no major price variations.

By March 2005, the value of non-traditional exports was US$2,234 m, thanks to an annual variation of 27.6% (US$483 m), basically from increased sales of industrial products (24.1%) and those of agricultural origin (40.1%). This performance is associated with larger shipments to markets in Venezuela (59.6%), Ecuador (36.3% - transport material, beef, electricity and wearing apparel, among other items) and the United States (21.7% - flowers, wearing apparel and products from the base metal industry) (Table 15). The United States purchased 40.1% of the total value of exported goods and services. The regional market of the Latin American Integration Association (ALADI) purchased 23.7% and countries of the European Union, 14.0%.

Imports in the first quarter of 2005 totaled US$4,251 m, with an annual variation of 26.2% compared with the same period in 2004. Input for industry, which was up by US$342 m (29.1% annual), largely sustained the momentum in foreign purchases. Imports of consumer goods were up by US$165 m (27.6%), with transport vehicle imports constituting a high point in this respect (Table 16).

TABLE 15

ANNUAL PERCENTAGE INCREASE IN THE DOLLAR VALUE OF COLOMBIAN EXPORTS, BY COUNTRY OF DESTINATION
JANUARY-MARCH 2005

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	Rest	Total
Totals	**22.5**	**58.7**	**42.9**	**47.2**	**38.0**	**24.7**	**44.7**	**35.2**
Non-traditional Exports	**21.7**	**59.6**	**36.3**	**12.7**	**(8.8)**	**21.7**	**27.3**	**28.9**
Agriculture and livestock sector	33.4	222.8	(1.6)	60.9	(14.4)	12.5	22.8	40.1
Industrial sector	22.9	43.3	33.0	32.2	0.2	21.1	22.2	25.7
Food, beverages and tobacco	24.5	(12.4)	17.5	47.5	5.6	(36.0)	24.0	14.2
Yarn, thread and fabric	(7.8)	(6.6)	44.7	n.a.	90.9	14.8	17.5	8.0
Clothing	7.3	51.1	53.0	66.7	(3.4)	79.5	36.9	20.3
Plastic and rubber products	61.3	40.0	1.3	n.a.	600.0	2.4	27.5	27.8
Leather and leather goods	23.1	122.9	21.2	22.2	132.0	7.5	(20.8)	(1.9)
Wood and wood products	22.5	45.7	10.2	(62.5)	300.0	15.6	11.1	21.3
Printing and publishing	56.6	(5.7)	17.9	8.1	(100.0)	11.3	9.6	11.4
Chemical industry	33.4	(4.6)	20.5	46.4	(10.1)	20.3	17.6	14.8
Non-metallic minerals	26.5	57.5	42.9	200.0	(43.3)	29.6	35.7	32.2
Base metal industry	71.0	48.3	88.4	16.7	(81.8)	55.8	38.5	48.2
Machinery and equipment	11.3	2.6	6.2	(75.0)	(70.3)	44.4	9.7	9.8
Transport material	56.8	515.7	101.4	n.a.	(100.0)	(83.8)	109.1	259.7
Optical, cinema and other equipment	5.2	51.9	20.7	(9.1)	180.0	(44.7)	(1.2)	(2.0)
Other industries	9.3	84.5	(8.4)	50.0	200.0	108.6	20.2	28.0
Mining sector **(*)**	(1.7)	17.1	67.5	(42.7)	133.3	700.0	114.3	31.4

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

TABLE 16

IMPORTS (FOB), BY ECONOMIC USE
(MILLIONS OF DOLLARS)

	January-march		Variation	
	2004	2005	Absolut	Percentage
Consumer goods	**598**	**764**	**165**	**28**
Durables	307	368	61	20
Non-durables	292	396	104	36
Intermediate goods	**1,593**	**1,969**	**376**	**24**
Fuel and lubricants **(*)**	62	63	1	2
For agriculture	135	149	14	10
For industry	1,395	1,756	361	26
Capital goods	**1,175**	**1,516**	**342**	**29**
Building materials	62	83	22	35
For agriculture	12	12	(0)	(3)
For industry	705	961	256	36
Transport equipment	395	460	64	16
Unclassified goods	**1**	**2**	**0**	**34**
Total imports	**3,367**	**4,251**	**884**	**26**

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

As illustrated in Table 13, the end of the first quarter of 2005 saw a deficit of US$499 m in foreign trade non-factor services (1.8% of quarterly GDP). This is US$111 m more than the deficit for the same quarter in 2004 and was due primarily to net payments for transportation services (freight and passenger). On the other hand, the higher deficit in factor income (US$89 m) is explained by outlays associated with the increase in profits and dividends drawn on companies with foreign capital (US$101 m). Interest payments on the external debt were up by US$74 m, largely because of government debt service.

Net income from ordinary transfers (US$873 m) rose by US$72 m (8.5% annual), mainly because of a 20.8% increase in transfers other than remittances (US$29 m). Income from worker remittances in the first quarter of 2005 totaled US$752 m, was up by 6.1% (US$43 m) and accounted for 2.7% of quarterly GDP, 11.9% of current income in the balance of payments and 91.4% of total capital income from FDI.

In fact, according to the figures at April, Colombia had a US$363 m trade surplus, thanks to a 33% annual increase in total exports and a 28.9% annual increase in imports. Sales of non-traditional products continued to grow at an annual rate of 29%.

The latest foreign trade statistics from DANE and the National Revenue and Customs Bureau (DIAN) show continued growth in exports and imports. In fact, according to the figures at April, Colombia had a US$363 m trade surplus, thanks to a 33% annual increase in total exports and a 28.9% annual increase in imports. Sales of non-traditional products continued to grow at an annual rate of 29%.

2. Capital and Financial Account

In fact, according to the figures at April, Colombia had a US$363 m trade surplus, thanks to a 33% annual increase in total exports and a 28.9% annual increase in imports. Sales of non-traditional products continued to grow at an annual rate of 29%.

As noted earlier, the first quarter of 2005 saw a change in capital flows, with US$227 m in outflows as opposed to US$845 m in inflows during the same period in 2004. A summary of financial account transactions, by sector and maturity, is provided in Table 17 for a better understanding of the nature of capital flows during the first quarter of 2005.

- Compared with 2004, the new trend in capital flows during 2005 is due to US$1,240 m in public-sector transactions to accumulate external assets. Some of these resources belong to the government (US$750 m) and are the result of transactions with Banco de la República (profits transferred and part of the sale of dollars to pay the debt with IDB[22]). The rest belong to decentralized agencies.

- Capital flows from the private sector, without FDI (financial and non-financial), were similar to those registered during the same period in 2004, although there has been a lot of recomposition in terms of maturity. In fact, while short-term private capital flows rose by US$139 m, the long-term flows (not including FDI) were down by US$239 m.

- Capital inflows from net FDI came to US$782 m. This is US$211 m more than in the first quarter of 2004. A look at the situation by sectors shows direct investment in Colombia was focused mostly

[22] Banco de la Republica sold dollars to the government during the period between March and April. This is why the balance of payments for the first quarter of 2005 includes only part of the transaction.

TABLE 17

CAPITAL AND FINANCIAL BALANCE
(MILLIONS OF DOLLARS)

	I Qtr.			Difference 2005-2004
	2003	2004	2005 (pr)	
Capital and financial account (a + b + c + d)	430	845	(227)	(1,072)
a. Net foreign investment in Colombia	276	571	782	211
b. Public sector total	95	27	(1,240)	(1,268)
c. Financial and non-financial private sector total, without FD	61	246	231	(15)
Leasing	123	(50)	34	85
Long-term	(442)	(61)	(299)	(239)
Short-term	378	357	496	139

(pr) Preliminary.
Source: Banco de la República.

on the mining and quarry sector (US$488 m), oil (US$188 m), and transport and commercial activities (US$47 m and US$45 m, respectively)[2 3].

3. Variation in International Reserves

There was a rundown in gross international reserves as a result of current and capital transactions between January and March, excluding US$593 m in appreciation. The balance was US$12.784 m. This is equivalent to 8.9 months of merchandise imports and 7.2 months of imports of goods and services. It also is 1.1 times the value of public and private debt amortization during the following year.

[23] The FDI figures for the first quarter do not include the sale of Coltabaco and Cementos del Caribe. These transactions occurred in the second quarter of 2005.

Box 4

Foreign Direct Investment in Colombia

Foreign direct investment (FDI) is a major source of external financing for economies. In the last five years, Colombia received an average of US$8,291 m in yearly long-term foreign capital: 29% from FDI and the rest from external borrowing. FDI is understood as capital used by a company or investor in one country to create or expand a branch office or affiliate in another. Because of its characteristics, FDI is seen as another development factor that enables countries to become more productive for a variety of reasons. For example, i) it not only implies a transfer of financial resources, but also generates a long-term relationship between the investor (who acquires control) and the recipient of the investment; ii) it facilitates access to new technology; and iii) encourages the development of new markets in the countries where the investment is made.

There are four types of FDI, depending on the business strategies involved[1]: a) the search for raw materials; b) the search for markets; c) the search for efficiency to conquer third markets; and d) the search for strategic elements based on innovation and technological associations.

In the case of Mexico and the Caribbean Basin, the focus of FDI has been on the search for efficiency to conquer new markets. This, in turn, has led to the creation of subregional export

[1] «Foreign investment in Latin America and the Caribbean 2003,» ECLAC, May 2004.

platforms, primarily by U.S. companies to take advantage of the North American Free Trade Agreement (NAFTA) and the US-Caribbean Basin Trade Association Law. As to areas of activity, FDI has centered on those using high technology, such as the automotive and electronic sectors, and on branches with a lower level of technology, such as wearing apparel.

In the South American countries, FDI flows have been directed towards the search for raw materials (oil, copper and coal, among others) and to take advantage of local markets in sectors such as telecommunications, energy facilities and the financial system. Deregulation and liberalization processes, as well as privatization programs in the region, favored these investments.

The nineties saw substantial FDI flows towards Latin America. These averaged US$70.6 b a year between 1996 and 2000. Later, from 2001 to 2004, the flow of FDI declined to an annual average of US$53,300 m[2] (Table B4.1).

In Colombia, the entry of FDI was facilitated by the elimination of restrictions on investment of this type, which were established prior to the nineties. The privatization and concession policy affecting several government-owned companies was another positive factor in this respect, as was modernization and capitalization of the financial sector.

TABLE B4.1
NET FLOW OF FOREIGN DIRECT INVESTMENT IN LATIN AMERICA AND THE CARIBBEAN: 1996-2004
(MILLIONS OF DOLLARS)

	1996-2000 (*)	2001-2004 (*)
1. South America	**53,174**	**30,878**
a. Chile	5,667	4,684
b. Mercosur	36,760	18,663
Argentina	11,561	1,520
Brazil	24,824	16,839
Paraguay	188	66
Uruguay	187	238
c. Andean Community	10,747	7,530
Bolivia	780	422
Colombia	3,081	2,184
Ecuador	692	1,340
Peru	2,001	1,517
Venezuela	4,192	2,067
2. Mexico and the Caribbean Basin	**17,421**	**22,458**
a. Mexico	12,873	17,685
b. Caribbean	2,340	1,910
c. Central America	2,208	2,863
3. Total	**70,595**	**53,336**

(*) Annual average
Source: ECLAC and IMF.

[2] "Foreign investment in Latin America and the Caribbean 2003," ECLAC, March 2005.

Thanks to these factors and the discovery of new oil reserves, FDI rose substantially as of 1992, the year when US$729 m in income was reported. Between 1994 and 1998, average annual FDI was US$2,784 m. The peak came in 1997, when foreign direct investments totaled US$5,562 m (5.2% of GDP). However, average annual FDI declined to US$2,225 m during the 1999-2004 period, although 2004 saw a major comeback (US$3,005 m).

The force of FDI in Colombia between 1999 and 1998 was associated with investment in electricity, gas and water (US$4,168 m), industrial manufacturing (US$3,087 m), the financial system (US$3,034 m) and the petroleum sector (US$1,538 m). As a whole, these sectors absorbed 85% of all FDI in the country (Table B4.2).

In 1999-2004, investment centered primarily on mining and quarries (US$3,835 m), thanks to privatization of coal mining and subsequent injections of investor capital to expand mining capacity to take advantage of high international coal prices. Important resources also were channeled to the financial sector (US$2,807 m), manufacturing (US$2,160 m) and transport and communications (US$2,133 m). Essentially, this is explained by capitalization of the nation's banking system and by efforts to expand multinational companies in the mobile telephone sector and the industrial paper, rubber and food sectors.

TABLE B4.2
FLOW OF FOREIGN DIRECT INVESTMENT INTO COLOMBIA
(MILLIONS OF DOLLARS)

	1994-1998	1999-2004
Direct Investment in Colombia, by Economic Activity	**13,918**	**13,347**
a. Petroleum sector	1,538	942
b. All other sectors	12,380	12,406
Agriculture, hunting, forestry and fishing	91	49
Mining and quarrying (including coal)	329	3,835
Manufacturing	3,087	2,160
Electricity, gas and water	4,168	(100)
Construction	160	123
Commerce, restaurants and hotels	506	1,088
Transport, storage and communication	723	2,133
Financial establishments	3,034	2,807
Community services	282	311

Source: Banco de la República.

