**Presentation, summary and conclusions**

**Review of inflation to December 2001**

- Annual consumer inflation was 7.6% in December 2001, running 0.4 percentage points below the 8.0% target set by the Banco de la República’s Board of Directors, and 1.1 points lower than a year earlier. Over the past 32 months annual consumer inflation has been 10.0% or less.

- The rate of inflation in December 2001 turned out exactly as the Bank’s Economic Studies Division (SGEE) had predicted in the December 2000 Inflation Report.

- Fourth-quarter inflation in 2001 (0.6%) was 3 percentage points lower than a year earlier (0.9%), largely because of slower price rises in the groups of entertainment, culture and recreation, transport and communications, and diverse expenses, and despite higher rises in some food items.

- The food and services group continued to drive price growth over the fourth quarter. Food inflation came mostly from the year-end increase in the price of potatoes, given this staple’s weight in the food basket. Though beef prices did not go up in the fourth quarter, their climb during the previous quarters made beef the biggest contributor to inflation for the year as a whole. Among services, the fastest rises were in water supply, sewerage, imputed rent, and waste collection.

- No inflationary pressures came from demand in the final months of 2001, to judge by lower annual inflation in the groups of culture and entertainment, diverse expenditures, and clothing.

- Over the fourth quarter, inflation in tradables continued to fall, as it had been doing almost without a break since mid-2000, thanks to decreasing devaluation. And inflation in nontradables, which had been on the rise since March 2001, dropped slightly.

- Core inflation, like headline inflation, behaved satisfactorily in 2001. In December, the core indicators averaged 6.7%, down from 7.0% in September and from 8.4% at the end of 2000, and none of them stood higher than either the headline or target rate.

- Producer inflation, too, performed well, running at 6.9% in December 2001, down by 4.1 percentage points on a year earlier and by 1.1 points on September. The fourth-quarter drop resulted from slower annual price rises in domestically produced and consumed goods and imports; by ISIC industrial activity, mining and manufacturing contributed most to the drop.

- No major inflationary pressures are expected in 2002. The evolution of consumer prices will benefit from moderate devaluation and sluggish world demand, which will be reflected in lower inflation in the main internationally traded commodities, including fuel. Although domestic demand is expected to pick up, ample available capacity precludes any pressure from this source.
The possibility of pressure from food prices cannot however be completely overlooked. The holding-back stage in cattle breeding is expected to extend into 2002, reducing the supply of beef and raising meat prices. Potato prices, which went up in December, are likely to remain high over part of 2002, because of a reduction in supply resulting from low prices in the second and third quarters of last year. Nor can the likelihood of price rises in food staples as a whole be ruled out, for there may be a recurrence of the climatic conditions known as the Niño by the end of the year. Inflationary pressure is also expected from public services, particularly water supply and sewerage, since the gradual dismounting of utility subsidies should continue during 2002.

Annual inflation is forecast to average 5.8% in the fourth quarter of 2002, according to the central path of the transmission-mechanism model. Combining inflation forecasts from different models gives an inflation of 6.4% by December 2002, the same figure as predicted three months ago.

This Report also presents a first forecast for the fourth quarter of 2003. The central path of the transmission-mechanism model shows inflation declining over the year to an average of 3.9% in the fourth quarter.

Lower inflation in 2002 and 2003 will be largely the outcome of a predicted absence of major inflationary pressures from demand, since expected economic growth should be easily accommodated by available installed capacity.

The central inflation forecast for 2002 has an upward-biased risk balance, which indicates the possibility of greater-than-expected inflationary pressures, owing to uncertainty about the behavior of food prices and the exchange rate.

Core inflation is expected to keep on falling in 2002. Measured as the average of the three indicators currently used by the Bank, it is projected by single-equation models to stand at 5.6% in December 2002. This is close to the figure for non-food CPI (5.3%) projected by the transmission-mechanism model. The core-inflation forecast comes with an upward-biased risk balance, as in the case of headline inflation and for the same reasons.

GDP grew at an annual rate of 1% over the third quarter, more slowly than in the previous two quarters because of weakening demand of every kind, particularly external and investment demand. Consumption demand benefited from a pick-up in government consumption and higher household demand for durable and semidurable goods.

