Presentation, summary and conclusions

INFLATION ASSESSMENT AT SEPTEMBER 2002

✠ Annual consumer inflation was 6.0 % at the close of the third quarter of 2002, less than in June of this year (6.2%) and in September 2001 (8.0%). After a slight rise during June and July, consumer inflation declined to 6.0% in the two months thereafter, thanks to an improvement in food prices.

✠ Inflationary pressure in the third quarter came primarily from the transport group and miscellaneous expenses, owing to the rise in gasoline prices and added devaluation. Expanded annual growth in prices for financial services and jewelry also exerted pressure. Price increases for the other groups in the market basket slowed during this period.

✠ Food inflation at the end of the third quarter was lower than in June (9.2%), despite considerable upward pressure from potato prices, which registered 8.0% annual growth in June and 51.3% in September. The reduction in food price inflation in September compared with June is due to less of an increase in the price of meat and meat by-products and in the price of vegetables and legumes.

✠ In terms of individual items, potato prices were the most important factor in third-quarter inflation. This product alone accounts for more than 33.0% of accumulated inflation during the quarter, and is expected to continue to play a significant role in accelerating consumer inflation, at least during October and November. According to the Bank's forecasts, the annual increase in the consumer price index (CPI) for potatoes could be close to 100% by the end of the year. However, next year, high prices should boost supply and allow for lower prices in the future. This factor, coupled with the end of the cattle retention phase and the onset of the liquidation phase, point to the prospect of a drop in real food prices as of the second half of 2003.

✠ These two factors should offset the upward effect generated by the presence of El Niño. The intensity of this phenomenon in the second half of 2002 and the first quarter of 2003 is expected to be slight. A farm business opinion poll taken by the Center for Livestock and Agricultural Studies (CEGA) shows producers are more optimistic about the second half of 2002. A recovery in overall investment and production, excluding coffee and livestock, is expected. This should result in a good supply of food at the start of 2003

✠ Judging by the core inflation indicators, inflationary pressure originating with demand has been controlled, The average of the three core inflation indicators declined throughout the third quarter, closing at 5.1% in September. This is 0.2 percentage points less than in June 2002 and 1.9 percentage points below the average in September 2001.

✠ The acceleration in devaluation has had only limited impact on certain segments of consumer prices, and its effect on overall consumer inflation is still not evident. In fact, inflation in tradable goods declined from 6.0% growth in June to 5.4% in September.

✠ Even so, increased devaluation has pushed producer prices up considerably. In terms of the annual variation, the producer price index (PPI) rose substantially between June (2.9%) and September (6.8%). The same was true of the imported component of the PPI (from 1.6% at June to 10.7% at September) and final consumption, which is closest to the CPI market basket (from 4.6% at June to 6.3% at September).

✠ GDP growth rose slightly during the second quarter of the year. According to DANE, annual growth in this period was 2.2%. This represents an increase over the start of the year (0.5%).

✠ However, on this occasion, a simple comparison between annual growth rates in the first and second quarters can be misleading. The outcome was affected by the fact that the Easter holiday fell during the first quarter, which is unusual. To avoid this statistical noise, the entire first half of the year should be examined in terms of GDP performance. Annual growth during the period was 1.4%. This is an increase over the second half of 2001 (1.0%) and the fourth quarter of that year (1.1%). These figures clearly show the economy has been more dynamic this year than at the end of 2001.

✠ The acceleration in demand during the first half of the year is explained by three factors: more private consumption, added growth in total exports of oil and coffee, and an import substitution process derived from a decline of 2.8% in imports during this period compared with the first half of 2001. The other components of demand; that is, public spending and private investment, contracted or slowed. In the case of private investment, the only high point was the annual growth in building construction (approximately 22.0%). The other components of private investment declined sharply.

✠ A slight acceleration in growth is expected again in the second half of 2002, which would raise GDP growth for the entire year by 1.6%. This is compatible with the government's latest projections. It is estimated that more growth in the second half of the year could be supported by an increase in the force of domestic demand, particularly private and public consumption. In the case of private consumption, these expectations are based on the acceptable performance shown recently by indicators for certain sectors, namely automobile sales and credit card purchases. As to public consumption, increased growth could originate with more spending for security and the budget additions scheduled for the coming months.