V. Fiscal Policy

Finances in the public sector showed a Col$1,539 b deficit at the end of March, which is equivalent to 0.6% of annual GDP. The imbalance in public-sector accounts was the result of a deficit in CG finances equal to 2.2% of GDP, which was offset in part by a surplus in the decentralized sector calculated at 1.9% of GDP.

A. First-Quarter Performance - 2005

At the end of March, public sector finances showed a Col$1,539 b deficit, which is equivalent to 0.6% of annual GDP. As opposed to the same period in 2004, this reflects a slight deterioration in the country's fiscal position and was due to major growth in the central government's (CG) deficit, brought about by a significant rise in spending. Generally speaking, the imbalance in public-sector accounts was the result of a deficit in CG finances equal to 2.2% of GDP, which was offset in part by a surplus in the decentralized sector calculated at 1.9% of GDP. Other factors to consider are the cost of restructuring the financial system, the balance reported by Banco de la República, and other adjustment items. On the whole, they added to the consolidated deficit by nearly 0.3% of GDP (Table 18)[24].

The CG reported a deficit of Col$6,255 b, thanks to Col$9,982 b in income as opposed to Col$16,237 b in payments. Income rose by 11.8% between January-March 2004 and expenses, by 22.8%. Revenue from income and external value-added tax (VAT), as well as customs duties saw respective increases of 14.2%, 25.6% and 27.9%. The rise in revenue from external VAT and customs duties came mainly from imports, which were up by 26.2% at the end of March compared with the value registered in the first quarter of the year. As to internal VAT, the figures are not indicative of further growth, even though the rate on certain goods and services was raised from 7% to 10%, as stipulated in Law 788/2002. This probably is

[24] BR financial performance is described in Chapter IV of this report

TABLE 18

CONSOLIDATED PUBLIC SECTOR
FIRST QUARTER FISCAL BALANCE

Items	Billions of dollars		Percentage of GDP	
	2004	2005	2004	2005
A. Total non-financial public sector (NFPS) (1 + 2)	**(278)**	**(836)**	**(0.1)**	**(0.3)**
1. National government	**(4,290)**	**(6,255)**	**(1.7)**	**(2.2)**
2. Decentralized sector subtotal	**4,012**	**5,419**	**1.6**	**1.9**
Electricity	37	81	0.0	0.0
FAEP	(113)	132	(0.0)	0.0
Ecopetrol	1,337	1,668	0.5	0.6
Telecom	9	(368)	0.0	(0.1)
Other entities	778	477	0.3	0.2
EPM	46	113	0.0	0.0
Emcali	81	96	0.0	0.0
Social security	1,194	2,170	0.5	0.8
Regional and local	556	971	0.2	0.3
National Coffee Fund	87	79	0.0	0.0
B. BR cash profit and loss	355	(133)	0.1	(0.0)
C. Fogafin cash profit and loss	141	80	0.1	0.0
D. Financial system restructuring cost	(475)	(399)	(0.2)	(0.1)
E. Adjustments	(699)	(251)	(0.3)	(0.1)
F. Total Consolidated Public Sector (A + B + C + D + E)	**(956)**	**(1,539)**	**(0.4)**	**(0.6)**

Source: Confis.

because internal VAT is collected every two months, which means the last payment for the preceding year and only the first installment for 2005 (January - February) went on record in the first quarter. There was no major increase in the gasoline tax, since higher prices lowered domestic demand (Table 19).

As to CG spending, with an annual increase of 22.8%, the official figures show a reduction of 8.2% in interest on the debt, 36.8% more operating costs and 30.8% more investment. The decline in interest payments largely reflects the impact of revaluation on financial costs in foreign currency. The rise in operating costs was associated with the trend in transfers and general expenses, which increased by 41.4% and 45.6%, in that order. The momentum in transfers reflects the growth in pension payments, which were up from Col$1,283 m in the first quarter of 2004 to Col$3,156 m in the first quarter of 2005. This annual variation of 146% is associated primarily with first-quarter transfers to the Social Security Institute and to the accrual of government payments to this agency in second quarter of the year[25]. Excluding pension payments, the increase in operating costs comes

As to CG spending, with an annual increase of 22.8%, the official figures show an 8.2% reduction in interest on the debt, 36.8% more operating costs and 30.8% more investment. Excluding pension payments, the growth in operating costs comes to 18.0%.

[25] The accrual in government Social Security pension payments was an unusual operation and is not expected to occur again this year.

Central Government
First-quarter Fiscal Balance
(Billions of pesos)

	2004	2005	Annual Growth 2004 - 2005
I. Total Revenue (A + B + C + D + E)	**8,927**	**9,982**	**11.8**
A. Tax Revenue	8,537	9,609	12.6
Income	2,967	3,389	14.2
Internal VAT	3,072	3,241	5.5
External VAT	1,083	1,360	25.6
Customs duties	469	600	27.9
Gasoline	255	274	7.5
Bank transactions	527	570	8.2
Others	164	175	6.7
B. Non-tax revenue	47	38	(19.1)
C. Special funds	65	70	7.7
D. Capital resources	247	234	(5.3)
E. Accrued income	31	31	0.0
II. Total Expenditure (A + B + C + D + E)	**13,217**	**16,237**	**22.8**
A. Interest	3,291	3,022	(8.2)
External	1,574	1,362	(13.5)
Internal	1,717	1,660	(3.3)
B. Operational 1/	8,775	12,008	36.8
Personal services	1,280	1,397	9.1
General expenses	349	508	45.6
Transfers	7,146	10,103	41.4
C. Investment 1/	809	1,058	30.8
D. Net loan	102	21	(79.4)
E. Accrued payments	240	128	(46.7)
III. Deficit (-) or Surplus (+) (I - II) 2/	**(4,290)**	**(6,255)**	**45.8**
Cost of restructuring the financial system	**475**	**399**	**(16.0)**
IV. Financing (A + B + C + D)	**(4,765)**	**(6,654)**	**39.6**
A. Net external credit	(160)	624	(490.0)
Disbursements	1,542	1,212	(21.4)
Amortization	1,702	588	(65.5)
B. Net internal credit	4,022	6,525	62.2
Disbursements	5,681	9,233	62.5
Amortization	1,659	2,708	63.2
C. Banco de la República profits	803	454	(43.5)
D. Others	100	(949)	(1,049.0)
V. Deficit as a Percentage of GDP	**(1.7)**	**(2.2)**	

1/ Includes payments and the floating debt.
2/ Does not include the cost of restructuring the financial system.
Source: CONFIS.

to 18.0%. On the other hand, rising investments can be attributed to actual spending, which was up by 13.4%, and to a 59.1% rise in floating debt accumulation.

The CG debt was financed mostly with domestic loans. Net foreign credit came to Col$624 b as a result of US$1,212 b in disbursements and Col$588 b in amortization. Net domestic borrowing increased to US$6,525 b, with Col$9,233 b in disbursements as opposed to Col$2,708 b in amortization. Col$10,012 b in TES were sold, including Col$5,652 b through auctions.

Table 20

Central Government Debt
as a Percentage of GDP

	Domestic	Foreign	Total
Dec-03	29.1	25.2	54.3
Mar-04	29.0	23.6	52.6
Jun-04	28.6	23.4	52.0
Sep-04	28.7	22.5	51.2
Dec-04	29.8	21.2	51.0
Mar-05	30.8	20.6	51.4

Source: Banco de la República

Due to these financing operations, the CG debt experienced a slight rise from 51% of GDP in December 2004 to 51.4% of GDP in March of this year (Table 20). While the domestic component of the debt increased during the quarter, from 29.8% of GDP to 30.8% of GDP, the external component declined from 21.2% of GDP to 20.6% of GDP, mostly because of peso appreciation in recent months. This shows the central government maintained a borrowing policy focused on domestic credit. In fact, the outstanding domestic debt as a portion of the total public debt rose from 53.4% in December 2003 to 60.0% in March 2005.

As part of the central government's program to reduce public debt exposure to foreign exchange and to improve the maturity structure, dollar and euro dominated securities maturing between 2005 and 2008 were swapped in June for fixed-rate TES and UVR-TES (units of real value) maturing between 2008 and 2015. In all, the transaction came to US$583 m. and helped to alleviate pressure towards short-term appreciation.

With respect to the other sectors and organizations, favorable performance was registered for Ecopetrol, the public sector at regional and local level, and social security. Ecopetrol generated a surplus equivalent to 0.6% of GDP, thanks to the trend in world prices for crude oil, an increase in the value of domestic sales due to the elimination of fuel subsidies, and fewer expenses, particularly for transfers and investments. Regional and local finances showed a surplus equal to 0.3% of GDP, largely because of more tax revenue collected by subnational administrations and the delay several departments and municipalities experienced in making investments. The surplus reported by social security was equivalent to 0.8% of GDP and originated with funds transferred from the central government to the various social security funds, particularly the Territorial Pension Fund (Fonpet).

B. The Fiscal Outlook for 2005

According to the March report by the Board of Directors, the consolidated deficit target set initially by the Fiscal Policy Council (Confis) was 2.2% of GDP for 2005. This objective could be expanded to 2.5% of GDP, if investment projects with a high social return are executed during the year.

The revised version of the 2005 Financial Plan, which was approved in early June, set the consolidated deficit target at 2.5% of GDP. This officially

created fiscal space for important initiatives like Families in Action, investment and capitalization in the rural area, and pavement and upkeep on 1,400 km. of roads. In addition to redefining the fiscal goal, the new 2005 Financial Plan contains several adjustments in the CG, Ecopetrol and social security estimates. However, they imply no major change in the figures for the non-financial public sector. With the latest adjustments, the fiscal goal will require the CG deficit, estimated at 6.1% of GDP, to be offset in part by a surplus in the decentralized sector that is equivalent to 3.7% of GDP.

The official figures show CG income will increase by 9.8% and expenses, by 12.9%. (Table 21). The most dynamic items will be internal VAT, customs duties and the tax on gasoline, with 13%, 15.1% and 16.1% growth, in that order. The force of internal VAT will be associated with a 7% to 10% rise in the rate applicable to certain goods and services, while customs revenue will depend on how imports perform (Table 21).

As to CG spending, interest on the debt will be up by 9.8% and operating costs by 15.1%, while investment payments will be 2.4% less. Personal services and transfers, as part of operating costs, are expected to be 6.9% and 18.5% higher, in that order. The momentum in this last item will depend on pension payments, which are expected to increase by about 50%, largely

TABLE 21

CONSOLIDATED PUBLIC SECTOR
FISCAL BALANCE: 2004-2005
DEFICIT (-) OR SURPLUS (+)

Item	Billions of dollars		Percentage of GDP	
	2004	2005 (p)	2004	2005 (proj)
A. Total non-financial public sector (NFPS) (1 + 2)	**(3,586.0)**	**(6,770.0)**	**(1.4)**	**(2.4)**
2. National government	**(13,983.0)**	**(17,041.0)**	**(5.5)**	**(6.1)**
1. Decentralized sector subtotal	**10,397.0**	**10,271.0**	**4.1**	**3.7**
Electricity	499.0	680.0	0.2	0.2
FAEP	167.0	200.0	0.1	0.1
Ecopetrol	296.0	91.0	0.1	0.0
Telecom	257.0	(19.0)	0.1	(0.0)
Other entities	1,527.0	1,410.0	0.6	0.5
EPM	502.0	335.0	0.2	0.1
Emcali	271.0	460.0	0.1	0.2
Social security	4,009.0	5,131.0	1.6	1.8
Regional and local	2,832.0	1,981.0	1.1	0.7
National Coffee Fund	37.0	2.0	0.0	0.0
B. Banco de la República cash profit and loss	**1,225.0**	**320.0**	**0.5**	**0.1**
C. Fogafin cash profit and loss	**720.0**	**326.0**	**0.3**	**0.1**
D. Financial system restructuring cost	**(920.0)**	**(950.0)**	**(0.4)**	**(0.3)**
E. Adjustments	**(886.0)**	**0.0**	**(0.3)**	**0.0**
F. Total Consolidated Public Sector (A + B + C + D + E)	**(3,447.0)**	**(7,074.0)**	**(1.3)**	**(2.5)**

(proj) Projected
Source: CONFIS.

because of the nearly Col$4 trillion (t) that will have to be transferred to the Social Security Institute (ISS), which has depleted its reserves.

Most of the money to finance the CG deficit will come from domestic credit, with Col$15,759 b in net borrowing due to Col$25,652 b in disbursements and Col$9,893 b in amortization. With Col$25,609 b in gross placements, TES B will be the main domestic debt instrument. Col$12,461 b of these bonds will be auctioned, Col$9,542 b placed through agreed transactions, and Col$3,606 b through forced subscription.

From a more structural standpoint, the government's projections, as outlined in *The Mid-term Fiscal Scenario,* show a gradual decline in the net debt of the non-financial public sector (NFPS) over the next ten years, from 39.4% of GDP in 2004 to 31.0% of GDP in 2015[26]. To accomplish this, the NFPS must generate a primary surplus equivalent to 2.7% of GDP in the years ahead, which is possible only if the necessary reforms continue to be analyzed and enacted.

