Presentation, summary and conclusions

Review of inflation to march 2002

✠ At the end of the first quarter of 2002, annual consumer inflation stood at 5.9%, down by 1.9 percentage points on a year earlier and by 1.7 points on December 2001. It was the lowest annual inflation for any March since 1962, having fallen continuously and ever faster in recent months, after a period of relative stability between February and November last year.

✠ It was also the first time this year that annual inflation stood below the 6% inflation target set for 2002.

✠ The first quarter saw annual inflation falling in all the major groups of the Consumer Price Index basket, but mainly in food, transport and communications. In the case of food, this was thanks to a good supply of staples, such as potatoes, and to a milder retention phase in cattle breeding. In transport, lower world oil prices from the second quarter of last year up to February this year, together with low devaluation, made it possible to stabilize domestic fuel prices in the first quarter.

✠ The alternate classification of the CPI basket shows that annual inflation fell by similar significant rates in both tradables and nontradables over the first quarter. In March, annual inflation was slightly lower in tradable s (5.8%) than in nontradables (6.0%), tradables having benefited from the peso's nominal appreciation against the dollar and from lower international inflation.

✠ Core inflation maintained its downward trend over the first quarter. The measures of core inflation (non-food CPI, inflation nucleus, and CPI excluding food staples, fuel and utilities) averaged 5.6% at the end of the quarter, 1.1 percentage points lower than in December 2001 and 2.3 points lower than in March 2001. The indicator registering the biggest drop relative to December was the inflation nucleus (1.4 percentage points), followed by non-food CPI (1.1 points) and the CPI excluding food staples, fuel and utilities (0.7 points). In March, all three core-inflation indicators were either on or below the 6% inflation target for 2002.

✠ Annual producer inflation was only 3.6% in the first quarter, 3.3 percentage points lower than in December 2001. The annual figure for March was the lowest for any month since reliable statistics began to be kept for producer inflation (1970). Moreover, annual inflation in final consumption, the component of the Producer Price Index (PPI) most resembling the CPI, stood at 4.3% in March, a fall of 4.2 percentage points relative to December 2001.

✠ Breakdown of the PPI by origin shows slower first-quarter price growth, at annual rate, both in locally produced and consumed goods and in imports; similarly, breakdown by industrial activity shows prices rising more slowly in all groups of the basket, particularly in manufactured and farm goods.

✠ There are several reasons for the first-quarter fall in inflation. First, inflation expectations continued to fall sharply, as evidenced by lower core inflation and smaller price adjustments in several traditionally indexed items, such as utilities and education. This is partly attributable to increasing credibility of a monetary policy consistent both with the inflation targets set by the Banco de la República's Board of Directors and with the long-term objective of price stabilization. Second, slower nominal devaluation of the peso since the middle of last year and lower international inflation together restrained price rises in tradable goods. Third, ample spare capacity, indicating weak aggregate demand, has kept economic growth from generating inflationary pressure. And, lastly, a relatively large food supply in recent months has substantially reduced food prices.

✠ As some of these factors should continue to exist over the rest of the year, no surge in inflation is expected to jeopardize meeting the 6% target. But food-price behavior will most probably be less favorable in the second half of the year. Today's relatively low prices for potatoes and other staples, combined with the productivity effects of the expected Niño climatic condition, may affect food supply during the rest of year, raising food prices substantially. In addition, prices for beef and beef substitutes will rise further as supply decreases in the course of the current retention stage in cattle breeding. Lastly, inflationary pressure began to increase again at the end of the first quarter because of the rise in world oil prices, which is likely to continue over the rest of the year, causing domestic fuel and transport prices to go up.

✠ On the basis of first-quarter figures, the Bank's forecast for inflation by the end of 2002 has been revised down from the rate predicted last December. The central path of the Bank's forecast now shows annual inflation averaging 5.0% in the fourth quarter of this year, down from 5.8% predicted three months ago. The latest forecast has an upward-biased risk balance because food and fuel prices and higher devaluation may create inflationary pressures. The combination of forecasts, using the structural models employed by the Economic Studies Division, gives a 5.6% inflation rate for December, which too is lower than the 6.4% projected by this method three months earlier.

✠ On figures to March, the Bank's forecasts continue to show core inflation decreasing over the rest of the year. According to the central path, core inflation as measured by non-food CPI will average 3.8% in the fourth quarter of 2002, and 3.5% in the fourth quarter of 2003.

✠ The few indicators available on real activity suggest that the economy continued to grow over the first quarter, albeit slowly. This view is based on such indicators as electricity demand up to March, and construction loans made in the first quarter. Household consumption seems to have been the main driving force behind first-quarter growth, to judge by the satisfactory behavior of new car sales to March, credit-card sales to March, beverage sales by the industry, and consumer imports to January. Investment growth was probably weaker than last year mainly because of the impact of the central government's fiscal-adjustment program, but should still have been positive thanks to investment in housing. Exports were not a major growth item in the first quarter, for sales to Venezuela slowed and nontraditional exports to the United States encountered difficulties.