✠ Other sources of demand, such as exports and investment, are not expected to contribute to growth. Exports will continue to be affected by the recession in Venezuela. Moreover, ATPA will play only a marginal role during the remainder of the year. Investment will face greater uncertainty over midterm macroeconomic stability and the cutback in sources of external funding, which will make growth difficult. Positive growth is anticipated only in the case of building construction.

✠ On a broader front, prospects for growth are now more indecisive than during the last quarter. The closure of external capital markets and the considerable need for internal financing on the part of the public sector impose a tight limit on the amount of private spending that can be funded. However, the extent to which this margin is widened or narrowed depends on how soon the financial markets reopen and, particularly, on how the public sector resolves its financing problems for 2003 and subsequent years.

✠ The economy continues to operate below its potential, as suggested by considerable unused installed capacity, high unemployment and the estimates on product gap. Given projected growth, this situation is not likely to change substantially in the months ahead, which is why demand-pull inflation is not expected to threaten this year's inflation target.

✠ Because inflation has stayed at around 6% and the inflation target is likely to be met by the end of the year, the Board of Directors decided not to alter interest rates during the third quarter. At the end of September, the Lombard expansion rate was 9.0%, the auction expansion rate, 5.25%, the auction contraction rate, 4.25% and the Lombard contraction rate, 3.25%.

✠ The representative market exchange rate (TRM) was Col$2,828.1 per dollar at the end of September, with 21.3% annual devaluation and 17.9% for the quarter. The accelerated pace of devaluation during the past three months activated intervention mechanisms to control exchange volatility. The first auction of call options was held on July 29 with a quota of US$180 million, which was exercised in its entirety. However, the pace of devaluation continued and Banco de la República convoked another auction of call options on August 1 with a quota of US$180 million. On that occasion, US$109.5 million in options were exercised. A similar auction for US$180 million was held on October 2, with US$124.5 million in options exercised by the time this report was written. No put options to accumulate reserves were exercised during the period in question.

✠ The demand for liquidity rose quickly during the last three months, particularly because of the demand for cash. The additional demand for cash is an exogenous shock, as suggested by the interest-rate stability throughout the year.

✠ Banco de la República has satisfied the growing need for liquidity without generating monetary surpluses that jeopardize the inflation targets, since an exogenous shock has been adapted to the demand for cash. Liquidity is provided through repo expansion quotas and the permanent purchase of government treasury securities (TES). Banco de la República purchased Col$829 billion in TES during the third quarter and Col$1,069 billion during the year to date. A portion of the purchase in the last quarter; that is, Col$130 billion, was acquired through the auction system and directed to financial intermediaries who are not part of the electronic transaction system (SEN), including brokerage firms and trust companies. These two types of financial institutions were authorized to conduct transitory expansion operations with Banco de la República.

✠ The increased demand for liquidity, compared with the expected levels in the reference line approved during March, obliged the Board of Directors of Banco de la República to calculate a new reference line for the remainder of the year. The new line was adopted at the end of September; it assumes 28.3% average annual growth in the monetary base during the fourth quarter of 2002.

- Annual growth in the monetary base at September was 26.0%, an increase over June (17.6%). As to M3, growth in September was 8.8%, which is less than in June (9.1%) but exceeds the rate observed in July and August. M3 growth continues to be sustained by the increase in cash, current accounts and savings accounts. The demand for time certificates of deposit continues to decline. Changes in the composition of M3 during the course of the year towards more liquid assets are explained by decisions on holdings in both the private and public sectors.

- Growth in the portfolio remained slow in nominal terms and declined in real terms. By September, annual growth of this aggregate was 1.6%, as opposed to 0.2% three months earlier. Commercial and consumer credit accelerated between June and August, increasing by 6.1% in August. Mortgage loans continued to decline in annual terms, although part of this situation is explained by securitization of the portfolio in the second quarter.

- The interbank rate at the end of the third quarter was 5.3%, which is practically the same as in June (5.4%). The 90-day interest rate on term deposits (DTF) also remained unaltered, fluctuating slightly at around 7.9%. The tendency in lending rates was downward, in spite of stable borrowing rates and broad liquidity made available by Banco de la República. Credit card rates and those on ordinary loans saw the largest quarterly growth, with respective increases of 104 and 36 basis points (bp). The other rates – consumer, prime and treasury – dropped in the last three months. In September, the credit card rate was the highest (29.0%) and treasury loans the lowest (9.3%).