In an important step towards ensuring fiscal sustainability, Congress finally passed a bill that reduces the nation's pension liability and eliminates special pension plans. According to the latest actuarial calculations, the reduction comes to 18% of GDP. The pension liability was 162.4% of GDP in 2005, prior to passage of the bill, and 144.4% afterwards.

However, this legislation needs to be supplemented with action on issues of even greater fiscal importance that are currently subject to temporary rules and regulations. The tax structure is a case in point and contemplates levies and exemptions that are effective until 2006[27]. On the other hand, territorial transfers are structured according to a temporary provision that ends in 2008. This is an issue Congress needs to consider.

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[26] Refers to the total public debt (net) on domestic and external financial assets.

[27] For example, the tax on personal income and wealth is effective until the 2006 tax year. The tax on bank transactions is effective until 2007.

VI. International Reserves

Banco de la República relies on three central elements to manage the country's international reserves: i) a monetary policy based on inflation targeting; ii) a floating exchange rate; and iii) optimum reserve management. These three macroeconomic-strategy components are intended to guarantee economic stability, which is fundamental to economic growth and social development.

As reiterated in several BDBR reports to Congress, Banco de la República relies on three central elements to manage the country's international reserves: i) a monetary policy based on inflation targeting; ii) a floating exchange rate; and iii) optimum reserve management. These three macroeconomic-strategy components are intended to guarantee economic stability, which is fundamental to economic growth and social development.

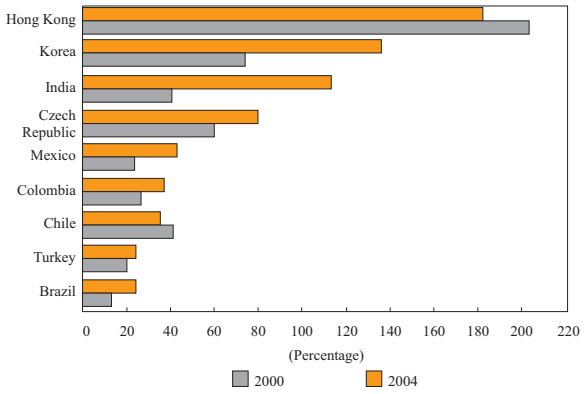
Colombia's international reserves are managed in light of three main objectives. i) One is to protect the economy against external shocks. ii) Another is to minimize the risk of loss and to guarantee that international liquidity will be available when needed. iii) The third is to ensure that liquidity will be provided efficiently, when conditions warrant using a portion of these reserves for this purpose.

In previous reports, the Board of Directors has explained the criteria used to assess the level of the country's reserves and the way they are managed. An "adequate" level varies, depending on factors such as changes in the international environment, the relative size of Colombia's external debt, the profile of external debt amortization, and the sustainability of economic growth. Therefore, maintaining international reserves has opportunity costs and benefits that increase in a direct way, with the level of reserves.

Permanently monitoring the indicators that measure the country's external vulnerability is a crucial part of this analysis. As outlined in the following section, the latest indicators show the country's international reserves could be considered adequate to deal with external shocks, should they occur. However, an international comparison based on the ratio of net reserves to the total external debt, as a reference indicator, shows that Colombia has

GRAPH 41

RATIO OF INTERNATIONAL RESERVES TO THE TOTAL EXTERNAL DEBT



Source: Datastream Calculations by Banco de la República.

fewer international reserves than other emerging economies (Graph 41).

A. EXTERNAL VULNERABILITY INDICATORS

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

- Debt amortization indicator (reserves/year to date amortization)
- Debt service indicator (reserves/total external debt service)
- Adequate liquidity position indicator (reserves/(amortization + current account deficit)).

The first indicator is sufficient in countries with no current account deficit or an overvalued currency, in which case the demand for international liquidity is limited to amortization of the total debt. The second is relevant when a country must turn to the international market to finance amortization of its total debt, as well as the interest on this obligation. The third indicator can be used to measure the external vulnerability of countries with sizeable amortization and interest payments, a current account deficit, and a desire to avoid any swift and abrupt adjustment in the current account should financial markets be closed to them. The international markets keep an eye on each country's characteristics and the value of these indicators. A relevant indicator below 1.0 is considered a warning sign in terms of the external vulnerability of the economy being examined for investment.

The international reserve indicators for Colombia during 2002 - 2004 are shown in Table 22. At the end of 2004, the external debt amortization indicators were above 1 and varied between 1.14 and 1.54. The indicators of total debt service and adequate liquidity position were near 1. For example, the reserves/(amortization + current account deficit) indicators were between 1.39 and 0.98.

Nevertheless, although external conditions remain favorable and the country-risk premium has declined significantly, the situation could change and capital inflows could come to a standstill or the country could be denied access to international financial markets. For this reason, Colombia must

Table 22

International Reserve Indicators for Colombia

	2002	2003	2004	2005 (*)
Balance				
Net international reserves (millions of dollars)	10,841	10,916	13,536	13,725
IMF international reserves (millions of dollars)	10,507	10,524	13,197	13,560
Indicators				
A. External debt amortization indicator				
External debt amortization (millions of dollars)	10,146	10,173	8,806	11,826
Net reserves/year-to-date external debt amortization	1.07	1.07	1.54	1.16
Net reserves/following-year external debt amortization	1.07	1.24	1.14	1.25
B. Debt service indicator				
NIR/ (current-year debt service)	0.86	0.87	1.20	0.95
NIR/ (following-year debt service)	0.86	0.97	0.94	0.98
C. Indicator of adequate external liquidity position				
NIR/ (current-year debt amortization + current-year C/A deficit)	0.94	0.98	1.39	0.99
NIR/ (following-year debt amortization + following-year C/A deficit)	0.97	1.12	0.98	0.97

(*) International reserve position at June 2005.
Source: Calculations by Banco de la República.

have enough international reserves to deal with an external crisis of medium proportions.

B. Current International Reserves and Criteria for their Management

Colombia had US$13,725.1 m in net international reserves at June 2005. This is US$189.3 m more than at December 2004[28]. In total, US$1,615.0 m in reserves were purchased during this period through discretional intervention, foreign currency was sold (US$1,250 m) and profits were transferred to the government (US$196 m). The net yield on the investment segment of international reserves was US$6 m.

The investment segment is the main component of international reserves and accounts for 92.2% of the total (US$12,650.3 m) [29]. The rest include (i) the reserve position with the IMF and the Latin American

[28] Net reserves are equal to total international reserves, or gross reserves, minus the external short-term liabilities incumbent on Banco de la República. The latter are comprised of sight liabilities in foreign currency with non-resident agents. Unless indicated otherwise, all the figures in this report pertain to the end of June 2005 and are provisional.

[29] The investment segment refers to the portfolio resources managed internally, delgated portfolios and the sum designated for working capital.

Reserve Fund - FLAR (US$738.5 m); (ii) US$173.4 m in special drawing rights (SDR); (iii) US$166.6 m in gold, Andean pesos and positive balances from international agreements; and (iv) US$ 2.0 m in demand deposits and cash. External short-term liabilities stood at US$5.7 m (Table 23).

Security, liquidity and profitability are the criteria Banco de la República uses to manage international reserves, in that order of importance. Based on these standards and to ensure payment of the country's external liabilities, reserves are invested in financial assets on a broad secondary market. Some are set aside as working capital to guarantee their immediate availability.

Pursuant to these guidelines, financial institutions outside the country are appointed to manage a portion of the portfolio in which Colombia invests

TABLE 23

COMPONENTS OF INTERNATIONAL RESERVES

Description	Jun-04		Dec-04		Jun-05	
	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage
Cash	**78**	**0.7**	**16**	**0.1**	**2**	**0.0**
Cash on hand	78	0.7	16	0.1	0	0.0
Demand deposits	1	0.0	1	0.0	2	0.0
Investments	**10,453**	**90.2**	**12,336**	**91.1**	**12,650**	**92.2**
Direct portfolio	5,207	44.9	6,948	51.3	5,578	40.6
Managed portfolio	5,245	45.3	5,389	39.8	7,072	51.5
Gold	**129**	**1.1**	**143**	**1.1**	**143**	**1.0**
On hand	0	0.0	0	0.0	0	0.0
In trust	129	1.1	143	1.1	143	1.0
International Monetary Fund	**588**	**5.1**	**627**	**4.6**	**590**	**4.3**
SDRs	169	1.5	183	1.4	173	1.3
Reserve position	419	3.6	444	3.3	416	3.0
Latin American Reserve Fund	**340**	**2.9**	**340**	**2.5**	**342**	**2.5**
Contributions	320	2.8	320	2.4	322	2.3
Andean pesos	20	0.2	20	0.1	20	0.1
International Agreements	**3**	**0.0**	**77**	**0.6**	**4**	**0.0**
Total Gross Reserves	**11,591**	**100.0**	**13,540**	**100.0**	**13,731**	**100.0**
Short-term Liabilities	**4**	**0.0**	**4**	**0.0**	**6**	**0.0**
International agreements	0	0.0	0	0.0	0	0.0
Foreign banks	0	0.0	0	0.0	0	0.0
Latin American Reserve Fund (FLAR)	0	0.0	0	0.0	0	0.0
Amounts payable. purchases. investments	0	0.0	0	0.0	0	0.0
Interest accrued on liabilities	4	0.0	4	0.0	6	0.0
Total Net Reserves	**11,588**	**100.0**	**13,536**	**100.0**	**13,725**	**100.0**

Source: Banco de la República.

its international reserves. These institutions are scrutinized carefully and selected on the basis of their experience in the business, the size of the funds they manage, and the extent of their management and risk-control capacity. As noted in previous reports, these institutions have improved the return on international reserves through specialized management.

Security, liquidity and profitability are the criteria Banco de la República uses to manage international reserves, in that order of importance. Based on these standards and to ensure payment of the country's external liabilities, reserves are invested in financial assets on a broad secondary market. Some are set aside as working capital to guarantee their immediate availability.

Banco de la República directly managed US$5,577.9 m (44.1% of the total investment segment), including US$553.0 m in working capital. The other 55.9% (US$7,072.3 m) was managed by Barclays Global Investors, J.P. Morgan Investment Management Inc., Goldman Sachs Asset Management and Morgan Stanley Investments L.P.

Most of the credit risk for the investment portfolio as a whole is concentrated in the sovereign sector and includes short and long-term holdings, with 69.5% of the portfolio. The rest is distributed among the other sectors; namely, 15.9% in the banking sector, 9.7% in the corporate sector, 2.0% in the supranational sector, 0.6% with the Bank for International Settlements (BIS), and 2.3% in buy-back agreements with the New York Fed. At June 2005, distribution according to credit quality based on ratings issued by specialized agencies[30] was a follows: 26.5% "P-1"[31]; 64.2% "AAA", 4.2% "AA", 2.2% "A", 0.6% in BIS and 2.3% in buy-back agreements with the New York Fed. The way credit risk is distributed reflects the emphasis on security in managing international reserves.

The yields on the various portfolios that comprise the investment segment of international reserves are shown in Table 24 and compared with the reference yield.

30 Standard & Poor's, Moody's and Fitch ratings.

31 "P-1" is the top of the short-term rating scale.

TABLE 24

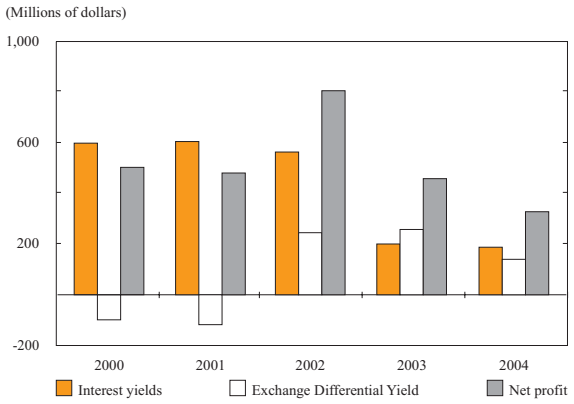
NON-ANNUALIZED YIELD ON THE INTERNATIONAL RESERVE PORTFOLIO 1/
DECEMBER 2004 TO JUNE 2005

Portfolio Manager	Non-annualized Yield		
	Portfolio	Reference index	Difference
Banco de la República 2/	(0.10)	(0.11)	0.01
Barclays Global Investors	(0.85)	(1.38)	0.54
J. P. Morgan Investment Management	(1.37)	(1.38)	0.01
Goldman Sachs Asset Management	1.14	1.07	0.07
Morgan Stanley Investments	1.28	1.07	0.21
Working Capital	1.29		

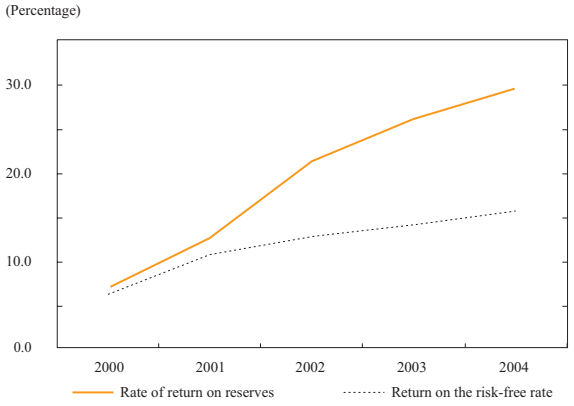
1/ These are provisional figures subject to revision.
2/ Does not include working capital.
Source: Banco de la República.

