

BANCO DE LA REPÚBLICA



INFLATION

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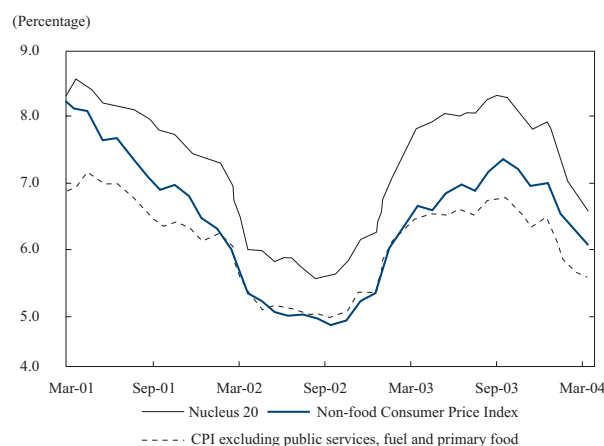
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THE INFLATION SITUATION IN MARCH AND THE OUTLOOK

1. INTRODUCTION

In the first quarter of this year, core inflation showed a clear downward trend. Annual non-food inflation was 6.1%, a sharp fall from the December figure (7.1%). All the other core inflation indicators followed a similar trend. The average of the three most used (non-food, nuclear and CPI excluding primary food, public services and fuel) in March was 6.0%, 1.1 percentage points below the December data and the lowest level since the end of 2002 (Figure 1).

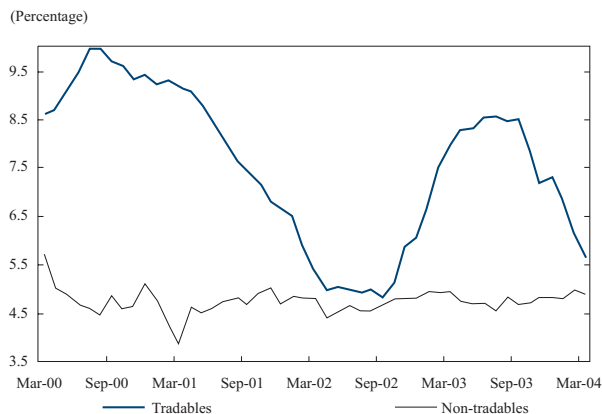
FIGURE 1
CORE INFLATION



Source: National Statistical Administrative Department (DANE), Bank's own calculations.

As forecast in previous reports, the fall in core inflation was due to the sharp reduction in tradable goods inflation, resulting from the stability of the exchange rate in the second half of 2003 and its appreciation since late 2002 (Figure 2). Even so, in the last three months the appreciation was higher than the forecast made in the previous quarter, and has offset the increase in the international prices of the commodities imported by Colombia.

FIGURE 2
ANNUAL CORE INFLATION CPI (*)
TRADABLES AND NON-TRADABLES



(*) Excluding food prices and prices of regulated goods and services.
Source: DANE, Bank's own calculations.

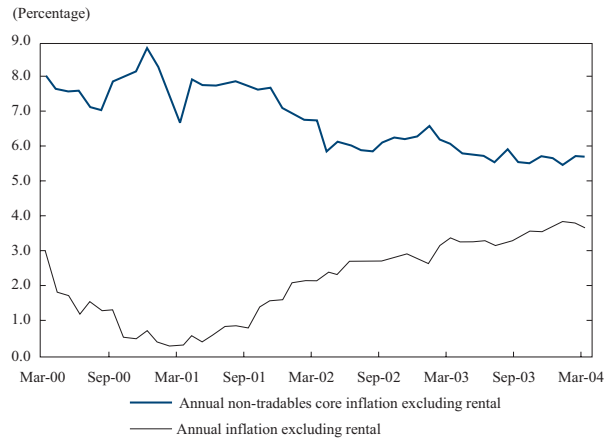
The recent trend in the inflation of tradables shows that the pass-through of the devaluation that took place between mid-2002 to mid-2003 had been largely completed by March this year, within the period forecast in previous reports. The inflation of tradables (excluding primary food and regulated prices) was 5.6% last month, similar to June 2002 (5.0%) when the devaluation phase began. Also, the pass-through of the exchange rate to tradables inflation was equivalent to three percentage points for every 10 of annual devaluation, and to total inflation 0.3 percentage points (excluding indirect effects on non-tradables inflation), close to the estimates used in the Bank's models.

Core inflation of non-tradables remained stable at slightly above 4.5% (Figures 2 and 3) as a result of rental inflation that did not increase in the first quarter for the first time since late 2003, while inflation for the rest of non-tradable goods stabilized in the range of 5.5% to 6.0% during this period.

The lowering of inflation expectations possibly contributed to the stability of non-tradables inflation, according to the various indicators (Figure 4). The latest quarterly expectations survey taken by the Bank in January revealed a fall in expected inflation over various horizons in relation to the measurements taken in previous quarters. For September 2004, respondents expected inflation of 6.3% with the latest survey, against 6.6% obtained in the October survey. The Bank's monthly expectations survey and the differential between the rates of fixed-rate Treasury bills (TES) and inflation indexed TES also suggested a reduction in inflation expectations.

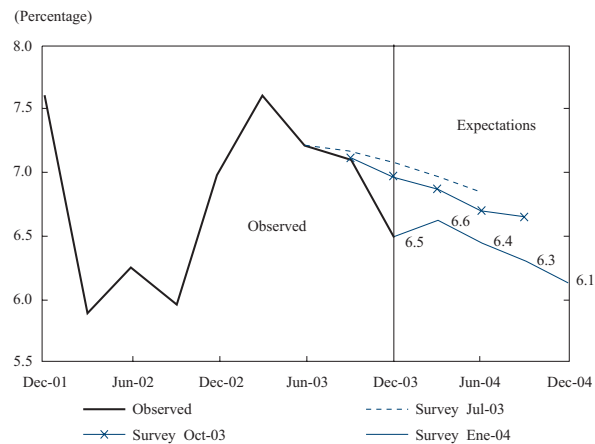
The good performance of core inflation offset the increase in food inflation in the first quarter (which was above the forecast). In addition to the food shock, in March the shocks on regulated goods and services continued (mainly fuel and public services). Last month, annual inflation in this sub-group was 11.7%.

FIGURE 3
ANNUAL RENTAL INFLATION
AND (*) NON-TRADABLES CORE INFLATION (EXCLUDING RENTAL)



(*) Excluding food prices and prices of regulated goods and services.
 Source: DANE, Bank's own calculations.

FIGURE 4
OBSERVED INFLATION AND INFLATION EXPECTATIONS
(AT 3, 6, 9 AND 12 MONTHS)



Source: Bank of the Republic, expectations survey January 2004.

II. CURRENT ECONOMIC SITUATION

A. External context, exchange rate and production of tradables

The most outstanding factor in relation to external variables since the last *Report on Inflation* has been the exchange rate appreciation. The recent trend in the

exchange rate suggests that the economy entered a phase of a stronger appreciation, that the one forecasted in the December report. This has occurred for several reasons:

- ✘ A higher than projected increase in remittances from abroad.
- ✘ The increase, higher than expected, in the international prices of various export commodities.
- ✘ Higher than expected increases in traditional (coal) and non-traditional exports (to Venezuela and the United States).
- ✘ Increased confidence in the outlook for the economy.

More recently, other factors such as the increase in Government net external financing, net portfolio inflows, and the shift in the trend in private-sector net external borrowing (mainly short term) have accentuated the revaluation trend.

The exchange rate appreciated in the early months of 2004 in the context of the increased capital flows into the emerging economies and a low aversion to risk, which maintained the country risk premiums of most regional economies at levels close to historical lows (Figure 5). The two previous factors were stimulated largely by broad international liquidity for over two years whose main expression has been the low real interest rates in the United States and Europe.

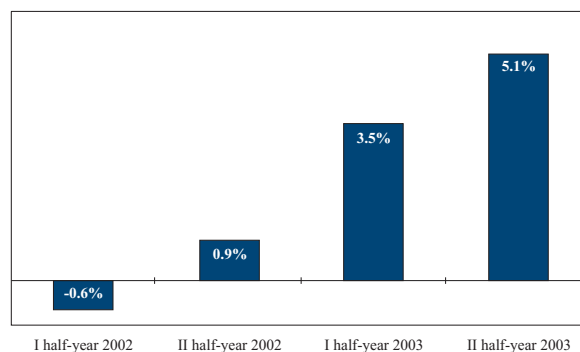
FIGURE 5
COUNTRY RISK PREMIUMS
EMBI+ ADJUSTED (*) VS. EMBI+ COLOMBIA



(*) EMBI+ adjusted excluding Argentina.
Source: Bloomberg.

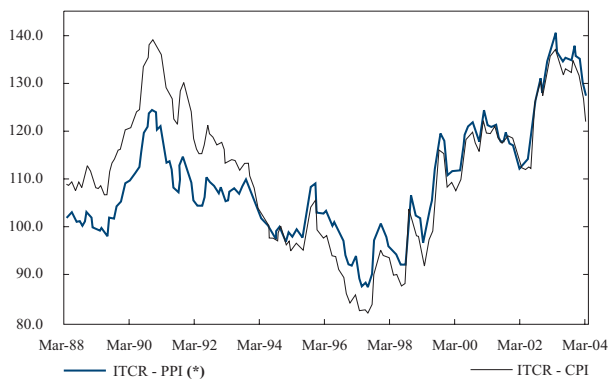
These favorable external conditions resulted in the steady growth of tradable sectors such as mining and manufacturing industry (Figure 6), despite the recent fall in the real exchange rate, which, in any event, continues at historically high levels (Figure 7).

FIGURE 6
ANNUAL GROWTH OF TRADABLE SECTORS GDP



Source: DANE.