Judging from several real-activity indicators, the pace of economic growth may have improved slightly over the fourth quarter, thanks particularly to higher domestic demand. Recovery in November in such factors as loans for building or buying housing and construction licenses points to faster growth in private construction in late 2001. Given this sectorís highly labor-intensive nature, its continued recovery would give a strong boost to job creation and hence to private consumption. Data on car sales to November show a considerable rise on levels registered in the previous 24 months. Retail sales and electricity consumption also behaved tolerably well.
A number of current circumstances favor growth in early 2002 and could make up for a weakening in exports. They include, notably, low interest rates, exchange-rate stability, lower net capital outflows, a recent reduction in unemployment, and tax incentives for investment in low-income housing. By improving consumer and investor expectations, they could strengthen domestic demand.

The Board of Directors continued to ease monetary policy over the fourth quarter of 2001, thanks to satisfactory inflation results and the fact that projections are in line with the set targets. The Bank cut interest rates three times in the fourth quarter, by a total of: 75 basis points in the auction expansion rate, bringing it down to 8.5% by the end of the year; 75 points in the auction contraction rate, down to 7.5%; 100 points in the Lombard expansion rate, down to 12.25%; and 50 points in the Lombard contraction rate, down to 6.25%.

Besides reducing intervention rates, the Board of Directors provided permanent liquidity to meet higher year-end needs by buying international reserves and through final purchase of public-debt securities, amounting in all to 993 billions pesos.

The exchange rate stood at 2,291 pesos to the dollar at the end of 2001, with an average devaluation of 5.4% and a year-end devaluation of 2.8%. Average devaluation, figure, which is lower than the difference between the domestic and external interest rates, is largely accounted for by foreign financing of the fiscal deficit and by smaller net outflows of private capital.

The monetary base moved closer to its reference line during the fourth quarter, ending the year with the 20-day average running on the reference line, and the 45-day average slightly below the line. M3, the broader measure of money supply, continued to expand over the quarter, registering a 10.5% annual growth in December, 1.6 percentage points higher than in September. This expansion came from a rise in checking and savings accounts, and especially from a strong increase in Repo operations with the Treasury, which have the advantage of not being subject to reserve requirements.

Greater availability of financial savings went to swell the financial intermediaries’ portfolio of Treasury paper, considerably increasing public debt, without breaking the recovery trend that the financial sector’s loan portfolio has been showing for several quarters. But this recovery continued to be very slow at the end of 2001, the gross nominal portfolio registering a 2% annual growth. By type of loan, the strongest recovery during the fourth quarter was in consumer loans, which expanded at an annual rate of 10.4%, much faster than in the third quarter (5.8%).

The drop in inflation over recent month, to less than 8%, is a positive factor in that it lowers inflation expectations, which can help to reduce the size and number of price adjustments in early 2002. As a matter of fact local and foreign analysts substantially reduced their inflation forecasts for 2002, even before knowing the inflation figure for December.

Available forecasts suggest that Colombia is set to meet the 6% inflation target for 2002 by the end of the year. Similarly, medium-term forecasts are compatible with achieving an inflation rate within the range of 4%-6% announced for 2003. Analysis of real economic activity points to recent improvements in some indicators of domestic demand. Economic recovery is expected to
continue all through 2002, without compromising attainment of the inflation targets, because the economy still has excess capacity, and also because greater credibility of monetary policy has brought down inflation expectations. Moreover, the monetary base’s moving average has recently moved close to its reference line, and the external situation is not expected to undergo any changes likely to jeopardize meeting the inflation targets.

On the basis of the foregoing considerations, the Board of Directors of the Banco de la Republica has decided to reduce the maximum and minimum auction expansion and contraction rates by 0.5 percentage points. The Lombard expansion rate has also been reduced by 0.5 percentage points and the Lombard contraction rate by 0.25 points. These modifications are compatible with the inflation forecasts indicated above.

Accordingly, the Banco de la Republica’s intervention rates now stand as follows: the Lombard expansion rate at 11.75%, the Lombard contraction rate at 6.0%, the auction expansion rate at 8.0%, and the auction contraction rate at 7.0%.

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