GRAPH 42

RETURN ON INTERNATIONAL RESERVES
2000-2003



ACCUMULATED RATE OF RETURN ON RESERVES
VS. THE RISK-FREE RATE IN DOLLARS



Source: Banco de la República.

Interest rates in the developed economies declined during the period from 2000 to late 2004. However, this trend changed in 2005, with the rise in short-term interest rates, which should continue to increase until the end of the year. It is, however, important to remember that prices for the securities in which international reserves are invested benefited greatly from the sharp drop in interest rates during 2000-2004. Added to this is the appreciation of currencies against the US dollar. These two factors combined led to unusually high returns on international reserves, well above what was forecast by Banco de la República and the return on the risk-free rate in the United States[32]. Graph 42 illustrates the cumulative rate of return on reserves as opposed to the risk-free rate of return in dollars. It also contains a breakdown of the return on dollar reserves from accruals and valuations in their fixed-income instruments ("interest yield") and from the exchange differential against the U.S. dollar ("exchange yield differential").

The investment policy for international reserves designed and applied by Banco de la República during 2000 - 2004 generated 86% more than the return on the risk-free rate in dollars during those years. Most of this surplus originated with the valuation of fixed-income assets and the interest earned on those investments. As illustrated, the return on interest rates between 2000 and 2002 came to approximately US$600 m per year; income from the exchange differential was not a major portion of total returns. In 2003 and 2004, because of generally low interest rates worldwide, the return on this item fell to a third and a fourth, in that order. 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.

Unlike the last few years, the first six months of 2005 saw a substantial rise in short-term interest rates in the United States. The Federal Reserve Bank

[32] 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.

increased its reference rate (Fed Funds) from 2.25% to 3.25%, and the US dollar revaluated against the euro and the Japanese yen (Graph 43). This affected the return on the international reserve investment portfolio. For example, (i) there have been losses from the exchange component, due to the devaluation of investments denominated in currencies other than the dollar. (ii) Also, despite higher interest rates in the United States, which negatively affected the price of assets, the return from accruals and valuations has been positive, mainly because of the interest generated by investments.

As mentioned in the March 2005 Report to Congress, the foreign exchange composition of Colombia's international reserve portfolio is as follows: 85% in dollars, 12% in euros and 3% in yen[33]. As detailed in Box 5, which also offers an international comparison, the foreign exchange composition of Colombia's international reserves is a reflection of the denomination of the country's liabilities with the rest of the world. By definition, one of the purposes of international reserves is to serve as a source of liquidity, in the event that external markets are closed to the country.

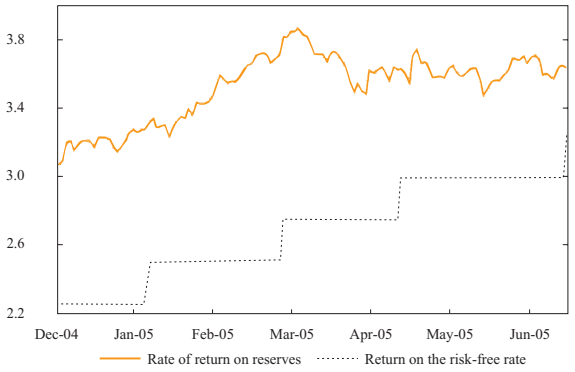
In terms of exchange rates, the euro devaluated by 10.75% against the dollar during the course of the year to June, while the Japanese yen devaluated by 7%. The appreciation of the dollar is related to high interest rates in the United States and good economic performance in that country compared with Europe and Japan. In this respect, during 2004 Banco de la República raised the reserve for currency fluctuation to Col$1,768.1 b, so as to be able to assimilate any exchange losses that might occur in 2005, without affecting transfers to the government.

[33] This refers to the managed portfolios and does not include working capital.

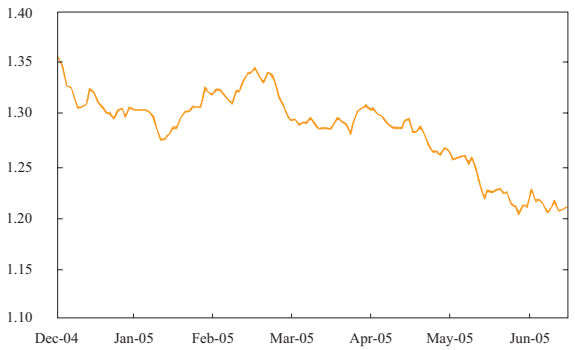
GRAPH 43

TREND IN INTEREST RATES ON US TREASURY BONDS AND THE DOLLAR AGAINST THE YEN AND THE EURO

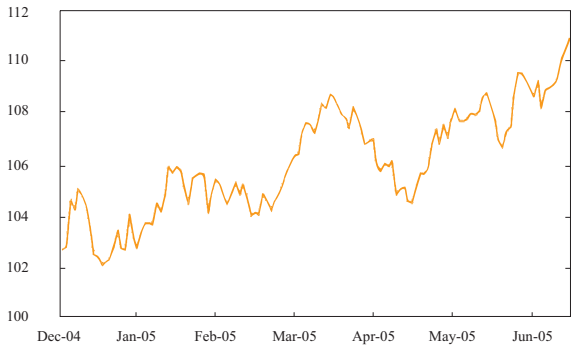
RATE OF RETURN ON TWO-YEAR TREASURY BONDS AND FEDERAL FUNDS IN THE UNITED STATES, 2005



EURO VS. U.S. DOLLAR, 2005



YEN VS. U.S. DOLLAR, 2005 (*)



(*) The inverse dollar/yen price means the yen loses value as it moves away from zero.
Source: Bloomberg L. P.

Banco de la Republic has an extensive structure to control investments made with international reserves. Besides internal controls, it is audited by an outside firm hired in 2002 (Deloitte & Touche). It also is subject to an audit review ordered of the President of Colombia.

The net return on total international reserves at June 30, 2005 was -US$10.0 m. Losses due to fluctuations in interest rates and the exchange differential came to US$186.3 m and were offset in part by US$176.3 m in returns from accrued interest. As mentioned in previous reports, Banco de la Republic has an extensive structure to control investments made with international reserves. Besides internal controls, the Bank is audited by an outside firm hired in 2002 (Deloitte & Touche). It also is subject to an audit review ordered of the President of Colombia.

There are several reasons why international reserve investments are audited. (i) One is to monitor investment operations on a permanent basis. This to ensure observance of the provisions established by the Internal Committee on Reserves and to guarantee several factors; namely, the security and defense of acquired assets, the fulfillment of the obligations derived from their management, financial performance compared to the reference portfolio and the effectiveness of management in dealing with liquidity, exchange, credit and market risks. (ii) Another reason is to review the risks posed by internal operating procedures, and (iii) to pay regular auditing visits to the external portfolio managers and security custodians. The idea is to examine the internal control environment established by these institutions to manage and control the resources entrusted to their care.

Box 5

Foreign Exchange Composition of International Reserves: an International Comparison

The foreign exchange composition of international reserves should reflect the denomination of the accounts payable by Colombians. By definition, one of the purposes of international reserves is to act as a source of liquidity should access to international financial markets be restricted. With this in mind, Banco de la República reviews the country's payments, according to the balance of payments, and modifies the foreign exchange composition of the reserve investment portfolio, if necessary. The last change was in January 2004 and left 85% in dollars, 12.0% in euros and 3% in yen. To determine this composition, Banco de la República calculates the three-year moving average for the composition of balance of payments outlays, by currency.

The following is a comparison between the method used by the Bank to determine the foreign exchange composition of international reserves and the methods used in other countries.

Countries with different degrees of wealth and development, and different geographic zones were taken into account. The information on international reserve management came from International Monetary Fund publications (Guidelines for Foreign Exchange Reserve Management, 2003): Brazil, Chile, Canada, Colombia, the Czech Republic, South Korea, Hong Kong, India, Mexico and Turkey. These countries have an important share of total international reserves, or are recognized worldwide for the way these reserves are managed.

The methods used most often by central banks to determine foreign exchange composition can be grouped into four categories (Table B5.1).

i. The first consists of matching the foreign exchange composition of the central bank's assets with that of its liabilities.

ii. With the second method, the central bank selects the currency composition of its international reserves based on the need for its intervention in the exchange market. In this way, the currency used for intervention accounts for a larger share of the reserves.

iii. Other central banks apply sophisticated financial optimization models to determine the exchange composition of their reserves, based on the long-term risk/return profile of currencies.

TABLE B5.1
METHOD TO DETERMINE THE FOREIGN EXCHANGE COMPOSITION OF INTERNATIONAL RESERVES: 2003

Country	Degree of Indebtedness	Exchange Regime	Method	
			Principal	Supplementary
Brazil	High	AER	Outlay flows	
Turkey	High	AER	Structure of liabilities	Outlay flows
Colombia	Moderate	AER	Outlay flows	
Chile	Moderate	AER	Outlay flows	
Mexico	Low	AER	Modelos financieros	
India	Low	AER	Outlay flows	
Czech Rep.	Low	AER	Intervención	Modelos financieros
korea	DC	AER	Outlay flows	Intervención
Hong Kong	DC	TCF	Intervención	Modelos financieros
Canada	DC	AER	Structure of liabilities	

Notes:
DC: Unclassified debt
AER: Free exchange rate
FER: Fixed exchange rate
Source: World Bank, IMF (2003)

iv. The last method calls for the country's reserves to mirror a specific feature of capital outflows. The foreign exchange composition of the external debt, the classification of imports by country of origin, and the foreign exchange composition of other outlays in the balance of payments are the factors taken into account when determining these reference outlays.

The foreign exchange composition of international reserves in Colombia depends on the currency structure of the outlays registered in the balance of payments. The three-year moving average of this structure is calculated to this end. This method is used by various central banks around the world.

According to IMF information on foreign exchange reserve management, the choice of a central bank's method to determine the foreign exchange composition of international reserves depends on the payment capacity of international reserves, the exchange system, and the objectives of international reserve management.

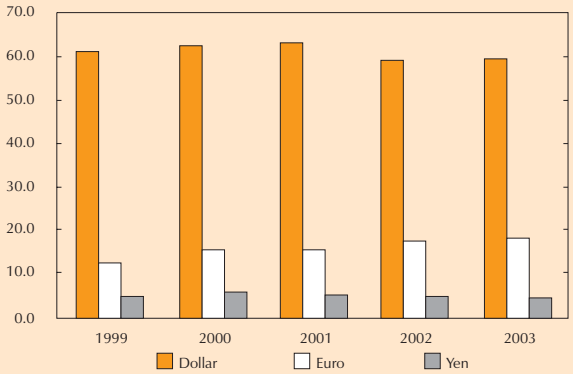
In countries where the level of international reserves is relatively low compared with external borrowing, central banks prefer the exchange composition of these reserves to be in keeping with the exchange make-up of a specific flow of capital outlays. Countries with less debt use financial models or methods based on the liability structure. Accordingly, in a country where the paying power of international reserves is relatively low, the preference is for exchange composition to comply with the country's external liabilities, or to protect it against capital outflows. In contrast, when the paying power of a country's international reserves is high, they can be managed in pursuit of objectives other than those mentioned earlier. This allows the central bank to use methods that imply more of a risk, specifically when the objective is to maximize the return on investments made with international reserves.

Although not as important because of the global trend towards floating rates, the exchange arrangement continues to be relevant for countries with a fixed rate of exchange. Hong Kong is a case in point (Table B5.1). On the other hand, despite current speculation about a massive migration of international reserves to euros, available information is contradictory for validating this hypothesis. And, judging from the increased amount of US Treasury Bonds held by official entities (especially central banks), the US dollar continues to gain relative importance as a reserve currency in contrast with others.

According to IMF statistics, the US dollar, as a share of global international reserves, only declined from 61% to 59.4% between 1992 and 2000, while the euro went from 12.7% to 18.4% during the same period. This could be interpreted as a movement towards the euro by currencies other than the US dollar, or on the part of new investment funds (Graph B5.1).

In addition, the figures reported by the United States Federal Reserve Bank on US government securities held by foreign entities of an official nature (mostly central banks) show the demand

Graph B5.1
Exchange Composition of Official Holdings in Foreign Currency at Year End
(Millions of SDR)



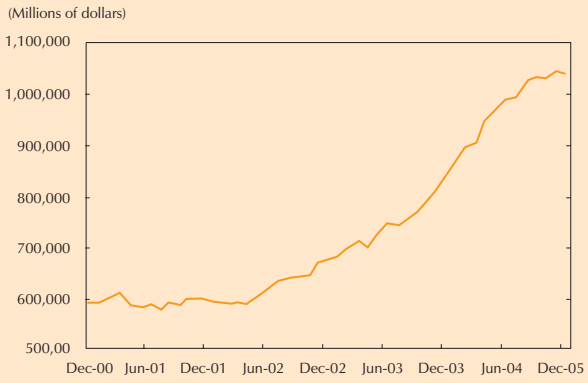
Source: IMF, Annual Report 2004. Calculations by Banco de la República.

for these instruments has grown considerably in the last five years. However, this increase has slowed in recent months (Graph B5.2).