FIGURE 7
REAL EXCHANGE RATE INDEX (ITCR)
(1994 = 100)



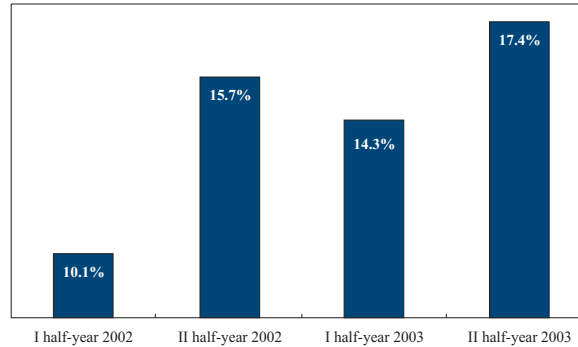
(*) IPP: producer price index
Source: Banco de la República.

B. Domestic demand and production of non-tradables

In the last six months, domestic demand continued to recover, led mainly by private investment (Figure 8). Household consumption, which until mid-2003 grew weakly, gained dynamism toward the end of the year, especially in the first quarter of 2004, as several leading sectoral indicators suggest, such as retail and wholesale trade and credit card sales (Figure 9).

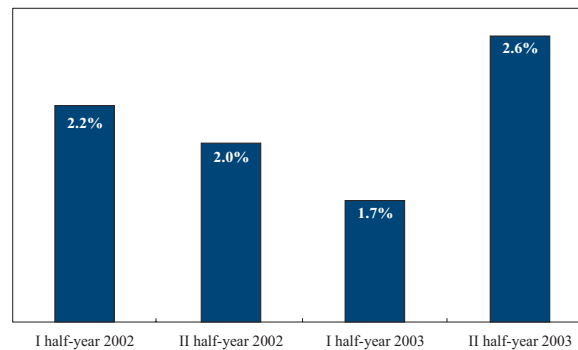
The pickup in domestic demand continued supported by low real interest rates, the increase in private-sector disposable income due to improved terms of trade, a significant increase in remittances from abroad, recovery of employment, and the increase in household wealth associated with higher asset prices. All this has been accompanied by greater availability of domestic financing, observed in the growth of loans from the financial system, and in the availability of earnings for corporate reinvestment.

FIGURE 8
ANNUAL GROWTH OF PRIVATE INVESTMENT



Source: DANE.

FIGURE 9
ANNUAL GROWTH
OF HOUSEHOLD CONSUMPTION



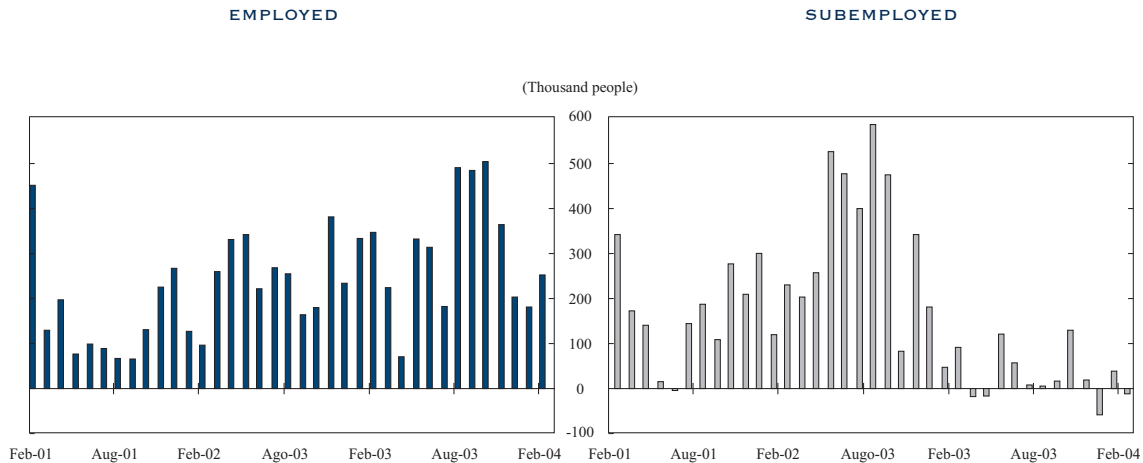
Source: DANE.

Domestic demand was also strengthened by increased consumer and business confidence, and easier access to international capital markets by both public and private sectors, thanks to low country-risk premiums and expectations of exchange rate appreciation.

On the labor front, economic expansion is leading to a recovery of the levels and quality of employment; in fact, the share of sub-employment in growth of urban employment has fallen sharply since mid-2003 (Figure 10).

In relation to supply, the increasing strength of domestic demand in recent months has continued to stimulate the expansion of sectors that produce non-tradable goods - especially construction, commerce and transport services - as shown by indicators such as building permits, loans to constructors, and the trend in retail sales reported by the National Federation of Retail Traders (Fenalco).

FIGURE 10
ANNUAL GROWTH OF THE NUMBER
OF EMPLOYED AND SUBEMPLOYED
FOR THE 13 MAIN CITIES



Source: DANE.

C. Spare capacity

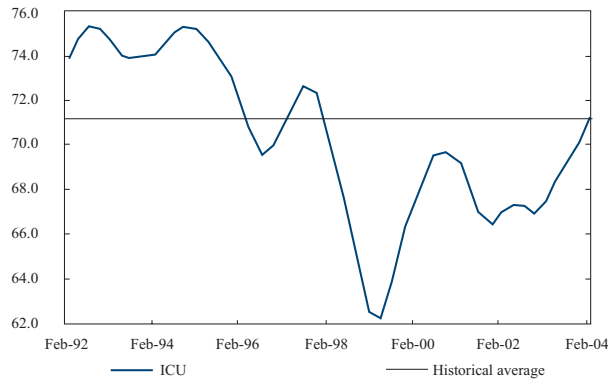
A key aspect of the evaluation of the current inflation situation is to determine how long the economy can expand at current or even higher rates without generating inflationary pressures that jeopardize inflation targets; several measures of spare output capacity are used to estimate this.

For the first quarter, the available indicators do not reveal a single trend. The industrial indicators - installed capacity utilization (ICU) and demand as main problem of expansion - suggest that spare capacity continued to decline in the first quarter of 2004. However, other information suggests the presence of broad levels of spare capacity, which are decreasing more slowly than forecast.

In relation to the first trend, on February figures, ICU increased sharply according to the National Association of Industries (ANDI). Even so, the level of this indicator for this month (71.3% for the seasonally adjusted series) was at the historical average, which has not happened since mid-1977. With respect to the demand indicator, the percentage of industrial firms that perceived demand as their biggest problem for expansion of production decreased again at the start of the year to levels similar to 1996 and 1997 (Figures 11 and 12). This trend indicates a sharp reduction in spare capacity to levels that could foreshadow the emergence of inflationary pressures even in the short term.

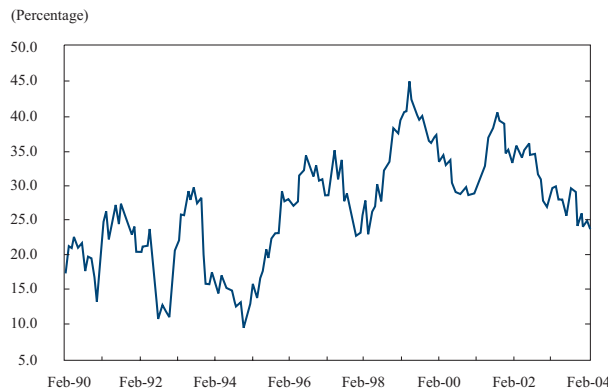
However, it should be noted, that the historical average of the Fedesarrollo ICU indicator has fallen because the observed data has been systematically lower than the mean of the last five years. For this reason, this average is not, currently, a reliable indicator of the presence of possible inflationary pressures. The average

FIGURE 11
 INSTALLED CAPACITY UTILIZATION (ICU)
 (FEDESARROLLO - TREND COMPONENT)



Source: Fedesarrollo, Bank's own calculations.

FIGURE 12
 INDICATOR OF INSUFFICIENCY OF DEMAND MEASURED BY ANDI (*)



(*) percentage of industrial firms that consider that their main problem for expansion of production is lack of demand.
 Source: ANDI.

ICU has fluctuated between 70.5% and 72.7%, and the February data is still in the lower part of this range. This shows that the manufacturing sector could expand more without putting pressure on inflation.

Also, at the start of the year the unemployment rate fell at a much slower rate than last year and is still at very high levels (17.1% in February), much above the recent estimate of the non-accelerating inflation rate of unemployment, which is 13.5%¹.

¹ This is the unemployment rate at which inflationary pressures could begin to appear in the economy. The non-accelerating inflation rate of unemployment (Nairu) is usually higher in developing economies and economies with more rigid labor markets.

Third, the output capacity of the economy could be expanding at a higher rate in 2004 taking into account the high growth of private investment in 2003 and early 2004.

On this basis, it was decided to re-estimate the output gap, assuming, among other things, a lower level of Nairu (according to recent studies by the Bank of the Republic), and a higher rate of private investment. The new calculation puts the average potential output gap in 2004 at -1.75%, a wider level than the estimate in December report (-1.36%). The new gap implies 3.6% growth of potential GDP in 2004 and not 3.0% as estimated in the last quarterly report.

III. MACROECONOMIC OUTLOOK

Economic performance during the next few quarters will continue to be linked to a series of domestic and external factors, some of which were identified in the December report. The main factors are:

- ✘ A monetary policy that stimulates economic activity through low real interest rates.
- ✘ The speed of the closing of the output gap in a context of more robust economic growth, and its possible effects on inflation in the non-tradable sector.
- ✘ The effect of the appreciation during the first quarter on tradable inflation.
- ✘ The expected trend in the exchange rate during the rest of the year and 2005, and its effect on the inflation of tradables and inflation expectations.
- ✘ The possible emergence of cost pressures associated with increases in the international raw materials prices and possible increases in the costs of some domestic inputs.