- The increase in certain lending rates coincided with a sharp comeback in TES rates on the secondary market as of July. The third quarter saw a major disinvestment in public debt paper in favor of assets denominated in foreign currency. This helped to accelerate devaluation. This shift in resources was prompted mainly by the turbulence on Latin America's financial markets and by uncertainty stemming from the government's fiscal situation and fewer expectations of economic growth at regional and local level. Inasmuch as TES rates are the main reference in the market at this time, if the increase continues, higher borrowing and lending rates could be expected in the midterm.

- The rise in TES interest rates for all maturities was associated with a major increase in the country's risk premium, measured by the spread on the 10-year national debt. This indicator was 1,002 bp, on average, at September, which is 469 bp above the level observed in June. A number of countries in the region also saw their risk premiums increase substantially

- Given the figures at September, the Bank's inflation forecast is still at around 6% for the end of 2002. This assumes an additional reduction in core inflation during the fourth quarter to about 4.8%, on average. Most inflationary pressure in the months ahead will come from food prices, which should increase by about 9.2%.

- Forecasts for 2003, based on the transmission-mechanism model, point to 5.5% total inflation. With the combined forecast method, the outcome for total inflation in 2003 is even lower (4.6% for September).

- As to inflation excluding food, the center lane of the transmission- mechanism model predicts 6.6% for the third-quarter average in 2003. Due to the acceleration in devaluation by

September and the increase in economic growth anticipated for the second half of 2002 and the early part of 2003, this new forecast is 70 bp higher than the outcome in June.

- Less total inflation for the fourth quarter of 2003 and the outcome for core inflation depend on a positive trend in food inflation during the coming year. According to the models used by the Bank, currently high food prices and those expected for this year should pave the way for a surge in agricultural supply that could help to straighten prices next year.

- On this occasion, the uncertainty surrounding the forecasts is considerably higher than it was in the second quarter, as potentially important price shocks are foreseen. The likely shocks next year include expansion in the value-added tax base, an adjustment in real rates for electricity, and elimination of the gasoline subsidy. In the case of the VAT reform, uncertainty is mounting because no one knows how extensive it will be. This depends of the text approved by Congress.

- The growing climate of uncertainty is also due to the behavior of external debt markets for the region's economies. How long these markets will be closed and the sources of funding the government obtains will depend largely on the trend in the exchange rate and the growth rate, and therefore on inflation in the next three months. In the past month, the government made good progress in its effort to secure financing, primarily from multilateral banks.

- With the exception of isolated cases, the increase in devaluation to date has not translated into higher prices for consumers, as suggested by the limited inflation in tradables in the CPI market basket (5.4%) and their downward trend throughout the year. Up to now, inflationary pressure has been on producer inflation.

- However, 2003 can expect to see inflationary pressure of some magnitude due to devaluation so far this year. Cumulative devaluation in 2002 (23.4%) is already enough to push prices up. Moreover, the devaluationist phase has lasted long enough (more than three months) to influence the cost structure of companies in a way that could result in price changes, unless the exchange rate declines substantially in the near future compared with its current level.

- The country's monetary policy faces a number of imponderables. There is the possibility of direct shocks to inflation (VAT, energy and gasoline). Also, there is the question of how long external financial markets will be closed, how long it will take to reach a new agreement with the IMF, the extent of funding for the government and midterm tax scenarios.

- However, many of these factors will have only a transitory effect on inflation. The high indexation characteristic of the Colombian economy, which has halted rapid reductions in inflation in the past, can contain it and keep expectations stable under the present circumstances.

- In short, the international economic environment has become more uncertain. This is evident in the increased volatility of exchange rates, higher financial costs and the difficulty in access to international markets. Moreover, growth prospects for the country's trading partners have declined, particularly in the case of the United States and Venezuela. However, the latest indicators of economic activity confirm the slow recovery in domestic spending. Available forecasts indicate the inflation target of 6% will likely be met. In view of this fact, the Board of Directors decided not to change the Bank's intervention interest rates.

Board of Directors

Banco de la República