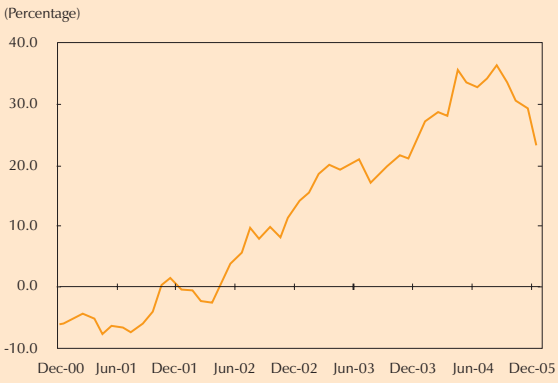
Many analysts argue that the recent devaluation of the dollar and the risks associated with sustainability of the current account deficit in the United States could prompt many central banks to reduce the portion of their international reserves denominated in dollars. However, several studies by the Bank of International Settlements (BIS) show that, in the long term, the predominance of the dollar as a reserve currency cannot be explained by foreign trade patterns

Graph B5.2
Official Foreign Assets Held by Federal Reserve Banks

Holdings: 1994-2004



Annual Growth in Holdings: 2000 - 2004



Source: United States Federal Reserve Bank.

or by the risk and return profiles of currencies alone (Horii, 1986). The importance of the dollar as a reserve currency also depends heavily on its liquidity in the exchange market and the depth of the bond market underlying the currency (BIS, 2004). For these reasons, the dollar is the currency preferred by many central banks for their intervention transactions.

Given these criteria, the method currently used by Banco de la República to determine the foreign exchange composition of international reserves appears to be correct. Colombia is a country with a moderate level of borrowing. The payment capacity of its international reserves is moderate as well. For this reason, the exchange composition of reserves is determined by two objectives: protection against capital outflows and payment of the external debt. These are the objectives taken into account when selecting the currencies in which international reserves are denominated. By replicating the exchange distribution of the balance of payments, the central bank is establishing a provision against contingent outflows of capital associated with foreign trade, external debt service and flight of funds.

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VII. The Financial Position of Banco de la República

The accounting system used by Banco de la República is subject to Law 31/1992, Decree 2520 of 1993 (the by-laws of the institution), relevant provisions established by the Banking Superintendent, and Decree 2649 of 1993.

The structure of the Bank's financial statements reflects the objectives and functions stipulated in the Constitution, in Law 31/1992 and in the by-laws of the institution. The present section contains (i) a description of the principal accounting policies and practices used to construct the balance sheet and to calculate annual financial performance; (ii) the financial structure of the major items on the balance sheet and the income statement; (iii) the trend in the financial statements during the year to date; and (iv) potential profits for 2005.

A. Legal Framework

The accounting system used by Banco de la República is subject to Law 31/1992, Decree 2520 of 1993 (the by-laws of the institution), relevant provisions established by the Banking Superintendent, and Decree 2649 of 1993 [34].

1. Principal Features of the Accounting System

The following are the principal features of the accounting system used by Banco de la República.

a. The accounting period is one year, and the accrual or cumulative method of accounting is used to recognize economic events.

b. The international reserve portfolio is valued daily at market prices.

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[34] Principios o normas de contabilidad generalmente aceptados en Colombia.

The by-laws of the Bank call for a currency fluctuation provision. It is constituted with the profits from each period that pertain to the increased net value of BR assets and liabilities in foreign currency....

c. Investments in TES are valued at market prices, pursuant to instructions issued by the Banking Superintendent.

d. Not all assets and liabilities in foreign currency affect international reserves. To be considered a foreign reserve, an asset must have the following characteristics: negotiability, availability, currency of origin and residence. It must be controlled by the monetary authority and be available immediately to finance external imbalances directly and to regulate them through intervention in the foreign exchange market.

e. Given the nature of the institution as a central bank, there are special rules for entering certain items on the books, such as (i) fluctuations of other currencies against the dollar; (ii) variations in the market price of investments in foreign currency; and (iii) the effect on the international reserve position of variations in the peso against the dollar. In the first two cases, the variations are reflected in the income statement; variations in the latter are mirrored in the equity surplus.

Fluctuations in the price of different currencies against the United States dollar (which is the accounting reference unit) affect BR operational earnings. This being the case, revaluation of the euro and the yen against the dollar implies a profit for the Bank, while the devaluation of those currencies against the dollar generates a loss, as has been the case during the course of 2005 to date.

Variations in the market price of the different securities or the international reserve portfolio lead to valuation or devaluation, and this affects the income statement. As a product of an increase in the value of the portfolio at market prices, a decline in interest rates in the United States and the European Union would spell a profit for the Bank, as has been the case in the last two years. If this pattern were to be reversed, the increase in international interest rates would devaluate the Bank's assets and generate operational losses.

Finally, variations in the peso against the US dollar are listed on the Bank's financial statements as an exchange adjustment and recorded under surplus equity. The exchange adjustment occasioned by assets and liabilities in foreign currency that are not part of international reserves is recorded in the earnings for the period.

.... originating with exchange variations between the dollar and the other currencies in which these assets and liabilities are denominated, provided they have produced a profit during the period in question.

f. The by-laws of the Bank call for a provision against currency fluctuation. It is constituted with the profits from each period that pertain to the increased net value of BR assets and liabilities in foreign currency originating with exchange variations between the dollar and the other currencies in which these assets and liabilities are

denominated, provided they have produced a profit during the period in question. If currency fluctuations result in a net loss at the end of the period, it can be absorbed with this provision.

g. The remaining annual profits, once the reserves have been appropriated, belong to the nation. If the books show a loss at the end of the annual accounting period, it should be covered first with the monetary and exchange stabilization provision, which was created specifically for this purpose. If this provision is not enough, the amount that is lacking should be met with appropriations from the national budget.

h. The net operational result is projected annually and used to draft legislation on the annual budget. The profits or losses are included in the income or expense budget for this purpose, as the case may be.

i. Profits or losses are paid or charged to the Nation in cash during the first quarter of each year, pursuant to Law 31/1992.

B. The Financial Structure of the General Balance and Statement of Earnings

1. Assets

a. Gross International Reserves

These are the main assets of the Bank. They represent 69.7% of total assets and are its primary source of income. The investment segment[35] (92% of gross international reserves at June 30, 2005) is comprised of commercial paper, escrow accounts and other financial assets the Bank has invested abroad. On the same date, 86.4% of these investments were denominated in dollars, 10.6% in euros, 2.6% in yen and 0.4% in other currencies. The Bank directly manages nearly half the segment (44% at June 30, 2005). The other portion (56%) is delegated to companies specializing in asset management; namely, Barclays Global Investors, J. P. Morgan Investment Management Inc., Goldman Sachs Asset Management and Morgan Stanley Investment L. P.

b. Investments

Basically, these pertain to the security portfolio, which accounts for 8.7% of total assets. The return on investments is a major source of operational

Profits or losses are paid or charged to the Nation in cash during the first quarter of each year, pursuant to Law 31/1992.

[35] Includes the managed portfolios and working capital.

These are the main assets of the Bank. They represent 69.7% of total assets and are its primary source of income. The investment segment accounted for 92% of gross international reserves at June 30, 2005.

income for the Bank, which makes these investments to manage liquidity through the definitive purchase or sale of government bonds (TES) on the secondary market.

c. Contributions to International Agencies

These are comprised of the Bank's investment in multilateral credit agencies that does not constitute a reserve asset and was made before Law 31/1992 took effect, primarily with the IMF[36], the Inter-American Development Bank (IDB), the International Bank for Reconstruction and Development (WB) and the Commission for Andean Development (CAF). These contributions account for 6.2% of the Bank's total assets and are offset by an entry for a similar amount under liabilities. Therefore, in net terms, they represent only 1.2% of all assets belonging to Banco de la República.

d. Resale-Temporary Liquidity Support Agreements

These are the repo transactions extended by the Bank. They involve the temporary purchase of government bonds and are intended to provide financial brokers with temporary liquidity. These agreements now account for 8.8% of total assets. The rate charged on repos is operational income for the Bank. During the year to date, there has been no liquidity support for credit institutions.

e. Other Net Assets

These include mainly the custodial rights to pension liability resources turned over to specialized institution for management, as well as property and equipment, art and cultural works, particularly the bibliographic material deposited in the different public libraries and the collections of gold work, paintings, sculptures and other works of art. Also included in this item is the book price of the real estate and artistic and cultural property belonging to the Bank. The balancing entry is reflected in the equity surplus. These net assets represent 6.6% of total assets.

2. Liabilities

a. Base Money

Base money is comprised of the notes and coins in circulation and the

[36] IMF contributions constituted in legal currency.

current accounts of financial brokers. It is the Bank's main liability and represents 39.1% of total liabilities and equity. The costs generated by these liabilities, such as the cost of currency issue and remuneration on reserve requirements, are reflected in the outlays made by the institution

Equity is comprised of initial capital, statutory reserves, the equity surplus, the amount of appreciation on art, cultural works and real estate, and earnings for the period.

b. National Government- National Treasury Office

These are national government deposits constituted through the National Treasury Office. They account for 16.7% of total liabilities and equity. They earn term interest and are reflected in the operational outlays of the Bank.

c. Liabilities with International Organizations

These are contributions in domestic and foreign currency placed at the disposal of international organizations.

d. Other Liabilities

Primarily, these include the provision registered for requirement pensions and employee liabilities. This item accounts for 2.2% of total liabilities and equity.

3. Equity

Equity is comprised of initial capital, statutory reserves, the equity surplus, the increase in the value of art, cultural works and real estate, and earnings for the period. The equity surplus is most important component and accounts for 30.1% of total liabilities and equity. The exchange differences from cumulative devaluation of the peso against the dollar, when reserve assets are re-expressed in pesos, are registered under this item. The statutory reserves account for 4.1% of total liabilities and equity, and include the currency fluctuation reserve (Col$1,768.1 b), the asset protection reserve (Col$93.0 b) and the exchange reserve (Col$6.6 b).

4. Income Statement

For administrative and budgetary purposes, the income statement is classified according to monetary, corporate and pension spending.

Historically speaking, more than 90% of Bank's total income is monetary in origin. It is not easy to estimate income of this type, as it depends on variables such as interest rates and external and internal fluctuations in the market prices of investment portfolios and in the price of reserve currencies compared with the Colombian peso.

The monetary budget includes the result of the constitutional functions assigned to the Bank as the monetary, exchange and credit authority, the bank of issue, the international reserve manager, the banker and lender of last resort for credit institutions, and the government's fiscal agency.

The corporate budget includes the results of the Bank's administrative management in its capacity as a fiduciary agency, income from commissions on banking services and from the purchase and sale of precious metals, personnel and pension spending, operating costs and cultural spending.

a. Monetary Income and Spending

Historically speaking, more than 90% of Bank's total income is monetary in origin. It is not easy to estimate income of this type, as it depends on variables such as interest rates and external and internal fluctuations in the market prices of investment portfolios and in the price of reserve currencies compared with the Colombian peso. It also depends on the monetary and foreign exchange measures adopted by the BDBR.

Monetary income:

- Returns on the international reserve portfolio.
- Appreciation of the portfolio of investments in government bonds, which is used for permanent liquidity operations.
- Interest on temporary liquidity operations (repos).
- Favorable exchange differences generated on assets and liabilities in foreign currency (other than international reserves), due to peso variation against the dollar.
- Income from placing in circulation currency that is equal to its face value. When coins are destroyed, the metal that is recovered produces an additional income.
- Dividends received from BR contributions to the Andean Development Corporation.
- Other minor income

It also depends on the monetary and foreign exchange measures adopted by the BDBR.

Monetary outlays:

- Interest paid to credit institutions on the reserve requirement for savings accounts and on CDs.

- Interest paid to the National Treasury on funds deposited with Banco de la República, pursuant to Law 31/1992.

- Commissions and expenses paid for management, safe-keeping of securities and legal advice on international reserve management outside the country.

- Unfavorable exchange differences generated on assets and liabilities (other than international reserves) in foreign currency, due to variation of the peso against the dollar.

- The cost of printing, importing raw materials, minting, destruction and national distribution of coinage and notes, which is recorded in the outlay when bills and coins are put into circulation.

- Other lesser outlays, particularly commissions paid for delegated management of the Petroleum Stabilization Fund (FAEP) portfolio and other expenses for use of the Swift system.

b. Corporate Income and Outlays

Corporate income normally accounts for 10% of total income and its pattern is explained by.

- The commissions the Bank receives in it capacity as the government's agent for issuing, placing and managing government bonds on the market and for FAEP portfolio management.

- Commissions from financial brokers for banking services. Among others, these include provision of cash, clearing checks, safe-keeping and operation of securities at the Central Securities Depository (CSD), interbank transfers, the electronic trading service (SEN), which allows affiliates to purchase/sell on the secondary market securities issued and managed by the Bank, and treasury and repo transactions.