A synthesis of the expected trend in these variables in the short and medium term is given below.

A. International context, external demand, and exchange rate

The growth outlook for 2004 for several of Colombia's trading partners has improved in relation to the projections made in the last report (Table 1). The improvement in the terms of trade is expected to continue, fueled by strengthening world demand.

Taking into account the more favorable external environment, the balance-of-payments scenarios for 2004 show 11.2% growth (in dollars) of total exports (against 9.8% in 2003), and 7.8% growth of non-traditional exports (excluding gold and emeralds), against -3.2% in 2003. On the other side, imports grow 15.2% (compared with 9.8% in 2003) due to higher economic growth, and the trend in the exchange rate which appreciates on average about 6.0% (in nominal terms), and about 7.2% in real terms.

TABLE 1
GROWTH FORECASTS
(PERCENTAGE)

	Observed 2003	Forecast made on:			
		April 5, 2004		January 8, 2004	
		2004	2005	2004	2005
Developed countries					
United States	3.1	4.6	3.7	3.1	4.4
Eurozone	0.4	1.8	2.5	1.0	2.4
Japan	2.7	2.8	1.6	2.7	2.1
Latin America					
Argentina	8.7	6.7	4.1	7.3	5.3
Brazil	(0.2)	3.4	3.6	0.1	3.4
Chile	3.3	4.7	5.1	3.3	4.6
Mexico	1.3	3.2	3.6	1.2	3.4
Perú	4.0	3.9	3.8	4.0	3.9
Ecuador	2.6	4.7	3.8	2.6	3.9
Venezuela	(9.2)	7.1	4.2	(10.5)	6.4
Colombia's main trading partners (*)					
	1.7	4.2	3.5	1.7	4.1

(*) Growth weighted by total exports accumulated from January to October 2003. Represents 78% of total exports.
Source: Observed IMF and Datastream forecasts.

The exchange rate forecast, however, is still uncertain: in a favorable scenario with growth of external demand, favorable terms of trade, and larger flows of private capital, the exchange rate could appreciate further or depreciate slightly. This would happen with modest increases in external interest rates and in the absence of country-risk premium shocks. On the other hand, in a less favorable scenario with a sharp rise in external rates, the conditions in the external sector could deteriorate (affecting the country premium, external demand, and the terms of trade). In these circumstances, the exchange rate depreciates more rapidly this year, and nominal and real devaluation in 2005 is higher.

The central scenario used in this report assumes a higher probability of a gradual and ordered adjustment in external interest rates, which does not greatly affect capital flows into emerging economies.

B. Domestic demand and economic growth

In this international scenario, the economy continues to consolidate its recovery. The tradable sectors (mining, agriculture and manufacturing industry) benefit from the improved conditions in the external sector, and their growth in 2004 will probably be higher than last year (3.7%), despite the appreciation of the real exchange rate, which continues at high levels.

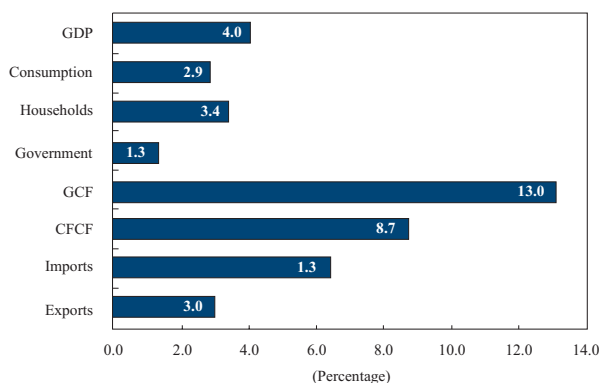
On the demand side, growth of domestic demand continues stimulating production in non-tradable sectors. The buoyancy of domestic demand in 2004 continues,

based on growth of investment, stimulated by factors of confidence and improved expectations, as well as by the expansion of capacity utilization in various sectors, and by the possible positive effects of the tax incentive for reinvestment of earnings included in the last tax reform.

Along with the strong expansion of investment in 2004, the growth rate of consumption is also expected to recover. This report forecasts growth of household consumption of around 3.4%, the highest since 1995.

In this context, GDP grows 4.0% in 2004 (Figure 13), which would not result in higher levels of inflation of non-tradable goods because of the probable persistence of a negative output gap, as indicated in the previous section.

FIGURE 13
GDP GROWTH IN 2004



GCF: gross capital formation (including change in inventories).
GFCF: gross fixed capital formation.
Source: DANE, Bank's own calculations.

IV. INFLATION FORECAST

For this report the short-term forecast (STF) for non-food inflation did not substantially change from the previous report. These forecasts, obtained from monthly time-series models and informative, non econometric models, produce non-food inflation of 5.7% and 5.5% in June and September, respectively. For food inflation, the STF to June is 5.1%, a slight increase from the previous report (5%). For September, the STF for food is 5.6%.

Based on these results, the STF for total inflation used in the transmission mechanisms model (TMM) is 5.6% and 5.7% in June and September. In the previous report, the STF for March was 5.4%.

As usual in the quarterly reports, uniequational structural models were also used. For annual inflation, the simple average of the predictions of these models gives total inflation of 5.3% in 2004. This prediction is 50 basis points (bp) lower than the last quarterly report. Using the combination of forecast methodology an even lower inflation (4.8%) is obtained. A new methodology for combining forecasts, which takes into account possible structural changes in inflation and which could be more reliable, produced an inflation of 5.5% for December 2004.

The TMM projections (Table 2) produce inflation rates of 5.7% for the end of 2004 and 4.9% for 2005, which are in line with the inflation target for this year and with the targeted range agreed by the Board for 2005 (between 3.5% and 5.5%), and consistent with stable interest rates in 2004 (certificate deposit rate, DTF, of 7.8% on average in the year). In 2005, however, the TMM suggests rises in interest rates in order to continue the downward trend in inflation in 2006. This result is related to the closing of the output gap in the next few quarters and to the predicted increase in external interest rates

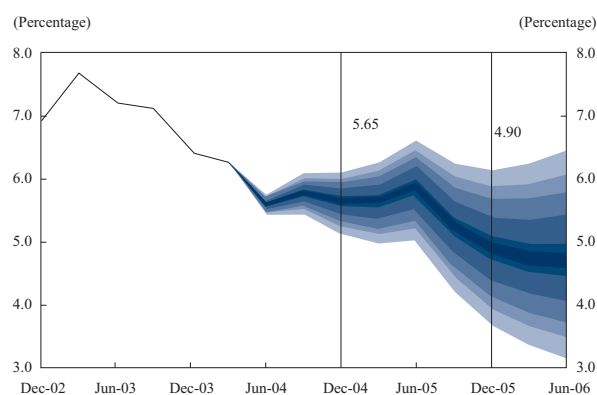
The balance of risks based on the TMM results, gives an 88% probability that inflation will end 2004 between 5% and 6% (Figure 14). For 2005, the probability of inflation below 5.5% is 79%.

TABLE 2
RESULTS OF CENTRAL MODEL (TMM)
(PERCENTAGE)

End of:	Inflation			Output Gap	DTF	Average annual devaluation
	Total	Non food	Food			
2004	5.65	5.68	5.58	(1.12)	8.16	(6.00)
2005	4.90	4.92	4.85	(0.86)	10.06	5.28
2006	4.72	4.71	4.76	(1.25)	11.02	11.32

Source: Banco de la República.

FIGURE 14
INFLATION PROBABILITY DISTRIBUTION



INFLATION PREDICTION CONFIDENCE INTERVALS

End of:	Inflation ranges					
	< 4.0%	[4.0% - 4.5%]	[4.5% - 5.0%]	[5.0% - 5.5%]	[5.5% - 6.0%]	[6.0% - 6.5%]
2004	0.0	0.0	2.0	31.3	56.8	9.7
2005	10.7	18.0	25.7	23.7	14.4	5.7

Source: Banco de la República.

In relation to the base scenario presented in the December report, the TMM produced an increase in the 2004 inflation forecast, due largely to the introduction of a STF for September much higher than that produced by the TMM three months ago, especially for food inflation. The correction of the food forecasts occurred because, in general, the Bank's models tended to underestimate observed inflation in the first quarter. The adjustment of the TMM did not significantly change the result of total inflation to 2005 with respect to the December report.

V. CONCLUSIONS

In general, inflation has followed the trends expected in the last report: tradable goods inflation declined consistent with the stabilization and later fall in the exchange rate, while non-tradables core inflation was unchanged below the target range. Only food inflation was higher than expected and, although in the next few months a downward correction is expected, the forecast for the year was revised upward (5.6% against 4.2% in the previous record).

Exchange appreciation was higher than forecast in the last report because of lower capital outflows by residents, portfolio inflows, and the ongoing improvement in export prices and volumes relative to projections. This trend in the exchange rate reduces the inflation forecasts, and results in inflation levels compatible with the ranges announced for the 2004 and 2005 targets, with lower interest rates than those projected in the December report. The continuous exchange rate appreciation in the Colombian economy since the end of last year opens the way for a loose monetary policy than the one considered in the December report. These conditions resulted in a 50 bp cut in the Bank's intervention rates in the first quarter of the year.

In the new inflation projections, based on the previous reductions in the policy rate, the path of the DTF rate projected by the TMM produces stable levels similar to the current ones, while the December report foresaw increases of 100 bp in 2004. However, in order to guarantee the downward inflation trend in the range announced for 2005 and 2006 (3.5% to 5.5%), the model projects increases in interest rates from next year. This result is related to the closing of the output gap over the next eight quarters and to the expected increase in external interest rates, especially in 2005. Given this trend in domestic interest rates, the model produces an 88% probability that inflation will end 2004 between 5% and 6%, and an 80% probability of inflation below 5.5% in 2005.

