

PRESENTATION, SUMMARY AND CONCLUSIONS

✕ Continuing price pressures over the first quarter of 2003 caused inflation to outstrip the 5%-6% target range set for the year by the Board of Directors of the Banco de la República. Annual consumer inflation was particularly high in March, running at 7.6%, up by 60 basis points (bp) on December 2002 and 170 bp on the previous March. Producer inflation rose even more steeply, ending the quarter at 11.5%.

✕ Higher inflation in the first quarter followed an unexpected price surge at the end of last year that had prevented the 6% target for 2002 from being met. That surge had resulted largely from a negative supply shock in perishable foods (mainly potatoes) and higher world prices for some agricultural imports. It was also associated to some extent with faster devaluation and the effect of this on tradables prices.

✕ Inflation had speeded up at the end of last year within a loose monetary-policy setting- created by a mid-year reduction of 325 bp in intervention rates-, and in the midst of strong devaluatory pressures. Higher devaluation and failure to meet the inflation target led to rising inflation expectations.

✕ Given this state of affairs, the Board decided in January to raise the Bank's intervention rates by 100 bp. And in February it announced its readiness to use up to \$1 billion of the country's international reserves to intervene in the exchange market. Accordingly, two one-month call-option auctions were arranged for March and April to deaccumulate reserves by \$200 each time.

✕ Price trends did not change overmuch during the first quarter. Prices continued to rise partly because of the presence of negative shocks in food supply and world food prices, to which were added shocks from VAT expansion and from rising utility and fuel charges.

✕ The different indicators of core inflation have also accelerated, bearing out the fact that the recent pick-up in inflation has not been caused exclusively by the supply shocks referred to above. Non-food inflation rose by 115 bp between December and March, to 6.6% by the end of the quarter, while the average of the three core-inflation indicators used by the Bank was 7.1% in March, far above their 6.3% average in December.

✕ Inflationary pressures from devaluation have, in turn, become more evident in recent months, with tradables inflation running at 8.9% in March, up from 6.6% in December. This occurred despite the fact that the exchange rate's rising trend was interrupted from mid-February,

which suggests that a very high rate of devaluation was implicit in its level at the end of March, with delayed effects on inflation.

✕ Besides devaluation, the main risk today for price stability is a possible upsurge in inflation expectations. Indicators of inflation expectations, such as the differential between fixed-rate TES securities denominated in pesos and those denominated in Real Value Units, rose from 6.5% in November to 10% in March of this year. Moreover, although the supply shocks that have affected prices are transitory, there is a risk that in the absence of suitable action by the Banco de la República their effects may persist through higher inflation expectations.

✕ Inflation does not so far appear to stem from demand. The prices of various nontradable goods and services such as rent and education have been rising by less than 6%. The economic upturn at the end of last year and the further reactivation expected for this year should not generate any large inflationary pressures. Capacity utilization has been below historical average levels and is not expected to change substantially over the next few months. Lastly, the productivity gap, as estimated by the Bank, is negative and will remain so for a good while even if growth rises sharply.

✕ The Bank thinks that the government's 2% growth forecast for 2003 is achievable and may even be surpassed, given the favorable signs shown by various sectoral indicators, such as industrial production and sales in January and February, electricity consumption and consumer and commercial credit to March.

✕ Growth will continue to be driven by private domestic demand over the first half of 2003, for external demand will still be suffering from the stalling of trade with Venezuela, at least in the coming months. Private domestic demand, in terms of both consumption and investment, continues to be boosted by low interest rates, falling unemployment, a greater availability of credit and an improvement in internal security, judging from the perceptions of consumers and businessmen. In the second half of the year, external demand may once more play a major role if exports to Venezuela manage to recover, and if the Andean Trade Promotion and Drugs Eradication Act (ATPDEA) allows Colombian businessmen to compete successfully in the United States market

✕ On the exchange front, the intervention announced by the Board in February for deaccumulating -currency reserves succeeded in stabilizing the exchange rate around 2,960 pesos to the dollar by the end of the first quarter. The supply of foreign exchange was also boosted by foreign markets' perceiving Latin America as less of a risk, as evidenced by a large reduction in country-risk premiums since January. In April, as this Report was being drafted, Colombia's risk spread continued to fall sharply, allowing the peso to appreciate.