Corporate outlays account for approximately 30% to 35% of total outlays and are attributed to:

- Personnel costs, particularly wages, employee benefits, payroll taxes and medical care. Personnel expenses include the cultural staff, which represents nearly 14% of the outlays for personnel.

- Operating expenses include taxes, insurance and contributions, and general expenses, in that order of importance. As to the general expenses, the major ones are for public utilities, janitorial services and surveillance, maintenance and repairs, and other services contracted

The pension liability provisions have been constituted and are updated according to the actuarial estimates, in order to create a self-sufficient funding arrangement.

with third parties. General expenses include costs of this type incurred by the cultural area, which account for almost 32%.

- Cultural expenses per se[37] are those incurred to fulfil the activity plan for the libraries, plastic arts, the musical and numismatic areas, and the Gold Museum and its branches. They account for approximately 2% of all corporate spending.

c. Pension Spending

The pension liability provisions have been constituted and are updated according to the actuarial estimates, in order to create a self-sufficient funding arrangement. The resources earmarked to cover the pension liability are managed by several fiduciary institutions, as autonomous equity, and the returns are used to defray part of the expenses related to pensions.

Accordingly, pension expenses are presented separately from corporate outlays. They register the net earnings on the portfolio constituted with pension liability resources and interest from the home loans extended to BR employees, as well as spending on monthly pensions, the provision for the actuarial calculation, and other expenses.

C. EARNINGS AT JUNE 2005

The following is an explanation of the variations in the main asset, liability and equity items at June 20, 2005 compared with December 31, 2004 (Table 25).

1. Assets

The resources earmarked to cover the pension liability are managed by several fiduciary institutions, as autonomous equity, and the returns are used to defray part of the expenses related to pensions.

Banco de la República reported Col$45,799.5 b in total assets, including an increase of Col$3,953.5 b during the half year (9.4%). The following were important variations.

- Gross international reserves, assessed at market prices, came to Col$31,913.4 b, which is equivalent to US$13,730.8 m. During the six months in question, reserves re-expressed in pesos were down by

[37] Most of these expenses involve fees paid to artists, the cost of instituting the different activities conducted during the year, shipping and transportation fees for works of art, artists and musical instruments, book binding, and mailing costs.

Col$443.5 b. However, in dollars, there was an increase of US$190.9 m (Table 26).

The variation in pesos is explained by the combined effect of two factors. One is the decline in reserves re-expressed in pesos, due to the exchange adjustment caused by revaluation of the peso against the dollar, which meant Col$874.2m less equivalence in pesos in the reserve stock. The other is the accumulation of US$190.9 m in foreign exchange, which is equivalent to Col$430.7 b (Table 27).

TABLE 25

THE BR BALANCE SHEET: STRUCTURE AND VARIATION, DECEMBER 2004 TO JUNE 2005
(BILLIONS OF PESOS)

	December 2004		June 2005		Variation	
	Balance	Percentage	Balance	Percentage	Absolut	Percentage
Assets	**41,846**	**100.0**	**45,799**	**100.0**	**3,953**	**9.4**
Gross international reserves	32,357	77.3	31,913	69.7	(444)	(1.4)
Contributions to international organizations	3,007	7.2	2,853	6.2	(154)	(5.1)
Investments	984	2.4	3,996	8.7	3,012	306.1
Resale -temporary liquidity support agreements	2,512	6.0	4,016	8.8	1,504	59.9
Other net assets	2,986	7.1	3,021	6.6	35	1.2
Liabilities and Equity	**41,846**	**100.0**	**45,799**	**100.0**	**3,953**	**9.4**
Liabilities	**23,824**	**56.9**	**29,096**	**63.5**	**5,272**	**22.1**
Base money	19,262	46.0	17,914	39.1	(1,348)	(7.0)
National government - National Treasury	1,062	2.5	7,643	16.7	6,581	619.7
Obligations with international organizations	2,483	5.9	2,290	5.0	(193)	(7.8)
Other liabilities	1,018	2.4	1,249	2.7	231	22.7
Total Equity	**18,022**	**43.1**	**16,704**	**36.5**	**(1,319)**	**(7.3)**
Capital	13	0.0	13	0.0	0	0.0
Statutory reserves	1,524	3.6	1,868	4.1	344	22.5
Equity surplus	14,624	34.9	13,780	30.1	(844)	(5.8)
Property appraisal (art, culture and real estate)	1,034	2.5	1,034	2.3	0	0.0
Profit or loss	828	2.0	10	0.0	(818)	(98.8)

Source: Banco de la República.

TABLE 26

VARIATION IN INTERNATIONAL RESERVES BETWEEN DECEMBER 31, 2004 AND JUNE 30, 2005

Balances in U. S. millions			Balances in billions of pesos		
Dic. 31/2004	Jun. 30/2005	Variation	Dic. 31/2004	Jun.30/2005	Variation
13,539.9	13,730.8	190.9	32,356.9	31,913.4	(443.5)

Source: Banco de la República.

TABLE 27

BALANCE SHEET - BANCO DE LA REPÚBLICA, DECEMBER 2004 TO JUNE 2005
(BILLIONS OF PESOS)

	December 2004		June 2005		Variation	
	Balance	Share (%)	Balance	Share (%)	Absolut	Percentage
Assets	**41,846.0**	**100.0**	**45,799.5**	**100.0**	**3,953.5**	**9.4**
Gross international reserves	32,356.9	77.3	31,913.4	69.7	(443.5)	(1.4)
Contributions to international organizations	3,007.1	7.2	2,853.2	6.2	(153.9)	(5.1)
Investments	984.0	2.4	3,996.3	8.7	3,012.3	306.1
Consolidated public-sector debt	0.0	0.0	0.0	0.0	0.0	0.0
Public sector monetary regulation	928.0	2.2	3,942.1	8.6	3,014.1	324.8
Capitalization bonds: pubic banks and others	56.1	0.1	54.2	0.1	(1.9)	(3.3)
Loan portfolio	4.1	0.0	3.3	0.0	(0.8)	(19.5)
Public sector-National government	2.4	0.0	2.3	0.0	(0.1)	(6.0)
Banks	0.0	0.0	0.0	0.0	0.0	0.0
Financial corporations	2.8	0.0	2.1	0.0	(0.7)	(24.9)
Rest of the financial system	0.0	0.0	0.0	0.0	0.0	0.0
Other loans	0.0	0.0	0.0	0.0	0.0	0.0
Provision	(1.1)	(0.0)	(1.1)	(0.0)	0.0	(1.4)
Resale - temporary liquidity support agreements	2,511.8	6.0	4,015.6	8.8	1,503.8	59.9
Accounts receivable	47.5	0.1	39.5	0.1	(8.0)	(16.9)
Other net assets	2,934.6	7.0	2,978.2	6.5	43.6	1.6
Liabilities and Equity	**41,846.0**	**100.0**	**45,799.5**	**100.0**	**3,953.5**	**9.4**
Liabilities	**23,823.7**	**56.9**	**29,095.8**	**63.5**	**5,272.1**	**22.1**
Foreign currency liabilities affecting international reserves	9.8	0.0	13.2	0.0	3.4	34.5
Base money	19,261.6	46.0	17,913.9	39.1	(1,347.7)	(7.0)
Currency in circulation	16,278.6	38.9	15,298.6	33.4	(980.0)	(6.0)
Coins	409.5	1.0	418.6	0.9	9.1	2.2
Deposits for bank reserves	2,379.7	5.7	2,213.6	4.8	(166.1)	(7.0)
Current account deposits - Rest of financial sector	193.8	0.5	-16.9	0.0	(210.7)	(108.7)
Other deposits	49.0	0.1	121.3	0.3	72.3	147.6
National government - National Treasury	1,062.0	2.5	7,643.1	16.7	6,581.1	619.7
Obligations with international organizations	2,482.6	5.9	2,289.9	5.0	(192.7)	(7.8)
External credit liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Instruments for monetary and exchange regulation	0.3	0.0	0.3	0.0	0.0	0.0
Contraction repos	0.0	0.0	0.0	0.0	0.0	0.0
Foreign-currency securities for financing and reserve deposit, 5/97 B.D.	0.3	0.0	0.3	0.0	0.0	8.0
Others	0.0	0.0	0.0	0.0		0.0
Accounts payable	48.6	0.1	103.3	0.2	54.7	112.4
Other liabilities	909.8	2.2	1,010.8	2.2	100.9	11.1
Total Equity	**18,022.3**	**43.1**	**16,703.7**	**36.5**	**(1,318.6)**	**(7.3)**
Capital	12.7	0.0	12.7	0.0	0.0	0.0
Reserves	1,524.1	3.6	1,867.7	4.1	343.6	22.5
Equity surplus	14,623.9	34.9	13,779.9	30.1	(844.0)	(5.8)
CEC Liquidation	453.5	1.1	453.5	1.0	0.0	0.0
Exchange adjustment 1993 and thereafter, plus surplus	14,111.8	33.7	13,237.6	28.9	(874.2)	(6.2)
Others	58.7	0.1	88.8	0.2	30.1	51.4
Property reappraisal (art, culture and real estate)	1,033.8	2.5	1,033.8	2.3	0.0	0.0
Profit or loss	827.8	2.0	9.6	0.0	(818.2)	(98.8)
Previous profits and/or losses	0.0	0.0	0.0	0.0	0.0	0.0
Profits and/or losses for the period	827.8	2.0	9.6	0.0	(818.2)	(98.8)

Source: Banco de la República.

Foreign exchange accumulation is explained by several factors; namely, (i) the amount of net returns actually received (US$209.4 m); (ii) foreign exchange purchased as part of exchange intervention (US$1,615.2 m); and (iii) the increased value of foreign currency deposits from the national government (US$64.5 m). This situation was offset by: (i) US$195.9 m in profits in foreign currency (2004) turned over to the national government); (ii) the transaction with the national government to help prepay the loan from IDB (US$1,250.0 m); and (iii) the decline in the value of adjustments as a result of appreciation (US$235.7 m). Additional details about the return on reserves up to June are provided in Chapter VI.

There were Col$29,095.8 b in liabilities, which is Col$5,272.1 b more (22.1%) that at the end of 2004.

- The investment portfolio in domestic currency, valued at market prices, showed a balance of Col$3,996.3 b. This is Col$3,012.3 b more than at the end of the year and was due to the definitive purchase of TES bonds during the first six months of the year.

- The repo balance (Col$4,015.6 b), which is Col$1,503.8 b higher than the figure reported on December 31, 2004 and originated with the increase in repo operations with financial brokers. Repos are used as a source of temporary liquidity.

2. Liabilities

There were Col$29,095.8 b in liabilities, which is Col$5,272.1 b more (22.1%) that at the end of 2004. Net performance for the main items explains this variation.

- The national government deposited Col$7,643.1 b through the National Treasury Office. This represents an increase of Col$6,581.1 b so far this year, thanks to the new liquidity arrangement whereby all funds in the National Treasury are managed by Banco de la República. These resources earn market rates (Box 1).

- Base money totaled Col$17,913.9 b, down by Col$1,347.7 b compared with the end of 2004. This decline is explained by the reduction in cash normally witnessed during the first half of the year.

3. Equity

Equity came to Col$16,703.7 b, which represents a decline of 7.3% (Col$1,318.6 b). The factors responsible for this drop are: (i) less of an exchange adjustment surplus (Col$874.2 b) due to revaluation of the peso, which meant fewer international reserves in domestic currency; and (ii) the transfer of 2004 profits to the national government (Col$454.1 b). This was offset by the surplus from the first six months of the year (Col$9.6 b).

The income statement at June 2005 showed Col$9.6 b in profits.

4. Income Statement

The income statement at June 2005 showed Col$9.6 b in profits (Table 28), thanks to Col$448.2 b in income and Col$438.6 b in outlays. This is the result of an increase of Col$88.6 b in income and Col$75.4 b in outlays compared with the same period the year before. This growth is monetary in origin and attributed primarily to the following.

- Monetary income originated mainly with appreciation of the TES portfolio (Col$304.5 b), thanks to more investment in these bonds and high prices during the period. As explained in the next section, the return on international reserve investments was down compared with June 2004 (Table 29).

- The bulk of corporate income came from BR fiduciary operations (Col$31.4 b) and remained constant. As part of this item, banking services were up by 43.1%, which is equivalent to Col$7.7 b.

- Outlays for monetary activity (Col$281.4 b) were 56.8% higher, largely due to the increase in earnings on National Treasury deposits (Col$100.1 b) compared with the same period the year before.

- Corporate outlays (Col$130.7 b) were only 1.9% higher. This indicates continued satisfactory results from the policy to curb spending. Personnel expenses were up by 7.0%, mainly because

TABLE 28

EARNINGS AT JUNE 2005
(BILLIONS OF PESOS)

	Performance to		Annual variation	
	June 2004 A	June 2005 B	Percentage B / A	Absolut B - A
Income	**359.6**	**448.2**	**24.6**	**88.6**
Monetary	286.7	384.8	34.2	98.1
Corporate	72.9	63.4	(13.0)	(9.5)
Outlays	**363.2**	**438.6**	**20.8**	**75.4**
Monetary	179.5	281.4	56.8	101.9
Corporate	128.8	130.7	1.5	1.9
Pensioners	54.9	26.5	(51.7)	(28.4)
Earnings (Losses) for the Period	**(3.6)**	**9.6**	**366.7**	**13.2**

Source: Banco de la República.