These scenarios assume a nominal average appreciation close to 6.0% in 2004 and an average depreciation of 5.0% in 2005, which would bring the nominal average exchange rate for that year close to 2,900 pesos per dollar. The 2004 projection includes the effect of the exchange rate intervention announced by the Board of the Bank of the Republic in its meeting of March 19. On that occasion the Board considered that the current episode of exchange rate appreciation was transitory, and that it would be prudent to make an additional accumulation of international reserves in case of possible reverses in capital flows, and abrupt adjustments in the exchange rate that could affect the future trend of inflation.

However, the movement of the exchange rate in 2004 and 2005 is one of the greatest sources of uncertainty in the macroeconomic forecasts. There is uncertainty

about the timing and size of the increase in the Federal Reserve rates, consistent with the sustained recovery of economic growth in the United States and with the disappearance of fears of disinflation in that economy. There are also doubts about the effect that these increases could have on capital flows into the emerging economies. This report assumes that the Federal Reserve raises its interest rates moderately in 2004, maintaining growth of external demand, a favorable level of the terms of trade, and net flows of private capital into Colombia. In 2005 much higher increases are projected in Treasury bond rates (around 200 bp).

The trend in the exchange rate in 2005 is critically dependent on the government's external borrowing policy. In the current forecast, net external borrowing by the non-financial public sector in 2005 is lower than the 2004 projection. However, in the same international scenario, if the government decides to increase its external borrowing, the trend in the exchange rate could vary substantially in relation to the base scenario (5.0% average nominal devaluation in 2005).

In the central scenario, which is the assumption used in this report, the Colombian economy continues to strengthen. Tradable goods production continues to grow in response to the favorable conditions of external demand. The recovery of domestic demand is maintained, as reflected in significant growth of production of non-tradable goods and services. These results are supported by the historically high level of the real exchange rate despite the recent appreciation, and the historically low levels of real interest rates. Accordingly, monetary conditions continue to stimulate aggregate expenditure and the gradual closure of the output gap.

The growth forecast for 2004 and 2005 (4.0%) does not result in higher levels of non-tradable goods inflation because of the persistence of a negative output gap. Although some indicators suggest a reduction in spare capacity in some sectors (such as manufacturing industry), other indicators, including the unemployment gap, indicate the persistence of spare capacity in the overall economy, especially in sectors intensive in unskilled labor. For the aggregate economy, after the Bank's recalculation of potential GDP, the average output gap in 2004 is -1.75% of potential GDP, higher than the estimate given in the last report (-1.36%).

The monetary policy stance over the next eight quarters will depend largely on the speed of reduction of the output gap in the context of faster economic growth and its possible effect on inflation in the non-tradable sectors, as well as on the expected trend in the exchange rate for the rest of 2004 and 2005 and its effect on tradables inflation and inflation expectations. Monetary policy must also take into account the possible emergence of cost pressures associated with increases in international prices of raw materials and the costs of some domestic inputs.

Based on these considerations, at its meeting of April 23, the Board decided not to change its intervention rates and announced a new options auction for US\$250 million to accumulate international reserves.

Board of Directors of Banco de la República



INFLATION REPORT

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I. THE CURRENT ECONOMIC SITUATION

Economic growth is taking place at a higher rate than expected in the previous report, without causing inflationary pressures.

In late 2003 and early 2004 the Colombian economy continued to recover. In the fourth quarter, economic growth was 4.5% annually. The available sectoral information suggests that in the first quarter of 2004 this growth rate was similar or even higher. The growth continues to be fueled mainly by private investment, but external demand is gaining ground following the pickup in exports to the United States and Venezuela. The first-quarter indicators also suggest that household consumption has begun to play a more important role in economic expansion, something not seen since 1997.

Household consumption has begun to play a more important role in economic expansion.

Economic recovery is due to several external and internal factors. On the external front, the recovery of the world economy, headed by the growth of the US economy, tended to consolidate strengthen early in the year. This development was accompanied by increases in the prices of several of Colombia's main export products and by stronger demand in its main trading partners in the Andean subregion, leading to an improvement in the trade balance. Domestically, growth was stimulated, among other factors, by an expansionary monetary policy whose main result has been the maintenance of historically low real market interest rates. The climate of confidence is also improving and is beginning to be comparable to the findings of business opinion surveys before 1998.

The higher growth rate has been accompanied by a stronger appreciation of the exchange rate than the forecast given in the last report.

The higher growth rate has been accompanied by a stronger appreciation of the exchange rate than the forecast given in the last report. In addition to the expansion of exports, the appreciation was due to an increase in net capital inflows from January. This phenomenon had already been observed in other regional economies (Chile and Brazil, for example), and is related to the existence of broad international liquidity, a low risk perception by the markets, and a return

Annual consumer inflation fell as a result of the strong downward correction in inflation mainly in the tradables sector.

differential favorable to investments in emerging economies. In fact, the increased capital flows did not reach Colombia to any extent until late last year.

In this context, annual consumer inflation fell from 6.5% in December to 6.2% in March, as a result of the strong downward correction in inflation mainly in the tradables sector. Unexpected pressure on primary food prices and the still high levels of inflation of regulated goods and services, including fuel, prevented total inflation from falling even further. Non-tradables inflation remained at the levels of the last quarter due to rapid economic growth, which suggests that there is still significant spare capacity in the economy.

Given the deepening of exchange appreciation, which should reduce inflationary pressures in the medium term, and taking into account the absence of important demand-pull inflation, the Board cut intervention interest rate by 50 basis points (bp) in the first quarter. The Board also announced the holding of reserve accumulation auctions for US\$700 million from March, with sterilization of up to 50.0% of the amounts purchased. The measure was intended to keep monetary expansion in line with the 2004 inflation target, and in the range announced for the 2005 target.

A. GROWTH, PRICES AND INTERNATIONAL INTEREST RATES

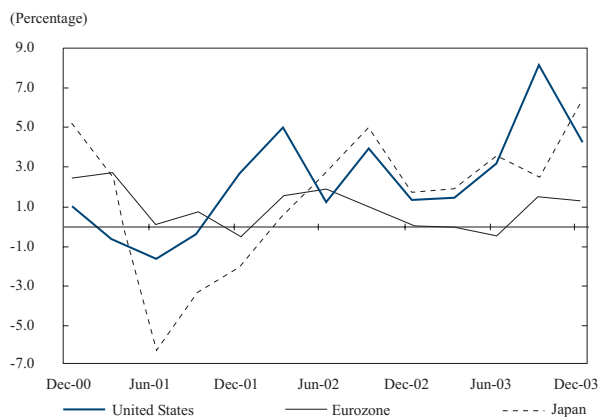
The latest data indicates that world economic activity in the first quarter of the year continued to make headway, and the current outlook is better than expected three months ago. The economic recovery in the United States and Japan has been evident,

while the Eurozone economy continues to growth slowly (Figure 1). In Asia, the strong expansion continued, especially in China; while in Latin America good external financing conditions remained during the quarter. International commodity prices rose steadily stimulated by the strong growth of the world economy.

In the United States, GDP expanded at an annual rate of 3.1% in 2003, fuelled by the recovery of private investment, which in previous years had had a negative effect, while private consumption maintained its growth. The indicators showed that the economy has remained strong so far this year. Industrial production speeded up 4% in the March quarter above the value of one year ago, a growth rate not seen since mid-2000. Also, installed capacity utilization expanded in the first quarter, although it is still at historically low levels.

FIGURE 1

QUARTERLY ANNUALIZED GROWTH OF GDP UNITED STATES, EUROZONE AND JAPAN



Source: Datastream.

In contrast, the Eurozone recovered moderately with 0.4% growth last year (lower than the 1.0% expected by the market three months ago); notably net exports grew despite the appreciation of the euro. Domestic consumption remained weak; the key indicators for this year show that the recovery is not yet across the board. As the April *European Central Bank Monthly Bulletin* reports, while industrial production fell again in January, after growing in the last quarter of 2003, retail sales increased significantly in the month. The unemployment rate in the zone was unchanged at 8.8% in the quarter (February data).

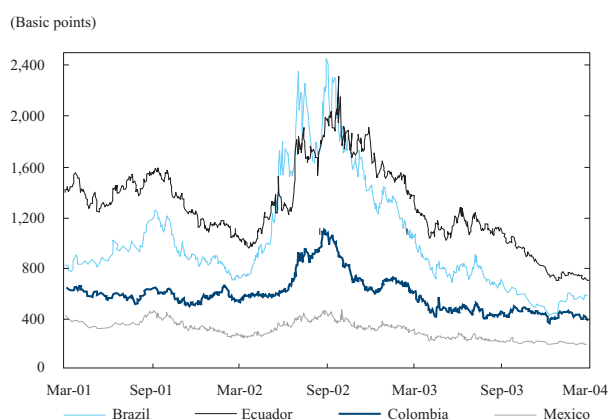
The Japanese economy grew 2.7% in 2003, stimulated by domestic and external demand. It seems that the strong growth of the export sector, especially to China and the rest of Asia, has begun to have an impact on domestic economic activity, so investment and private consumption have increased. In the rest of Asia, robust growth continues, particularly in China whose economy expanded at an annual rate of 9.1% in 2003 and 9.7% in the first quarter of 2004.

In Latin America the favorable external financing conditions continued in the first quarter of the year, as a result of the low interest rates in developed countries, vigorous world demand and higher international prices. In this context, country-risk premiums and exchange rates remained at low levels in the quarter (Figure 2 and Table 1). Ecuador and Venezuela - Colombia's main trading partners in the region - grew -9.2% and +2.6% in 2003, respectively. So far this year, both countries have been favored by high oil prices, although they still face problems of political instability. Ecuador has been favored by the opening of a new oil pipeline.

