

PRESENTATION, SUMMARY AND CONCLUSIONS

* Annual inflation for the consumer in December was 6.99%, that is 0.99 percentage points higher than inflation recorded for the previous quarter, but 0.6 percentage points lower than in December, 2001. This annual inflation figure is the lowest for any December, since 1970 (when it registered 6.8%). Even though inflation at year end was higher than the target of 6%, this was largely due to the notable recovery in the price of potatoes, a transitory phenomenon. If the price of potatoes is disregarded, inflation to the consumer would be 6.1%.

* Discounting temporary impacts on prices, just as basic inflation is measured, the inflation target was met. The average of the three measurements for basic inflation, calculated by the Bank was 5.6%. Even thus, the three indicators rose with respect to the level reached in September, thereby breaking the downward tendency that had been exhibited by basic inflation since early 1999.

* The increase in consumer inflation in the last quarter can be explained by three causes. The most important has to do with a reduction in agricultural supply, especially in the case of some of the tubers, such as potato. This phenomenon caused inflation in foodstuffs to rise from 8.6% in September to 10.9% in December. Secondly, the high level of nominal devaluation recorded since mid-year, which began to spill over to consumer inflation as of October, provoked price hikes in traded goods, such as medicines, fuel, personal care items and some processed foods, among others. Lastly, the increase in several international prices, such as fuel, cereal, cacao, oil and fats brought about significant increases in gasoline and food prices, particularly.

* One sign of the pressures exerted by devaluation and international prices is the increase in the inflation of tradable goods. In December this indicator was at 6.6%, notably higher than the figure (5.4%) for September.

* With respect to food prices, it should be pointed out that they began to relax in December. This situation is, to a large extent, a reflection of the fall in the price of potatoes, which had an annual variation in December of 89.8% compared to 121% in November. It might be further added that information for the first two weeks in January from the agricultural sector price information system (SIPSA), data on the Producer Price Index (IPP) for November and December and the forecasts of the Assistant Manager for Economic Studies (SGEE) suggest, in general terms, an important correction in the drop in inflation for the perishable food category at the beginning of 2003, largely, based on a strong drop in the potato price.

* Annual producer inflation showed an important comeback during the last quarter, rising from 6.8% to 9.3%, as a consequence almost exclusively of devaluation, as shown by the increase in inflation of imports (from 4.6% to 16.0%). To judge by this important recovery and above all by the component mentioned, it is probable that there will continue to be a backlog of inflationary pressure on the CPI, which could manifest itself in coming months.

* Everything would seem to indicate that the economy continued to accelerate its growth rhythm during the second half of the year. The GDP figures for the third quarter indicate that the economy expanded at an annual rate of 1.9% during this period, above the rate reported for the first semester of the year, which was 1.4%. Compared to the second quarter, growth was lower, but as mentioned on previous occasions, growth for this period was high as a result of a low base for comparison in 2001, associated with a lesser number of working days.

* For the fourth quarter, various sector indicators, such as production and industrial sales, building licenses and surveys on commercial activity and tourism suggest that growth tendencies remained stable. Therefore, it can be expected that in the last months of 2002, economic growth accelerated a little and that growth for the entire year would slightly surpass the government's goal (1.6%).

* Just as was expected, growth in the second semester continued to be driven by domestic private demand, basically by household consumption and by investment in buildings. On the other hand, external demand has been a source of contraction, due to lower oil and coal exports and due to the reduction in non-traditional exports aimed at Venezuela and the U.S.

* For the coming year, it is expected that private domestic demand will continue to be the main source of growth. However, its ability to pull the rest could be limited by the effect on available income of the recently approved tax reform and by the second and third installments of the capital tax, among other factors. With respect to external demand, it will continue to be strongly affected by the political crisis in Venezuela, at least in the first months of the year, and therefore not contribute to growth. Exports to the U.S., although picking up due to ATPA and greater dynamism in the economy, will not be sufficient initially to compensate for the alterations in exports to Venezuela.

* At year's end, some of the risk factors for growth that were identified in the September Inflation Report had diminished. This is the case of the nervousness shown in capital markets at mid-year with respect to Latin American economies, as a result of the doubts generated by political transition in several countries of the region, headed by Brazil. To date, markets seem to have given some breathing room to the governments of Brazil and other economies, by virtue of which the country risk premiums could be corrected downwards with respect to the high levels reached at mid-year. Public debt placements undertaken by some countries in the region, including Colombia, in December and early in the year, also constitute a favorable indicator.