BR Profit and Losses: December 2004 - June 2005
(Billions of pesos)

	Performance to			Annual Variations C/B	
	Dec-04 A	Jun-04 B	Jun-05 C	Percentage	Absolut
I. Operating budget (P and L)					
1. Income from P & G	1,569.0	359.6	448.2	24.6	88.6
1.1. Monetary income	1,412.7	286.7	384.7	34.2	98.0
1.1.1 Interest and returns	1,296.9	232.1	332.2	43.1	100.1
International reserves	828.6	(4.6)	(24.7)	(439.9)	(20.1)
Loan portfolio and otherss	6.1	0.2	1.4	474.0	1.2
Liquidity operations-repose and temporary support	131.3	62.2	49.8	(19.9)	(12.4)
TES valuation	328.9	173.0	304.5	76.0	131.4
Valuation other securities	2.0	1.2	1.1	(5.7)	(0.1)
1.1.2 Advance deposit redemption - BD external resolution 5/97	0.0	0.0	0.0	n,a,	0.0
1.1.3 Exchange difference	55.6	23.2	17.7	(23.8)	(5.5)
1.1.4 Coins	38.1	11.8	15.5	31.5	3.7
1.1.5 Others	22.1	19.6	19.3	(1.3)	(0.3)
1.2 Corporate income	156.4	72.9	63.4	(13.0)	(9.4)
1.2.1 Commissions	135.8	66.3	57.0	(14.1)	(9.4)
Banking services	43.0	17.9	25.5	43.1	7.7
Fiduciary business	58.9	30.2	31.4	3.9	1.2
Foreign currency management	33.9	18.3	0.0	(99.8)	(18.2)
1.2.2 Others	20.5	6.5	6.4	(1.3)	(0.1)
2. Outlays from P & L	741.2	363.2	438.6	20.8	75.4
2.1 Monetary Outlays	496.7	179.5	281.4	56.8	101.9
2.1.1 Interest and returns	225.4	95.4	188.9	98.1	93.5
Reserve requirements on deposit accounts	98.7	46.3	52.5	13.5	6.3
National Treasury deposit accounts	85.8	23.2	123.3	431.3	100.1
External lines of credit	5.4	4.1	0.0	(100.0)	(4.1)
Repo operations for monetary contraction	9.3	7.5	0.0	(100.0)	(7.5)
International reserve management expenses	26.2	14.3	13.1	(8.5)	(1.2)
2.1.2 Exchange differences	193.2	50.2	36.7	(26.9)	(13.5)
2.1.3 Cost of currency issue and distribution	71.2	31.1	53.3	71.6	22.3
2.1.4 Others	6.9	2.9	2.5	(13.7)	(0.4)
2.2 Corporate outlays	267.2	128.8	130.7	1.4	1.9
2.2.1 Personnel expenses	165.7	82.0	87.8	7.0	5.7
2.2.2 General expenses	43.6	19.0	17.8	(6.4)	(1.2)
2.2.3 Taxes	6.1	2.9	3.2	8.5	0.2
2.2.4 Insurance	9.2	5.5	3.8	(31.1)	(1.7)
2.2.5 Contributions and Memberships	4.2	1.8	1.6	(7.7)	(0.1)
2.2.6 Cultural expenses	6.6	2.6	2.5	(1.5)	0.0
2.2.7 Depreciation. provisions. amortization and others (including deferred software)	31.7	15.0	14.0	(6.8)	(1.0)
2.3 Spending on pensioners	(22.6)	54.9	26.5	(51.7)	(28.4)
3. Operational Income (Losses) (1-2)	827.8	(3.6)	9.6	(365.2)	13.2

n.a. Not applicable.

Source: Banco de la República.

of the 7% wage hike outlined in the 2005 collective bargaining agreement reached by BR employees for 2005. Between the two periods under analysis, 72 employees were taken off the payroll.

- General expenses were down by 6.4% compared with 2004. The highlights in this respect include: (i) a decline of 0.2% in public utility costs owing to administrative arrangements for better rates as a non-regulated customer and because consumption was down; and (ii) a drop of 20.7% in spending on maintenance and repairs, thanks to structural changes and administrative management.

- As to spending on pensioners, the net figure at June 2005 was Col$26.5 b. This is down 51.7% with respect to the same period in 2004, due to more returns (Col$33.7 b) on the pension liability resource portfolio and Col$5.3 b in pension spending, with an increase of 4.5%.

D. Projected Earnings for 2005

The profits projected for Banco de la República during 2005 (Col$185.4 b) are Col$642.3 n less than those registered the year before. This reduction is due to less income (Col$325.3 b) and more outlays (Col$317.0 b) (Table 30).

The drop in income is explained by (i) fewer returns on international reserves (Col$358.3 b); (ii) less interest from monetary expansion transactions through repos (Col$50.5 b); (iii) less income from differences in the peso/dollar exchange rate (Col$47.1 b); and (iv) less income from commissions (Col$41.2 b). The drop in income has been accentuated, in part, by the reduced return on TES bonds (Col$171.6 b).

Personnel expenses were up by 7.0%, mainly due to the 7% wage hike outlined in the 2005 collective bargaining agreement reached by BR employees. Between the two periods under analysis, 72 employees were taken off the payroll.

The growth in outlays is explained by increases in: (i) remuneration on deposit accounts (Col$173.7 b); (ii) the cost of issuing currency (Col$109.1 b); and (iii) retirement pensions (Col$160.9 b). The reduction in outlays for peso/dollar exchange differences (Col$173.7 b) partly offset the rise in these expenses.

Valuation of the dollar against the euro and the yen explains the decline in income from international reserve investments compared with the preceding year. This factor could reduce income from the peso/dollar exchange differential by US$341 b and lower projected net profits on reserves by US$133.0 m (Table 31).

Table 30

BR Income Statement, 2004 - 2005
(Billions of pesos)

	December 2004 (A)	Projection 2005 (C)	Difference (A-C)
I. Total income	1,569.0	1,243.7	(325.3)
1. Operating income	1,551.7	1,238.2	(313.5)
Interest and returns	1,303.2	1,060.4	(242.8)
International reserves	834.9	476.6	(358.3)
TES valuation through monetary expansion operations	322.0	493.6	171.6
Transitory purchase of securities and quotas	131.3	80.8	(50.5)
Others 1/	15.1	9.5	(5.6)
Commissions	135.8	94.6	(41.2)
Exchange differences	49.3	2.2	(47.1)
Others 2/	63.4	80.9	17.5
2. Non-operational income 3/	17.3	5.6	(11.8)
II. Total Outlays	741.3	1,058.3	317.0
Interest and returns	225.4	412.3	186.9
International reserves			
Deposit accounts	184.5	383.7	199.3
Transitory sale of securities	9.3		(9.3)
Others 4/	31.6	28.6	(3.0)
Exchange differences	193.2	19.5	(173.7)
Cost of issuing notes and coins	70.8	179.9	109.1
Employee expenses	165.7	179.7	14.0
Retirement pensions	(23.3)	137.6	160.9
General expenses	43.6	46.6	3.0
Others 5/	65.9	82.7	16.8
III. Profits or losses for the period	827.8	185.4	(642.3)

1/ Includes valuation of public bank capitalization bonds and TES, pursuant to law 546, and others.
2/ Includes issue of coins and notes, precious metals and others.
3/ Includes unexpected income from profits on the sale of assets and reversion of outlays from previous periods (due to the return of properties and fines levied for operational default).
4/ Includes external lines, negotiable securities, international reserve management costs, currency issued, precious metals and others.
5/ Includes taxes, insurance, contributions, cultural expenses, provisions, depreciation, amortization and other operational and non-operational outlays.
Source: Banco de la República.

Table 31

Profits on International Reserves
(Millions of dollars)

Item	2004	2005 1/	Difference
1. Return on interest rate 2/	185.2	393.2	208.0
2. Exchange difference	139.3	(201.7)	(341.0)
3. Net profit (1 + 2)	324.5	191.5	(133.0)

1/ Up to June 2005.
2/ Includes accrued interest and valuation or devaluation due to changes in external interest rates.
Source: Banco de la República.

Table 32

International Prices

	Dec. 31/03	Dec. 31/04	Jun. 30/05
Euro/dollar	1.2595	1.3558	1.21
Dollar/Yen	107.22	102.45	110.8
Gold (oz.)	415.5	438.1	435

Source: Bloomberg.

These effects are explained as follows:

Exchange Differential

The euro and the yen have devaluated against the dollar during the year to date. The euro went from 1.36 dollars/euro in December 2004 to 1.21 in June 2005, while then yen went from 102.4 yen/dollar to 110.8. The price of gold was down from US$438.1 per troy ounce to US$435.0 during the same period (Table 32). Banco de la República registered US$201.7 b in exchange losses during the first six months of 2005 as a result of these factors. The opposite occurred the year before, when the euro and the yen gained ground against the dollar and the price of gold was up. For Banco de la República, this meant higher returns on reserves. If these currencies and the price of gold remain at the levels registered in June 2005, income from the exchange difference probably will be US$341 m less than in 2004. Therefore, profits on reserves during the remainder of the year will depend on how these variables behave in the months ahead.

Return on Interest Rates[38]

The projected return from interest on the international reserve portfolio in 2005 is up by US$191.6 m compared with the actual return in 2004 (3.14% versus 1.58%). Nevertheless, it is below the average rate observed between 2000 and 2002 (6.76%) (Table 33). This is due to a slight devaluation in the reserve portfolio, which was offset by income from interest. However, it is important to bear in mind that this return will depend on how external interest rates behave.

[38] Includes accrued interest and valuation or devaluation of external interest rates.

Table 33

Return on Interest Rates
(Percentage)

Item	2000	2001	2002	2003	2004	2005
Return on interest rates **(*)**	8.05	6.7	5.52	1.73	1.58	3.14

(*) Does not include the exchange differential.
Source: Banco de la República.

Total Return on the Investment Portfolio
(Percentage)

Item	2000	2001	2002	2003	2004	2005
Total return on the investment portfolio (*)	6.61	5.45	7.89	4.08	2.53	1.52

(*) Includes working capital.
Source: Banco de la República.

The profitability of the investment segment of international reserves should be 1.52% this year, due to movement caused by exchange differentials and interest rates. This is a decline compared with previous years (Table 34).

The following variations also are important:

- The effect of bond purchases in the first quarter and the valuation associated with the decline in the interest rate at which TES are traded on the market should mean more of a return on TES for monetary expansion (Col$171.6 b).

- Income from interest on repo transactions for monetary-expansion should be down by Col$50.5 b. This is because of the need for less temporary liquidity, due to the expansionary effect of BR foreign currency purchases on the exchange market.

- There should be Col$41.2 b less income from commissions, since Banco de la República no longer receives cash deposits in dollars from financial institutions.

- The cost of issuing coins and notes is expected to increase by Col$109.1 b, due to the currency production schedule for the year[39].

- Retirement pensions are expected to be up by Col$161 b compared with the year before, due to an additional Col$85 b in the provision for this item and Col$55 b less in estimated returns on the pension investment portfolio. Contrary to the situation in 2004, portfolio valuations originating with a reduction in interest rates are not being taken into account this year.

[39] This calculation includes Col$70 b for the destruction of currency. This outlay is offset when profits are distributed, since the asset protection provision set up by the BDBR in past years to meet this expense is used automatically.

- Outlays for interest on income-earning deposits with Banco de la República should be up by Col$199.3 b, thanks to monetary contraction needs and the new liquidity arrangement adopted in conjunction with the national government (Box 1).

- Finally, higher spending is expected to be offset in part by Col$173.7b fewer outlays for "exchange differences". This is because assets in foreign currency (other than reserves) are not expected to devaluate this year, as they did last year with revaluation of the peso.

Box 6

Tendencies in Central Bank Duties and Personnel

Banco de la República conducted a study on the staff tendencies at central banks in a large group of countries. An econometric model was designed to estimate the BR staff. To interpret the findings of the model, the trend in the primary and secondary duties was examined as well.

The following are the more relevant aspects of our analysis of several duties that have an impact on the staff at central banks; namely, currency distribution, operation of payment systems, production of coins and notes, and cultural activities. The changes in personnel at central banks during the last five years and the results of an exercise to estimate the staff for Banco de la República, compared to a sample of 133 central banks[1] , are included as well.

I. Currency Distribution

Up until the eighties, central banks distributed coins and notes with their own resources. In the nineties, some began to hire outside operators to perform this function, prompting a reduction in the number of branches. Since then, 18 of the 48 central banks studied (11 in advanced economies and seven in Latin America) have hired third parties to handle all or part of this distribution, making it possible to broaden the coverage of this service and to reduce the size of the staff.