In the first quarter of the year, total inflation in the United States did not change significantly, ending March at 1.7%; in contrast, core inflation rose sharply to 1.6% in the month. This trend created great uncertainty in the market about possible moves by the Federal Reserve to increase interest rates. Inflation in the Eurozone and Japan was substantially unchanged in relation to three months before. In most Latin American countries inflation fell between December and March, particularly in Chile where March inflation was -0.7%, apparently due to strong exchange appreciation in the second half of 2003.

FIGURE 2

COUNTRY RISK PREMIUM
EMBI+ LATIN AMERICAN COUNTRIES



Source: Bloomberg.

TABLE 1

DEVALUATION OF LATIN AMERICAN
CURRENCIES AGAINST THE US\$

	Quarterly (*)	Annual end of March 2003
Argentina	(2.6)	(3.8)
Brazil	0.2	(13.6)
Chile	3.2	(16.5)
Colombia	(3.6)	(9.5)
Mexico	(1.0)	3.4
Peru	(0.1)	(0.5)
Uruguay	1.3	2.9

(*) Relates to March devaluation vs. December (end of period).
Source: Datastream.

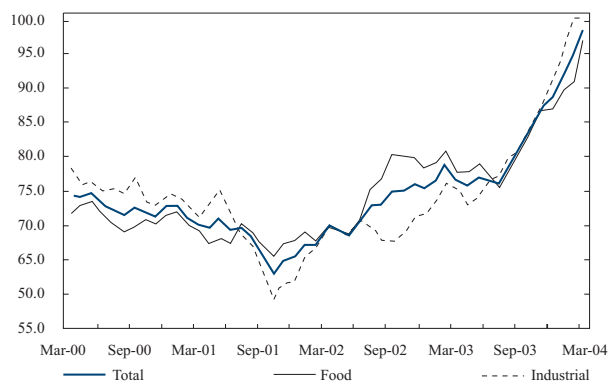
The international prices of Colombia's export goods continued to rise.

Contrary to the inflation trend, international commodity prices continued their rise in the first quarter in response to the strong growth of the world economy and, in the case of some cereals, to unfavorable climatic conditions which reduced supply, as evidenced by *The Economist* price index, which gained 10.9% between December and March. The increase affected both food and industrial goods, whose prices grew 11.5% and 10.1%, respectively (Figure 3).

The international prices of Colombia's export goods continued to rise, which favored the terms of trade. In the first quarter, coal, nickel and gold prices all rose in relation to the last quarter of 2003 (Figure 4). The high levels of international oil prices persisted in the quarter, especially in March when they overtook US\$38 per barrel (WTI). The trend in crude prices was due to low stocks in the United States, the slow recovery of Iraqi production, and strong demand especially in the United States and Asia. The Organization of Petroleum Exporting Countries (OPEC) decided to cut its production quotas by one million barrels per day from April. Most OPEC member countries are producing at full strength leaving very little capacity to respond to unexpected demand shocks, which has generated great uncertainty among market agents. The average price of WTI crude was US\$35.2 per barrel in the first quarter, higher than expected three months ago. Lastly, international coffee prices have trended upward this year, averaging 78.3 US cents/pound.

FIGURE 3

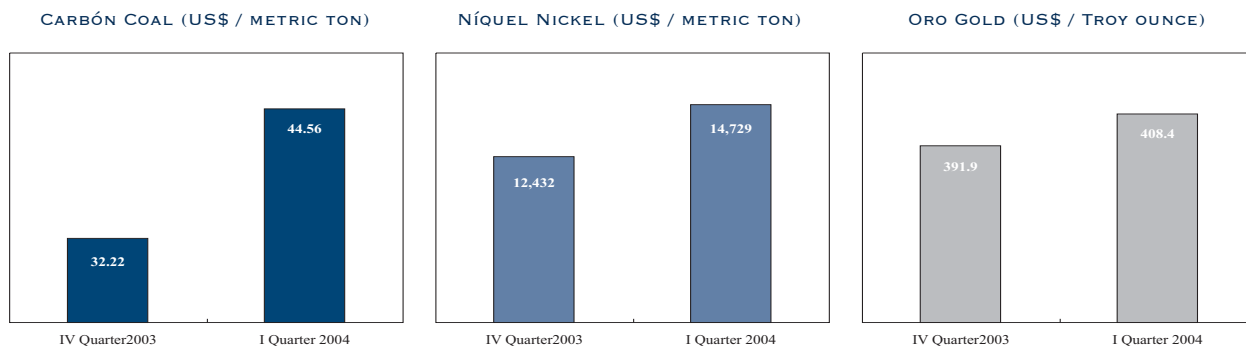
MONTHLY PRICE INDEX OF MAIN COMMODITIES (1995=100)



Source: *The Economist*.

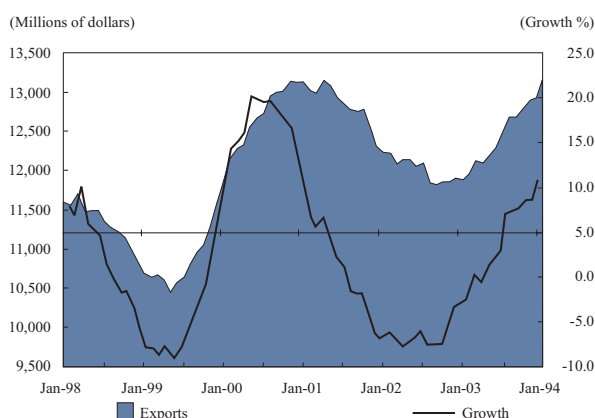
TABLE 4

AVERAGE INTERNATIONAL PRICES



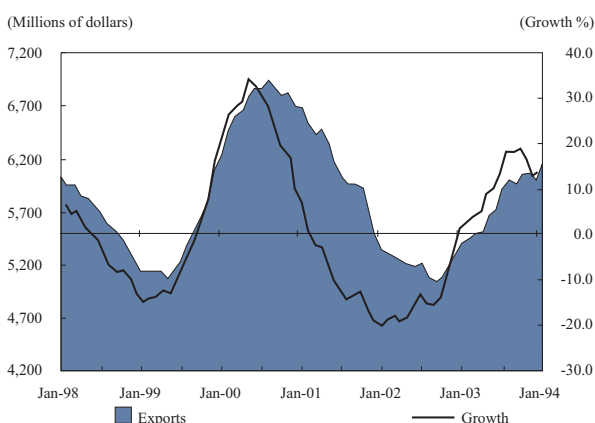
Source: World Bank. Pinksheet. April 2004

TOTAL EXPORTS
(LAST 12 MONTHS)



Source: DANE.

TRADITIONAL EXPORTS
(LAST 12 MONTHS)



Source: DANE.

B. TRADABLE GOODS PRODUCTION

The growth rate of total exports increased in a context of a high commodity prices and buoyant world demand (Figure 5).

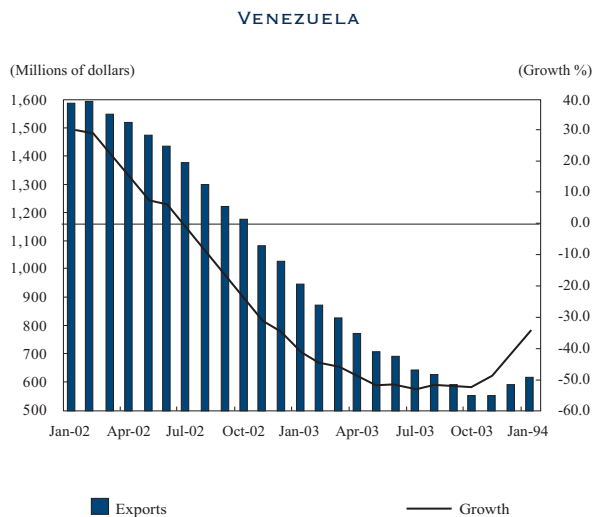
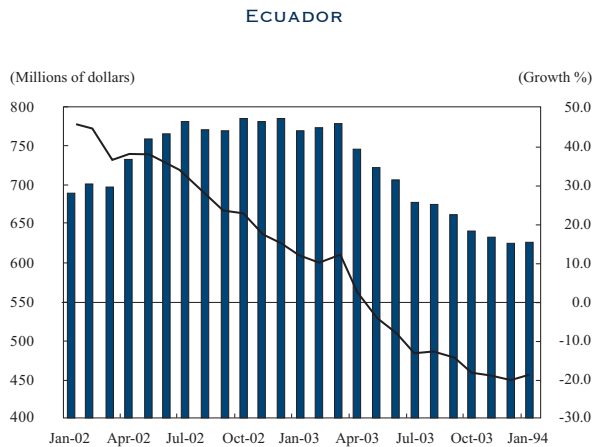
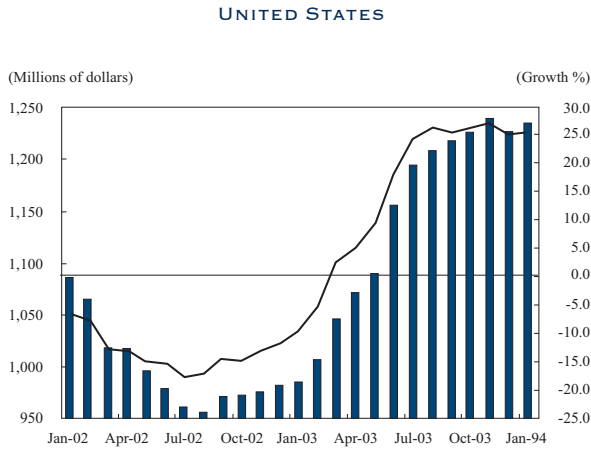
The good performance of traditional exports (Figure 6) is explained by the trend in coffee, coal and gold exports. The growth of coal and gold sales in January is in line with the balance-of-payments forecast presented in the previous report. In the case of coffee exports in the first quarter, Federación Nacional de Cafeteros de Colombia (the National Coffee Growers Federation) reported that the number of sacks exported rose 20.0% against the same period last year. This growth differs from the forecast in the balance of payments for the full year (1.0%). If this trend extends into the second quarter, the forecast will have to be revised upward.

