Presentation, Summary and Conclusions

Evaluation of the inflationary situation at june, 2002

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Board of Directors of the Central Bank