✠ As regards growth over the rest of the year, a number of conditions exist that are conducive to it, including low interest rates, higher employment levels, a rising flow of remittances from abroad, and higher oil prices. These circumstances make it possible to expect positive growth during the coming quarters. But there are also large sources of uncertainty. In particular, doubts have arisen about approval of the Andean trade preference scheme in the near future. They are essential to revival of the industrial sector, given the poor outlook for sales to Venezuela. And it is still not clear whether the structural reforms needed for long-term adjustment of the country's public finances will be implemented in full and in good time, particularly in view of the change of government on August 7. These uncertainties and the current situation of public order may lead consumers and investors to postpone some of their spending. The recent deterioration of business and consumer expectations is a bad sign in this respect.

✠ The rate of growth expected for 2002 should not cause any significant inflationary pressures, for the economy continues to operate below potential. This is indicated by Fedesarrollo's data to February, which show capacity utilization running lower than a year earlier. In fact, the considerable investment effort made by business in 2001, reflected by a high volume of capital goods imports, may have left the economy with ample productive capacity to meet large rises in demand without putting price stability at risk.

✠ Falling inflation allowed the Board of Directors to reduce the Bank's intervention interest rates twice in the first quarter, by a total of 125 basis points in all rates except the Lombard contraction rate, which was cut by a total of 100 points. At the end of March, the Bank's rates stood as follows: Lombard expansion rate 11.0%, auction expansion rate 7.25%, auction contraction rate 6.25%, and Lombard contraction rate 5.25%.

✠ The Board also provided permanent liquidity during the first quarter by exercising reserve-building options amounting to $101.5 million.

✠ The interbank interest rate fell in the first quarter in line with the Bank's rate cuts, to 7.6% in March. The other market rates also declined in nominal terms, substantially in the case of consumer loans and credit card rates and less so in the case of Treasury and preferential loans and the DTF deposit rate.

✠ The Board of Directors set a new reference line for the monetary base at the beginning of March. The new line implicitly envisages a 14.4% average annual growth in the monetary base over 2002.

✠ In Marc, the monetary based stayed within the levels contemplated by the new reference line. At the end of the month, the monetary base's 20- and 45-day moving averages were very close to their respective reference lines. The broader measure of liquidity, M3, grew more slowly in the first quarter of this year than in the previous three months. This trend break resulted from a decline in CDs too strong to be offset by increases in current accounts, cash holdings and Treasury Repos.

✠ In the first quarter, the financial system's gross nominal loan portfolio maintained the slow pace of growth (about 2.0%) registered at the end of last year, but the rate of change varied for the different types of loans. The nominal consumer portfolio expanded by annual rates of 11.3% to February, while commercial loans grew by only 2.8%, and the mortgage portfolio continued to shrink. The overall portfolio grew slowly despite ample liquidity provided to the market by the Banco de la República, because of the real sector's low demand for credit, and also because the financial system seems to regard public-debt securities as a more suitable investment option in the present circumstances.

✠ The peso displayed a revaluationary trend over the first quarter of 2002, a development not fully anticipated by the market. At the end of March, the exchange rate stood at 2,261 pesos to the dollar, representing a revaluation of 2.1% relative to the same period in 2001 and of 1.3% relative to December. The drop in the exchange rate is partly explained by lower net private-capital outflows, higher inflows of remittances from Colombians living abroad, and the dissaving of oil earnings (Oil Savings and Stabilization Fund) authorized by law.

✠ Inflation in March was lower than predicted by the Banco de la República or expected by the market. It led to forecasts for the end of the year being revised downward, so that meeting this year's 6% inflation target is now highly feasible. The March result also bodes well for reducing inflation further in 2003 and for achieving the Board of Directors' long-term inflation target of 3%. An analysis of the country's real economic activity confirms that internal demand has revived moderately, while review of the international context indicates a weakening of external demand for Colombia's nontraditional exports.

✠ In view of the foregoing and with the aim of facilitating economic growth, the Board of Directors of the Banco de la República decided to cut the Bank's intervention rates by one percentage point (100 basis points) effective from April 15, 2002. They now stand as follows: Lombard expansion rate 10.00%, auction expansion rate 6.25%, auction contraction rate 5.25%, and Lombard contraction rate 4.25%. Thus, the Bank's total rate cuts so far this year come to 225 basis points, a steeper drop than the 170 basis-point fall in inflation over this period.

✠ Furthermore, pursuant to its policy of maintaining a reasonable ratio of international reserves to short-term foreign-debt payments, the Board of Directors, decided to set the amount for the auction of reserve-building options in May at $100 million.

The Board of Directors,

Chairman
Juan Manuel Santos Calderón
Minister of Finance and Public Credit

Directors
Carlos Caballero Argáez
Sergio Clavijo Vergara
Salomón Kalmanóvitz Kraute
Fernando Tenjo Galarza
Leonardo Villar Gómez

Governor of the Bank
Miguel Urrutia Montoya.