* However, it is possible that this dynamism in foreign capital markets for Latin America will not be sustainable throughout the year due to vulnerabilities the region faces: the political crisis in Venezuela, the economic crisis in Argentina, the risk factors in Ecuador, uncertain recovery in the U.S. economy and weakening of the dollar, among other things. For the year as a whole a pickup of capital flows in the region is not expected, and neither is a greater correction downward of spreads.

* Colombia could achieve some degree of differentiation in the region, as recognized by some by the risk qualifying agencies themselves, due to its success in the recent approval of tax, labor and pension reform by the Congress of the Republic, and due to the backing of multilateral credit institutions, including the International Monetary Fund (IMF) with which a standby agreement was signed. Nevertheless, culmination of this process critically depends on popular approval of the referendum, which constitutes an important factor of uncertainty, even though the majority of the analysts take this result for granted. But, even if its probability is considered to be low, failure to approve the referendum could drastically affect risk perception in the economy, devaluation expectations and financial flows towards the country, given the scarce margin of fiscal maneuverability the government has. On the other hand, the Venezuelan crisis, with its uncertain resolution, continues to be a factor that affects, and could affect even further, growth prospects for important industrial and trade sectors in Colombia.

* Taking into account the foregoing, it is expected that the Colombian economy will continue to exhibit positive growth rates for the coming year, even though it is considered improbable that there will be any significant acceleration with respect to the results observed in 2002. These forecasts are in line with the growth goal the government has set for 2003 of 2%. In view of this, and the low levels that in November continued to be reported for the various installed capacity indicators as compared to their historical averages, important demand inflationary pressures are not foreseen for the early months of 2003.

* During the fourth quarter, the Board of Directors of the Bank kept its intervention rates stable. At the end of December the rates were the following: Lombard expansion, 9.0%; auction expansion, 5.25%; auction contraction, 4.25%, and Lombard contraction 3.25%.

* Since mid-year, the Bank has granted ample liquidity to the markets, which has allowed it to attend to the strong year-end demand without inconveniences. Particularly, in the last three months of the year, the Bank continued to purchase TES and to exercise options for accumulation of reserves and thus supply a constant flow of liquidity. The total amount of permanent TES purchases in this period reached \$139.8 (mm) billion, with which purchases for the entire year rose to \$1,208.4 (mm) billion. At the same time, through exercise of options for reserve accumulation expansion of \$141.8 (mm) billion in the quarter took place, equivalent to US\$50 million. Through this set of mechanisms, the Banco de la República provided permanent liquidity during the last three months of the year for a value of \$281.8 billion.

* In the last few months a reduction of demand has been observed as suggested by the low demand for 30-day expansion Repos. With the year-end liquidity program, the Bank defined expansion Repos at 30 and 90 days for a total of \$2,100 billion, of which only \$1,105.9 billion were demanded. Likewise, during the fourth quarter, growth of the most liquid monetary aggregates has decelerated significantly. As of December, the monetary base grew at an annual rate of 20.3%, while M1 did so at 18.3%. With respect to M3, its growth also decelerated, dropping from 8.8% in September to 7.4% in December.

* The deceleration of monetary aggregates did not impede a significant acceleration of the growth of total nominal portfolio for the financial system, which rose from an annual growth rate

of 1.6% in September to 4.1% in December. The acceleration occurred fundamentally in the portfolio of non-mortgage banking, which grew at an annual rate of 6.6% in December. Likewise, with figures for November, acceleration was also observed in commercial portfolio and consumption. Recovery of portfolio occurred simultaneously with a reduction in TES placements by the government.

* Recovery of portfolio and lower growth of monetary aggregates did not turn into pressure on nominal market interest rates. Throughout the fourth quarter, the interbank rate was situated slightly above 5.0%. In December, its level was 5.0%, 30 basic points less than in September. As for the DTF, in December it was at 7.7%, 20 bp lower than the figure three months before, reaching its historically lowest level. Finally, the active nominal rates for all types of credit were reduced between 20 bp and 50 bp in the last three months.

* Meanwhile, the TES rates in the secondary market, between September and December showed an important correction downward in all of the sections of the yield curve. By December, the level observed for these rates for various terms was slightly higher than at mid-year, prior to the third quarter comeback. The reduction, which is largely associated with a lower risk perception for internal and foreign markets, was greater in the case of short term rates than for long term rates. Furthermore, in December the long term rates showed a slight recovery that can be reflected in an increase in expectations for inflation in the market.