Non-traditional exports recovered on the figures available to January, while non-traditional industrial exports, exports to United States and the other trading partners continue to grow strongly. Exports to Ecuador seem to have touched bottom, and the Venezuelan market is beginning to recover its levels, as anticipated in the last report (Figure 7).

The growth rate of total exports increased.

FIGURE 7

NON-TRADITIONAL INDUSTRIAL EXPORTS
(LAST 12 MONTHS)



Source: DANE.

The good performance of traditional exports throughout 2003 and the high level of the real exchange rate was reflected in the recovery of tradable sector production, especially mining which expanded 11.0% (Table 2), and some branches of manufacturing industry such as textiles, clothing and wood products.

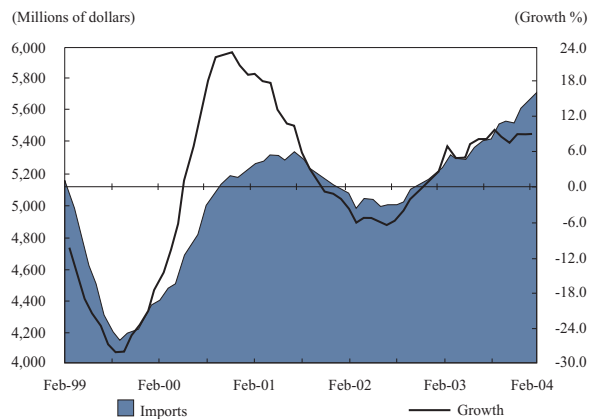
In manufacturing, the survey of the National Association of Industries (ANDI) showed a significant rise in production in the first two months of the year. The Fedesarrollo survey found that orders were at their highest point since 1994, while the inventories indicator was at its lowest level since 1994. Another indicator of manufacturing production - imports of intermediate industrial goods - grew over 10% in the last 12 months, a level similar to early 1998 (Figure 8).

C. EXCHANGE RATE

The appreciation trend in late 2003 intensified in 2004. The exchange rate, which in December stood at 2,778 pesos per dollar, had fallen by the end of March to 2,676

FIGURE 8

IMPORTS OF INTERMEDIATE
INDUSTRIAL GOODS
(LAST 12 MONTHS)



Source: DANE.

ANNUAL GROWTH OF QUARTERLY GDP BY BRANCH OF ACTIVITY, 2003 (PR)
(ANNUAL PERCENTAGE CHANGES)

Branch of activity	Quarter				Annual
	I	II	III	IV	
Agriculture, forestry, hunting and fishing	2.39	(0.42)	4.09	3.50	2.37
Mining and quarry production	(0.46)	18.57	21.88	5.45	11.04
Electricity, gas and water	3.54	2.19	3.34	4.05	3.28
Manufacturing industry	8.21	1.11	3.59	4.22	4.24
Construction	15.19	5.87	11.10	14.53	11.61
Buildings	8.43	19.93	22.04	25.57	19.19
Civil works	24.61	(9.73)	(1.20)	1.05	2.51
Commerce, repairs, restaurants and hotels	5.26	3.49	5.64	5.15	4.89
Transport, storage and communications	5.11	3.22	4.85	5.49	4.67
Finance, insurance and real estate	5.49	3.97	5.29	2.92	4.40
Social, community and personal services	0.95	1.05	0.55	3.14	1.42
Gross domestic product	4.12	2.22	4.14	4.49	3.74

(pr) Preliminary.
Source: DANE.

pesos and in the third week of April to around 2,640 pesos (Figure 9).

Several factors, which were present in the second half of 2003, strengthened the Colombian peso:

- ✘ The weakening of the dollar against the euro and other currencies, given the low interest rates in the United States and uncertainty about economic reactivation. This trend persisted in the first quarter, although the dollar regained some ground against the euro in March.
- ✘ The attractive return still offered by some of the paper denominated in pesos, especially public debt bonds, despite the price rises from February.
- ✘ The improved outlook for growth of the economy, along with a recovery in the terms of trade.
- ✘ The good performance of Colombian exports at the beginning of the year, which, in some cases, as such as coal and non-traditional exports, outstripped initial projections.
- ✘ Increase in remittances from Colombians resident abroad and other current transfers since 2003.

FIGURE 9

EXCHANGE RATE
REPRESENTATIVE MARKET RATE



Source: Banco de la República.

It can be presumed that without the intervention the exchange rate would have been substantially lower

Thanks to the higher TES interest rates and expectations of appreciation, in the early part of this year there was a small inflow of short-term portfolio investments, which increased supplies of foreign exchange. Local investors were more willing to borrow abroad in the short term and there were signs that the net short-term external debt had recently increased.

As a result, in the first quarter of the year the net supply of foreign exchange from operations by the productive sector increased US\$906 million from the same period of 2003. This net supply, which results mainly from operations associated with the capital account, was largely absorbed by the Bank through put options for accumulation of international reserves (US\$400 million) and by the General Treasury of the Nation through the exchange market (US\$226.5 million). Exchange market intermediaries (IMC) increased their own cash position by US\$78 million. It can be presumed that without the intervention by the Bank and the Treasury, the exchange rate would have been substantially lower (Table 3).

TABLE 3

BANK'S OWN CASH POSITION AND EXCHANGE FLOWS
(MILLIONS OF DOLLARS)

	2003	2003			Accumulated	
	Accumulated	January	February	March	march 2003	
Change in cash position of exchange market intermediaries	321	33	(80)	113	66	
Foreign exchange trading by Bank 1/	238	0	0	145	145	
Foreign exchange trading by Treasury (TGN) 1/	123	120	3	0	123	
Change in cash position of foreign exchange market intermediaries	38	0	0	0	0	
Net purchases of productive sector	(78)	(87)	(83)	(31)	(201)	
Current account	1,368	78	112	39	230	
Capital account	(1,624)	(233)	(121)	(134)	(488)	
Statistical errors and/or omissions 2/	178	67	(74)	63	57	
		2004			Accumulated	Change
		January	February	March	march 2004	march 2004-2003
Change in cash position of exchange market intermediaries	(120)	38	160	78	12	
Foreign exchange trading by Bank 1/	(400)	0	0	(400)	(545)	
Foreign exchange trading of Treasury 1/	(28)	(47)	(153)	(227)	(350)	
Other changes in cash position of foreign exchange market intermediaries	0	0	0	0	0	
Net purchases by productive sector	308	84	312	704	906	
Current account	7	161	220	388	158	
Capital account	258	(74)	(2)	182	669	
Statistical errors and/or omissions 2/	43	(2)	94	135	78	

(pr) Preliminary.

1/ The positive sign defines the sale of foreign exchange by the Bank (call options) or the Treasury; the negative sign defines foreign exchange purchases by the Bank (put options) or the Treasury.

2/ Foreign exchange flows not reported on the current or capital accounts of the exchange balance, and changes in cash position not reflected in exchange flows and which have not been identified.
Source: Bank of the Republic, Exchange Balance.

D. DOMESTIC DEMAND AND NON-TRADABLE GOODS PRODUCTION

Household consumption in the second half of 2003, especially in the fourth quarter, was favored by low real interest rates, better economic conditions, a lower perception of risk, and the expansion of credit (Table 4). The recovery of private consumption is attributable mainly to non-durable goods which recovered at a higher rate than population growth.

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These conditions extended into the first quarter of 2004, while the wealth effects continued to increase thanks to the fall in the country-risk premium of the external debt, the favorable trend in share prices, and the upturn in real estate prices. Labor market conditions also improved as suggested by the decline in the sub-employment rate (Figure 10). All these factors were accompanied by improved consumer confidence (Figure 11).

Fixed investment grew strongly in 2003 (13.1%), thanks to better perception by the business sector of the political and economic conditions for investment (Figure 12), the recovery of the financial system, increased capital inflows and higher corporate earnings. In the early months of this year, other factors came into play,

TABLE 4

ANNUAL GDP GROWTH ON DEMAND SIDE, 2003
PERCENTAGE CHANGE

	Quarter				Annual
	I	II	III	IV	
Gross domestic product	4.12	2.22	4.14	4.49	3.74
Total imports	18.91	1.03	10.65	8.60	9.54
File consumption	1.57	1.32	1.94	3.63	2.12
Households 1/	1.93	1.48	2.64	3.48	2.39
Final domestic consumption households 2/	2.16	1.47	2.45	3.38	2.36
Non-durable	0.96	(1.34)	1.55	2.16	0.83
Semi-durable	0.12	5.22	2.28	3.46	2.76
Services	2.90	2.97	2.87	2.52	2.81
Durable	8.40	3.71	5.48	18.06	8.92
Government	0.55	0.85	(0.05)	4.08	1.35
Gross capital formation	47.21	5.16	16.04	13.72	18.67
Gross fixed capital formation	19.03	5.73	12.68	15.48	13.12
Agriculture, forestry, hunting and fishing	0.30	(0.82)	(4.86)	(0.64)	(1.54)
Machinery and equipment	21.82	10.10	22.34	26.78	20.43
Transport equipment	57.53	(9.55)	(2.50)	(7.80)	5.07
Buildings	8.65	20.04	22.29	25.97	19.38
Civil works	24.66	(9.64)	(1.17)	0.95	2.51
Subtotal: final domestic demand	7.42	1.93	4.30	5.40	4.73
Total exports	0.32	2.59	10.18	3.88	4.17
Total final demand	6.26	2.04	5.18	5.17	4.65

(p) Provisional

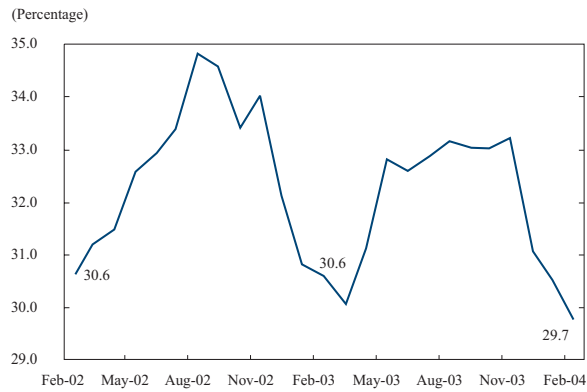
1/ Includes goods purchased by residents made abroad and excludes purchases by non-residents made in Colombia.