✕ The raising of intervention rates in January did not lift the chief market lending or deposit rates. But it did temporarily push up treasury paper (TES) rates, reflecting higher funding costs for investors as well as persisting inflation expectations

✕ Higher inflation and stable nominal rates led to a reduction of real market interest rates. In March the real DTF deposit rate was 0.1%, down from 0.7% in December and far below its

historical average, while the real interbank rate was -1.1%, remaining negative for the tenth month in a row.

✕ The broader monetary aggregate (M3) expanded at an increasing pace over the first quarter, registering a 11.4% rate of annual growth in March, which was still compatible with expected nominal GDP growth for 2003. Since January recovery in M3 has gone hand in hand with a pick-up in sales of term certificates of deposit, breaking last year's declining trend. At the same time, credit provided by the financial system continued to recover, driven by commercial and consumer loans; the overall annual growth at the end of the first quarter was 7.0% in nominal terms.

✕ Actual Inflation in the first quarter was higher than the rate forecast by the Bank in December. The forecasting error is explained by underestimation of both food and non-food inflation. Regarding the latter, the Bank's forecasting did not fully take into account the effect of devaluation and the repercussions of some temporary shocks, such as the price increases of utilities and fuel, that occurred sooner than envisaged in the December 2002 Inflation Report.

✕ On the basis of inflation figures registered in March, the Bank's central model forecasts an average headline inflation rate of 7.2% for the fourth quarter of 2003. This is an upward revision of the 6.1% rate predicted in December, because of higher projections for both food and non-food inflation. Food inflation is projected to average between 6% and 7% in the fourth quarter of 2003, while non-food inflation may average between 6.5% and 7.5%.

✕ The upward revision of non-food inflation is explained by the fact that accumulated devaluation to March is now expected to have a greater impact on tradables prices, and by higher inflation expectations. Similarly, a greater shock is envisaged from the rise in utilities prices, consistent with this subgroup's price behavior so far this year. All the same, it is important to point out that, if the exchange rate remains stable, the pressures described above, particularly those associated with devaluation, should begin to wane in the second half of the year, thereby allowing non-food inflation to fall.

✕ At a meeting held on April 28 the Board of Directors reviewed the state of affairs described above and saw strong signs that the monetary policy then being pursued would not serve to keep inflation expectations under control. The Board also considered that low interest rates were not helping exchange-rate stability, since real intervention rates were negative and the other relevant interest rates were very low in real terms. These circumstances, the Board felt, could cause:

- ◆ Inflation expectations to be passed on to new contracts, thereby prolonging the temporary price shocks (from the VAT expansion and higher utilities and fuel charges); and
- ◆ The Colombian economy to start operating at inflation rates increasingly far removed from the long-term target set by the Board.

✕ Although the exchange rate has recently become stable, accumulated devaluation is still high and poses the risk of continuing to pass through to prices, which are being pushed up by

rising inflation expectations. Moreover, possible future developments in the external sector, especially a decline in nontraditional exports this year or in oil exports in 2004, may generate new devaluation expectations that would adversely affect the path of inflation.

✦ Consequently, to counteract higher inflation expectations and keep the exchange rate stable, the Board considered that its structure of intervention rates needed to be raised by 100 bp from April 29. The new rates are: Lombard expansion rate 11%, auction expansion rate 7.25%, auction contraction rate 6.25%, and Lombard contraction rate 5.25%. The Board also decided to hold an auction to deaccumulate reserves by means of options worth \$200 m, to be exercised in May.

Board of Directors of the Banco de la República