Prior to April 1997, Banco de la República operated a network of 28 branches to cover all the services required by the different cities in Colombia. As a result of the study on cash circulation

[1] The entire document is available at http://www.banrep.gov.co/banco/hom4.htm.

and demand, it closed the treasury areas in 13 cities around the country where the volume of operations was low, and reinforced its cultural services. The cutback in treasury areas goes hand in hand with the development of a mixed operating arrangement whereby the Bank relies on private operators to supply necessary cash, thus meeting the needs of the public, to oversee the quality of notes and coins, and to maintain confidence in the currency that is in circulation.

II. Operation of Payment Systems

The payment systems are a basic component of financial and capital market infrastructure. Their primary role is to allow money to circulate in a safe and efficient way, both inside the country and internationally. For the most part, central banks take it upon themselves to make sure the payment systems are safe and effective. Some operate both high and low value systems; others concentrate on high-value payment systems, leaving operation of the low-value systems to private entities[2]. In the advanced economies, more than half the central banks do not operate low-value payment systems directly. In contrast, the United States Federal Reserve Bank operates low and high-value systems through a competitive arrangement with the private sector.

By helping to modernize payment systems through electronic services aimed at facilitating transactions for financial brokers and capital markets and making them more efficient, safer and economical, Banco de la República has become a pioneer in Latin America. It now directly operates several systems: CUD, DCV, Cedec, Cenit, SEN and SON[3]. Some of these systems coexist with private competitors.

III. Production of Coins and Notes

In Colombia, Banco de la República operates the Casa de Moneda (comprised of the National Mint and the Bureau of Engraving and Printing) and produces all notes and coins required by the Colombian economy. It has produced currency for Chile, Ecuador and Costa Rica as well. The Central Currency Bureau, an industrial complex designed to combine research and development, production, movement, and securities management, is now being built and will

2 In terms of operation, it is understood that a central bank has its own human, physical and technological resources to handle transfers, clear and/or settle payments.

3 The Deposit Account System (CUD) to transfer funds electronically between financial institutions; the Central Securities Depository (DCV) to manage dematerialized securities; the Electronic Check Clearing System (Cedec); the Clearing System for Electronic Interbank Transfers (Cenit), the Electronic Trading System (SEN) for government bonds on the secondary market, and the System for International Operations (SOI).

improve the productivity of these processes. The National Mint is ISO 9000:2000 certified by Icontec to mint, pack and dispatch coinage and intermediate goods thereof.

In the European Union, 47% of the central banks have a note engraving and printing plant. Changes in management modes are being made, due to introduction of the euro to replace national currencies. In Latin America, only the central banks of Colombia, Mexico and Venezuela produce notes. In Brazil and Chile, bank notes are produced by the government and, in Argentina, by a private company. In the other Latin American countries, notes are imported. Only the central banks of Colombia, Peru and Venezuela mint coinage. The Central Currency Bureau will allow for exploring the possibility of soon producing coins and notes for other countries in the region.

IV. Cultural Activity

The international comparison show varied involvement in cultural activities. For example, 42.3% of the 133 central banks in question have some type of cultural activity, generally small and mainly libraries specialized in economics and finance for students and researchers, as well as coin collections. This is the specific case of 75% of the central banks in the advanced economies. However, in Latin America, 94.7% of the central banks are involved in some type of cultural activity. The central banks of Bolivia (1995), Costa Rica (1994), Guatemala (1997) and Paraguay (1999) promote culture through a foundation. Banco de la República has the largest infrastructure dedicated to the promotion of culture, followed by the central banks of Ecuador, Peru and Brazil.

Thanks to continuity in its cultural and scientific roles, Banco de la República has enriched the collections available to the public (documents, works of art and Colombian and foreign coins). Through its cultural endeavors, the Bank contributes to regional development within the country. There are 28 cultural areas now operating outside Bogotá, with seven regional museums, 18 libraries, five documentation centers and one stamp collection. In short, although a number of central banks are engaged in cultural activities, none compares to Banco de la República, which is far larger in terms of its collections, services and geographic coverage.

V. Staff Reduction

Banco de la República reduced its staff by 21.6% between 1999 and 2004. This is consistent with the generalized trend towards personnel cuts at the central banks of the advanced and Latin American economies[4]. Banco de la República made one of the largest staff reductions and, in this respect, ranks ninth among the 48 central banks of the advanced and Latin American economies (Graph B6.1).

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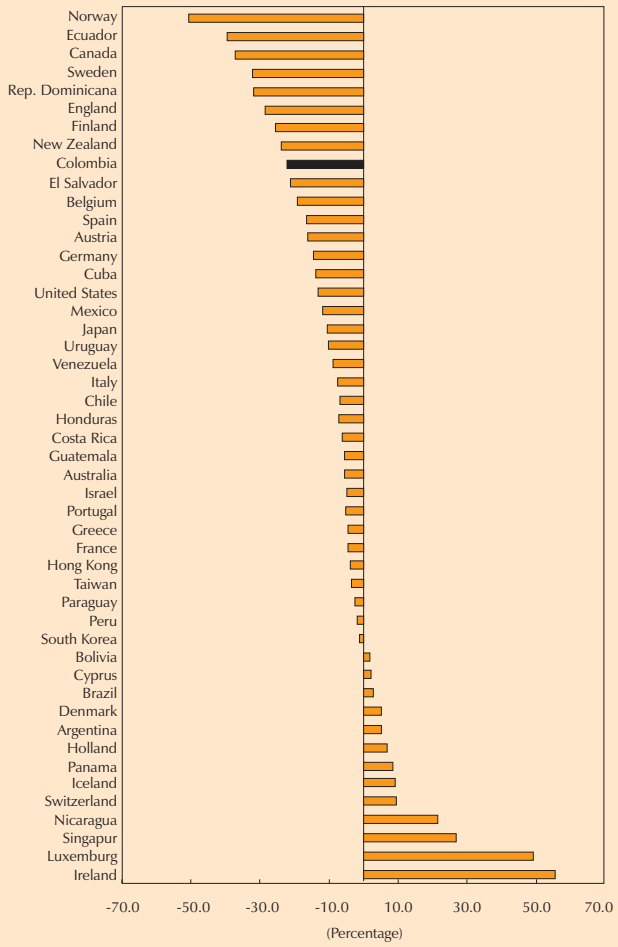
[4] According to the International Monetary Fund classification.

Graph B6.1
Staff Variations in the Sample of 48 Central Banks



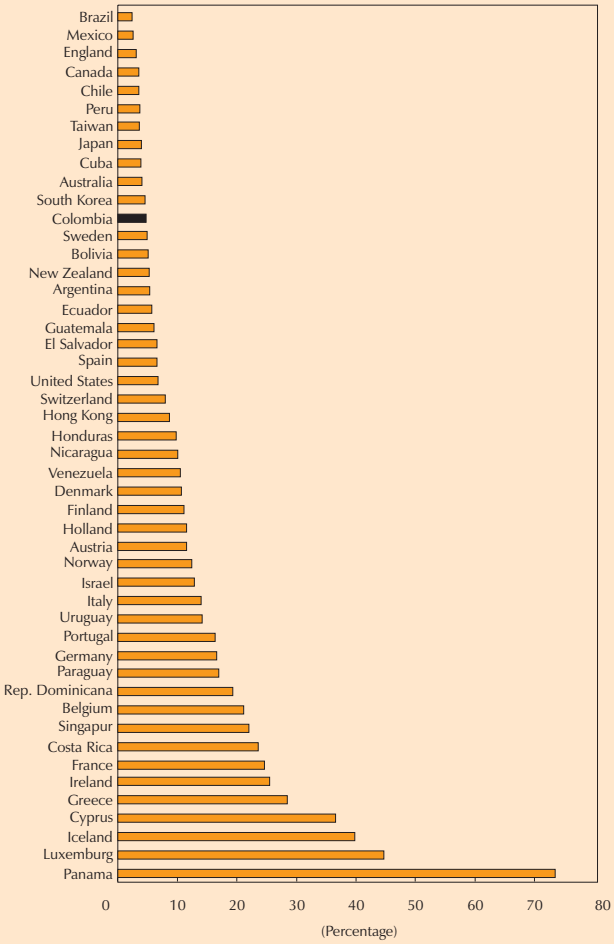
Source: Morgan Stanley, Central Bank Directory, 2005.

In the index of employees per 100,000 inhabitants (published annually by *The Economist*), Colombia is twelfth among the 48 central banks of the advanced and Latin American economies, with 4.9 employees for every 100,000 inhabitants[5] (Graph B6.2).

At the international level, a number of central banks have reduced their personnel through outsourcing and by transferring supervisory responsibilities to government agencies (as in the

[5] To draw a comparison, the index for Colombia was calculated without the cultural staff, since the cultural role of Banco de la República has a far greater impact on services and locations, and its associate staff is not comparable to that of the other central banks, which are much less involved in cultural activities. With the entire staff, the index for 2004 is 5.8.

Graph B6.2
Central Bank Employees per 100,000 Inhabitants
Sample of 48 Central Banks



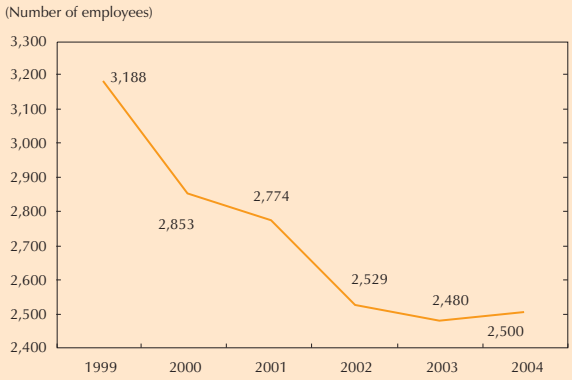
Source: Morgan Stanley, Central Bank Directory, 2005.

case of the European Union). The same thing is happening in Latin America, fundamentally because of the changes in treasury duties. This reflects a tendency among central banks to focus on their main functions and to contract secondary activities with third parties.

In the last five years (1000-2004), Banco de la República reduced its staff by 688 employees (21.6%), from 3,188 to 2,500 (Graph B6.3).

The 21.6% staff reduction in the last five years primarily involved the branches (305 employees), the industrial area (204), the administrative area (70) and banking services (52). The cutback at the branches was due to closure of the treasury area at 13 branches, new contracting arrangements

Graph B6.3
Changes in the Staff at Banco de la República
(1999-2004)



Source: Banco de la República.

with third parties, and regionalization of the economic research areas. The reduction in the industrial area was basically at the National Mint, owing to a new operational arrangement with a minimum staff and work shifts, which made it possible to cut the staff by 76%. New information systems were introduced in the administrative area and third parties were hired to take charge of certain operational and administrative support duties. The staff in the banking service area was reduced thanks to the simplification and/or elimination of certain procedures. This was made possible by changes in regulations and efforts to standardize processes.

VI. The Findings of a Staff Estimate Model for Central Bank Personnel

An econometric model[6] was developed to estimate the staff required by a central bank, depending on its role and the characteristics of the economy. The model uses 2003 figures and a sample of 133 central banks, which represent 82% of the central banks throughout the world. The sample was classified into three groups, according to homogeneous characteristics based on per capita income and geographic area (Table B6.1).

According to the findings, Banco de la República fulfils its role with a staff that is below average for the central banks included in three of the four samples used. As to the total sample of 133 institutions, Banco de la República has 10.9% fewer employees than the number estimated by

[6] The model includes discrete variables that capture job performance with the central bank's own resources. Reference is made to financial supervisory duties, cash distribution and management, printing notes, minting coins and the way the payment systems operate. Also included are exogenous variables such as the population of the country and per capita income. The estimate was made with a cross-section parametric model of the log-log variety that satisfactorily passed the normality and heterocedasticity test.

Table B6.1
Banco de la República Personnel Calculations for 2003

	Total Sample	Staff at December 2003: 2,096 employees 1/		
		Group 1: Latin America and the Caribbean 2/	Group 2: Medium-Low Per capita Income 3/	Group 3: Advanced Economies 4/
Staff Calculated for Banco de la República	2,352	2,846	2,693	1,739
Actual verses estimated staff	(256)	(750)	(597)	357
Percentage deviation in the estimate	(10.9)	(26.4)	(22.2)	20.6

1/ The staff without cultural employees, for the purpose of a comparison with other central banks.
2/ Includes the 25 central banks in Latin America and the Caribbean.
3/ Comprised of the central banks in 40 countries (including Colombia) with a per capita income between US$766 and US$3,055, according to the World Bank classification.
4/ Includes the central banks of the 29 advanced economies, according to the IMF classification. The calculation was done for Banco de la República, even though it is not part of the sample.
Source: Banco de la República.

the model (2,352 staff members). In Group 1, it is 26.36% below the regional average, with 750 fewer employees. In Group 2, it is 22.17% below the estimated staff.

Compared with similar institutions in the advanced economies, Banco de la República exceeds the average staff estimated for these central banks by 20.56%. However, the estimate for Colombia is less than the estimates for Germany, France, Austria and Finland.

In short, Banco de la República has made more staff cuts than most central banks and currently operates with fewer employees than the average for the central banks in the reference groups.

Abbreviations and Conventions

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
Board of Directors of Banco de la República	BDBR
United States Federal Reserve Bank	Fed
Union of Swiss Banks	UBS