2/ Final consumption of resident households made in Colombia.

Source: DANE.

FIGURE 10

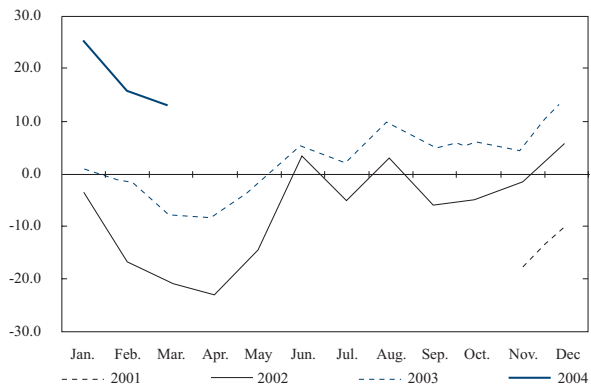
SUB-EMPLOYMENT RATE - 13 CITIES
NEW METHODOLOGY



Source: DANE.

FIGURE 11

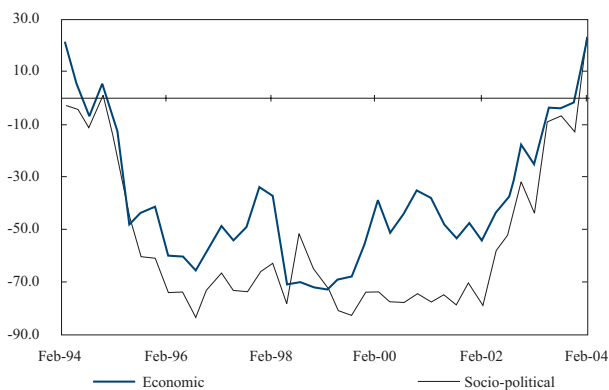
CONSUMER CONFIDENCE INDEX



Fuente: Fedesarrollo.

FIGURE 12

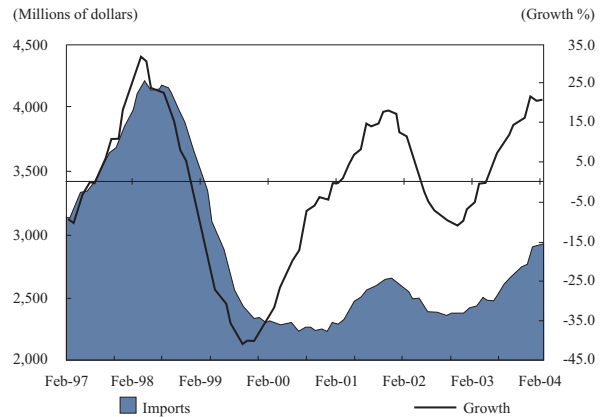
CONDITIONS FOR INDUSTRIAL INVESTMENT
(BALANCES)



Source: Fedesarrollo.

FIGURE 13

IMPORTS OF INDUSTRIAL
CAPITAL GOODS
(LAST 12 MONTHS)



Source: DANE.

including greater access to finance alternatives (such as corporate bond issues) and tax incentives for earnings reinvestment¹. The information available to February on imports of capital goods for industry shows that investment spending continued to grow (Figure 13).

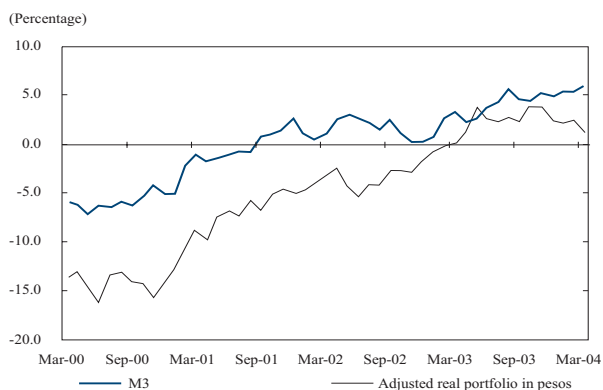
As a result of buoyant domestic demand and growth of GDP, non-tradables production speeded up in the second half of 2003, especially construction, commerce, transport and the financial sector (Table 2), which has probably extended into the first quarter of 2004.

E. MONEY AND CREDIT MARKETS

As mentioned in the last report, in recent years monetary policy has permitted historically low real interest rates, which facilitated the recovery of aggregate expenditure and credit, in a context of falling inflation. As Figure 14 shows, the loose monetary policy is reflected in

¹ According to Article 68 of the latest tax reform (Law 868 of 2003), taxpayers may deduct 30% of the value of their investment in real productive assets.

**M3 AND GROSS ADJUSTED PORTFOLIO IN PESOS
(PERCENTAGE REAL ANNUAL GROWTH)**



Source: Banco de la República.

positive expansion of M3 since the second half of 2001; even so, lending only began to recover in real terms in 2003.

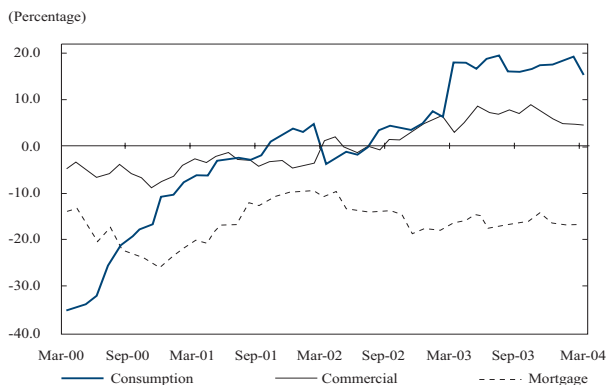
However, so far this year growth of lending has been slowing, especially commercial and mortgage loans, although consumer credit has an upward trend (Figure 15). The weakness of commercial loans probably reflects increased use of the earnings generated by the productive sector. There is also evidence of growing net external borrowing, and the expansion of financing through corporate bond issues.

On the other side, in the first quarter monetary aggregates (base and M1) expanded at annual rates of 10.3% and 12.0%, respectively, against 17.6% and 20.3% in the same period 2003 (Figure 16). The Bank's broad provision of liquidity through its instruments such as expansion repos, TES purchases and accumulation reserves, kept interest rates at historical lows (Figure 17).

TES prices have recovered significantly since the fourth quarter of 2003 (Figure 18), associated with the appreciation of the peso against the dollar, falling inflation and its expectations, and the improvement of the economic outlook on the domestic and external fronts. The low interest rates prevailing in the United States and Europe have also encouraged growing demand for domestic paper from foreign and local investors, pressuring prices up and interest rates down.

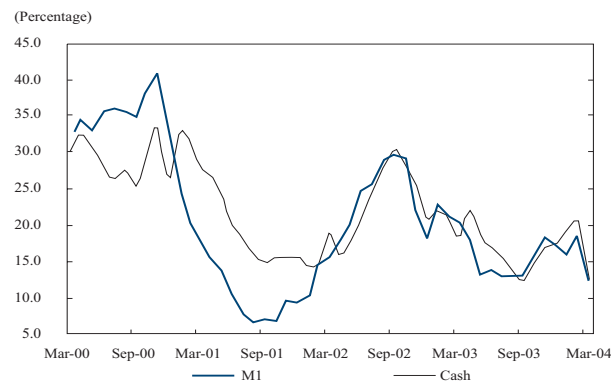
In the last weeks of April, TES rates rose cautiously, especially longer-dated instruments. This upward trend in the yield curve seems to be associated with the peaking of the yield curve of US Treasury bonds, reflecting expectations of growth in their short-term rates. Market nervousness about these developments has recently resulted in a spurt in the country-risk premium of the debt of the regional economies.

**GROSS REAL PORTFOLIO IN PESOS, BY TYPE OF LOAN
(ANNUAL GROWTH)**



Note: the information at March 2004 is provisional.

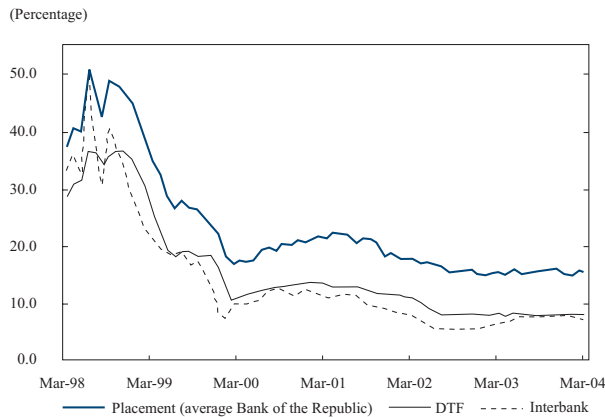
**M1 AND CASH
(ANNUAL GROWTH RATES OF MONTHLY AVERAGE)**



Source: Banco de la República.

