

31 July 2002  
Bogotá D. C. (Colombia)

*Honorable Chairmen and Members of the  
Third Standing Constitutional Committees of  
the Senate and House of Representatives  
Bogota, Colombia*

*Dear Sirs:*

*Pursuant to Article 5 of Law 31/1992, the Board of Directors of Banco de la República hereby submits to the Congress of the Republic of Colombia a report on the macroeconomic results of the year 2002 to date, together with a description of the goals adopted by the Board of Directors for the current year and prospects for the various macroeconomic variables. The last section of the report contains information on the composition of international reserves and projections concerning the financial position of Banco de la República in 2002.*

*Sincerely,*



Miguel Urrutia Montoya  
Governor, Banco de la República

## INTRODUCTION

The following report, presented to the Colombian Congress, offers an analysis of Colombia's economic performance and the macroeconomic policy implemented in 2002. Economic activity continued to be slow during the early months of the year, although the second quarter saw a rebound. Unemployment remained high, although it has declined and occupation has increased. The current account in the balance of payments registered less of a deficit than in the first quarter of the previous year, thanks to more of a decline in imports as opposed to exports. Annual inflation dropped during the first four months of 2002 in response to continued excess capacity in the economy, exchange stability, and the credibility of the monetary policy and its goals. May and June saw evidence of a rise in inflation due to an increase in food prices.

The latest reports to Congress emphasize various issues concerning the country's economic performance. One highlighted the fact that the financial sector is usually slow to recover after a crisis. Another dealt with the factors that explain unemployment in an economy. A third examined the dangers of public debt unsustainability in Colombia. Each of these topics was intended to alert Congress and the public to the country's primary economic problems. The overriding purpose of this report is to reflect on the role of monetary policy in growth and inflation, with several analytical comments and others on the Colombian experience in recent years. Basically, the Colombian economy is obliged to contend with two weaknesses. The first deals with potential product growth, which seems to have declined in the last few years. The second refers to the low growth in aggregate spending, which causes the economy to function below capacity.

Monetary policy has prevented potential product from being further weakened by reducing the level and volatility of inflation and making resource allocation and decisions on savings and investment more effective. It has also attempted to exert a positive impact on aggregate spending by lowering interest rates and providing abundant liquidity for household and company consumption and investment.

Chapter III offers an analysis of the macroeconomic policy applied in 2002. As in the last two years, monetary policy has been managed with an eye towards encouraging as much economic growth possible, while maintaining a commitment to the inflation target. In recent years, this policy has been managed in what can be characterized as an anti-cyclical and expansive way. Accordingly, interest rates have fallen substantially, with a

positive impact on the trend in aggregate demand. Nonetheless, there are still no signs that credit will perform as hoped, simply because the financial sector is still recovering and economic agents remain cautious about getting into debt. The indicators for the financial sector continued to improve throughout the course of 2002, despite protracted and progressive deterioration in non-performing loans in the mortgage banking sector.

As to the exchange situation, the early months of this year saw considerable fluctuation. The peso continued to appreciate up until the first fortnight of May, after which the tendency has been towards devaluation. Accordingly, the nominal exchange rate at June 30 was 4.7% more than at the end of 2001. Exchange performance in the early months was influenced by low external interest rates, by pre-financing the public sector obtained abroad during 2001, and by expectations that the government would monetize its foreign currency in 2002. The exchange rate was also affected by the fact that pension funds needed to reduce the exposure of their portfolio in foreign currency. However, new conditions on external financial markets and an external-for-domestic-debt swap by the government in May reversed the trend in expectations of devaluation. The peso devaluated by 4.6% between May 15 and June 30, 2000, even though it still has a real annual appreciation rate of -4.12% .

With respect to fiscal policy, 2001 saw public income and spending rise above nominal GDP. Although the trend in public investment contributed to growth in domestic demand, increased tax revenue due to tax reform measures had an effect on available income and explains part of the slowdown in the growth of private consumption during 2001. In spite of attempts to reduce public spending, which were constrained by inflexibility of the budget, there was almost no change in the public sector deficit: 3.3% of GDP in 2000 and 3.2% in 2001. The deficit in the consolidated public sector for the first three months of 2002 was similar to the one observed during the same period the year before. The track record for central government finances was similar, with a major decline in expenses and income.

Performance of the principal economic variables in the early months of 2002 and prospects for the rest of the year are analyzed in Chapter IV of this report (as is traditionally the case). The limited extent of economic growth is associated with external and domestic factors. Among the most notable of the external factors is the downturn in terms of trade and external demand, associated with performance of the world economy. These factors were amplified by other internal ones, such as persistent unemployment and the uncertainty and violence generated by the breakdown in peace talks. As to macroeconomic prospects for the rest of 2002, weak product growth in the first quarter and a difficult international environment prompted the Ministry of Finance and Public Credit and the National Department of Planning (DNP) to revise the growth target for the year as a whole. The government's new projections point to economic growth on the order of 1.5%, although more of an acceleration in world economic recovery could increase growth to 2%. For its part, inflation is expected to remain on a course compatible with the target of 6% for the

current year. According to projections on the balance of payments, the current account deficit in 2002 is expected to be 2.3% of GDP, thanks to a decline of 2.3% in merchandise exports and 2.0% in merchandise imports.

The report ends with a look at the trend in international reserves, which are at historically high levels. It also considers the financial position of Banco de la República. The new projections on income -considering the impact of the dollar's devaluation against other currencies- indicate the Bank will increase its earnings to Col\$661.7 b., compared with the estimate of Col\$200.9 b. included in the March 2002 Report to Congress. However, the final outcome will depend on how the euro and the yen perform.