* During the fourth quarter, the exchange rate showed extreme volatility. Between September and mid-November a tendency to revaluation could be seen that was associated with a lower perception of risk by the market, in part, as a consequence of lower external uncertainty, but also as a result of the progress shown in tax and pension bills put before Congress and the support shown by multilateral banking. However, in the last month and a half, the exchange rate was devaluated again for reasons associated with a greater demand for exchange currency by the real sector and also the absence of exchange supply by the Nation's General Treasury. To this, we may add the low cash level of intermediaries in the exchange market, which means their response to higher demand is very limited. At the end of December, the representative market rate (TRM) was situated at \$2,864.8 while year end devaluation was 25.0% with an average for the year of 9.1%.

* The Banco de la República foresees average inflation of 6.2%, without food for the fourth quarter of 2003, which is lower than the forecast presented in the September report (6.6%). This drop in the forecast is the result, among other things, of lower expected inflationary pressures on exchange markets, given the forecasts of September. In the area of food inflation, the forecast for the same period is 5.8%, higher than the forecast made three months ago (2.8%). Thus, total average foreseen inflation for the fourth quarter of 2003 is 6.1%, that is, greater than that shown in the previous report (5.5%).

* The SGEE considers that the effect of the IVA reform, to take effect during 2003, on inflation should be temporary and not very significant. However, we must not ignore the increases that it could cause on expected inflation, with which its effect could become prolonged over time.

* Risks to projected inflation continue to be considerable. Some of the most important are:

* The magnitude of net capital flow, both public and private that could enter the country during 2003. Although in the last weeks markets have shown signs of opening up, it cannot be said that this situation is stable yet, and there is still great danger of a new closing up in the face of changes in internal or external conditions. Among the latter, it is necessary to highlight the normal uncertainty surrounding approval of the referendum. Although several of the analysts consider this event improbable, a negative result could deteriorate the confidence markets feel in the consistency of the government's macroeconomic program, producing increases in the exchange rate and country risk at levels that are hard to foresee.

* Another important risk to inflation in 2003 is the possibility of greater inflationary expectations, given the break in the general tendency inflation has shown since the second semester of last year. Although this change in the tendency reflects transitory factors (associated with the shock from food supplies and the external financing shock), its effect on the inflation rate can become permanent if these inflation expectations are transmitted in the medium and long term. At this moment, information available to evaluate the recent changes in this variable are scarce, but the fact that long term rates on the debt have stabilized around 7.5% in real terms, as compared to 5.7% that had been reached as of last July, 2002, would show that in addition to the other factors, the market could be transmitting recent inflationary increases to long term rates and that it would not be possible to get lower rates on debt before the market has expectations of a clearer inflationary panorama in the medium term.

* On the other hand, the current level of real rates for expansion and contraction of the Banco de la República are -1.6% and -2.6%, respectively. These rates, the lowest of the largest economies in the region, have been reduced by 270 pb with respect to the level that they had in January, 2002, and near 100 pb with respect to June of the previous year.

* By contrast, no particular risks of consideration are associated with inflationary pressure on the demand side. For the moment, cost pressures are unknown and could result from the recent readjustment in minimum salary or increases in other salaries within the economy. There are also positive risks on inflationary behavior: the principal one is that with the approval of the referendum, an improvement will be wrought in country risk that induces greater net capital flows, both public and private, with a positive effect on growth and on expectations for devaluation. Every additional US\$100 m of incoming capital diminishes average devaluation by about 80pb and induces a drop of 12 pb in basic inflation according to Banco de la República models.

* Based on the foregoing considerations and taking into account that in recent months a break in the basic inflation tendency has been observed, which can be attributed to greater peso devaluation with respect to the dollar and furthermore, failure to fulfill the goal in December could raise inflation expectations, the Board of Directors decided to increase the entire rate structure of Banco de la República intervention by 100 pb. In this way, the new intervention

rates are the following: auction expansion: 6.25%; auction contraction, 5.25%; Lombard expansion, 10%; Lombard contraction 4.25%.

The Board is confident that with this measure it can control inflation expectations and increase the probability of fulfilling the goal for 2003 and 2004 without affecting the process of reactivation of the economy.

Board of Directors of the Banco de la República.