FIGURE 17

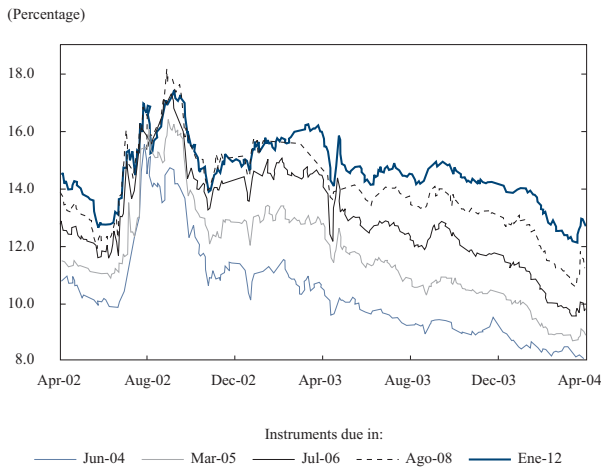
NOMINAL INTEREST RATES



Fuente: Banco de la República y Superintendencia Bancaria.

FIGURE 18

NOMINAL INTEREST RATES
TES PAPER ON SECONDARY MARKET



Source: Banco de la República.

F. SPARE CAPACITY

A key aspect of the evaluation of the current inflationary situation is to determine how long the economy can expand at the present rate and even higher without generating inflationary pressures that endanger the inflation targets. To do this, the Bank uses various measures of capacity utilization. At present, some of these measures suggest a significant closing of the output gap, while others indicate the existence of considerable spare capacity.

The first group of measures contains the Fedesarrollo and ANDI surveys, which found that the installed capacity utilization (ICU) of companies continued to expand. In both series, the February ICU rose to their respective historical averages for the first time since 1997 (Figure 19). Although this is a substantial reduction in spare capacity, it cannot be considered as convincing evidence for anticipating the emergence of demand-pull inflation in the short term. When the average level of ICU is calculated throughout the sample, the results of the last five years' observations have to be taken into account. As these have been systematically lower than the mean, they affected the measurement of the average throughout the sample (the historical average of the

ICU from 1981 to 2000 was 71.7% vs. 71.2% in the 1981 to 2004 period.). To obtain a better approximation of the historical ICU for the Fedesarrollo indicator, an interval was constructed around the historical average of the 1986-2004 series. For this time period, the mean fluctuated between 70.5% and 72.7%. Thus, the level of ICU which the Fedesarrollo series recorded in February 2004 (71.3%) was situated in the lower part of the constructed interval, indicating that the manufacturing sector still has room to increase its ICU without generating pressure on prices (Figure 19).

An indirect indicator that suggests a contraction of spare capacity is the percentage of industrial firms that consider that their main problem for expanding production

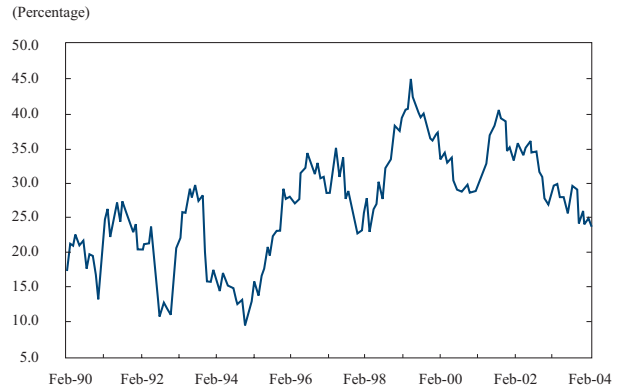
is lack of demand, as measured by the survey. In February 2004, this indicator continued to fall sharply, reaching its lowest level since 1997 (Figure 20).

However, the latest results of the Fedesarrollo investment survey² show a recovery of corporate investment spending since 2000, compared with the 1996-1999 period (Figure 21). Also, 35% of the company's surveyed said they had developed

² Fedesarrollo included a set of special questions on investment in manufacturing industry in its January business opinion survey. Information is available since 1989.

FIGURE 20

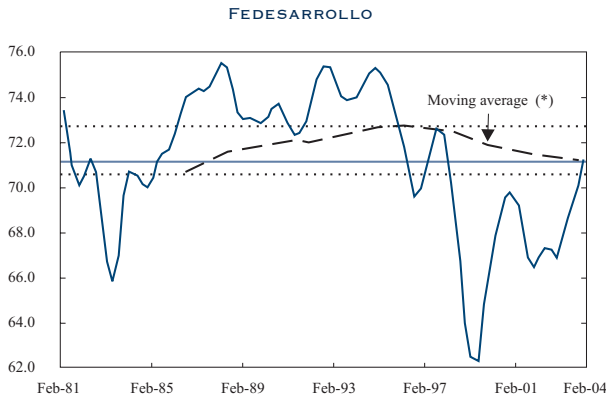
INDICATOR OF INSUFFICIENCY OF DEMAND (*)
MEASURED BY ANDI



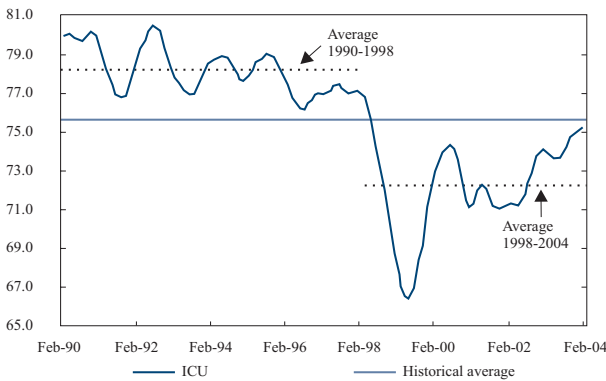
(*) Percentage of industrial firms that consider that lack of demand is their main problem for expanding production.
Source: ANDI.

FIGURE 19

INSTALLED CAPACITY UTILIZATION
(TREND COMPONENT)



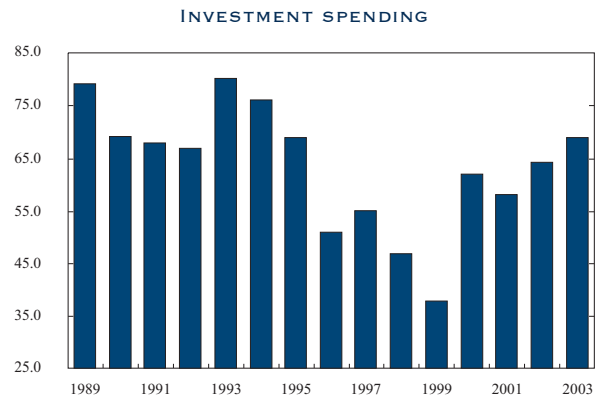
ANDI



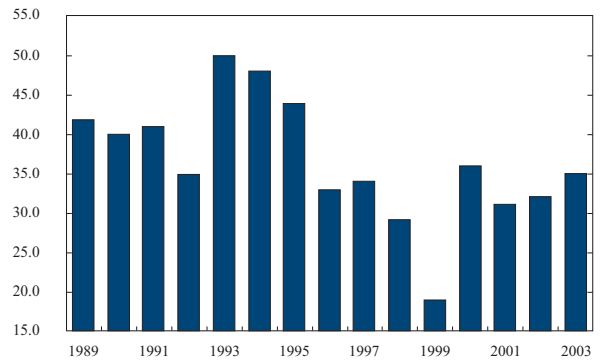
(*) Calculated as: $\frac{\sum_{1981}^n UCI}{\# \text{ de observaciones.}}$, where n is 1986, 1987, ... 2004, with quarterly frequency.
Source: Fedesarrollo and ANDI, Bank's own calculations.

FIGURE 21

INVESTMENT SPENDING AND OUTPUT CAPACITY
WITH RESPECT TO PREVIOUS YEAR



PRODUCTION CAPACITY



Source: Fedesarrollo, EOE - Investment Module.

The output gap closes during the year more slowly than was predicted in the previous report.

investment projects to expand their production capacity in 2003. Thus, it could be expected that the stronger demand is being accompanied by an expansion of output capacity.

The estimate of the output gap was modified from the figure in the previous report. On this occasion the Bank of the Republic recalculated the growth rate of potential GDP for 2004, using a production function model and considering new studies of the natural rate of unemployment and stable-inflation capacity utilization (see Box). For this year growth of potential GDP is estimated at 3.6% (against 3.0% in the December report), which closes the output gap during the year more slowly than was predicted in the previous report.

Taking into account the uncertainty associated with the estimate of the output gap, the Bank uses other tools and indicators. The results of these exercises also indicate that the economy will continue to operate below its potential in 2004.

To March, the exchange rate maintained its fundamental role in reducing consumer inflation.

G. CURRENT INFLATIONARY PRESSURES

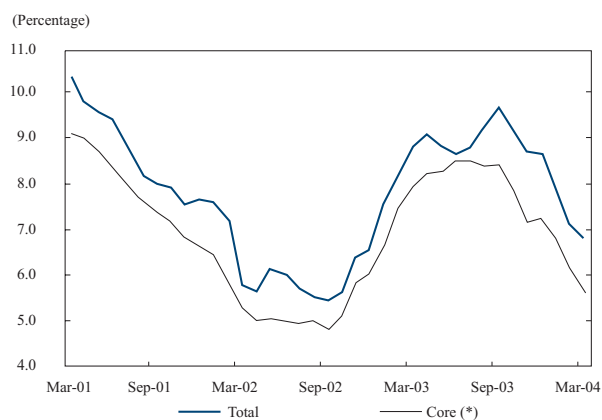
Based on the analysis presented in the preceding sections, inflation in the quarter continued to respond to several factors:

- ⌘ Stability of the exchange rate in the second half of 2003 and its appreciation in early 2004.
- ⌘ Higher economic growth in a context of ample spare capacity.
- ⌘ Supply shocks at the level of primary food and prices of regulated goods services.
- ⌘ High international prices of some products imported by Colombia, especially food.
- ⌘ Declining inflation expectations.
- ⌘ Weak cost-push from wages.

To March, the exchange rate maintained its fundamental role in reducing consumer inflation. Exchange stability in the second half of 2003 continued its pass-through to consumer prices via lower tradables inflation. Total tradables inflation dropped from 8.7% in December 2003 to 6.8% in March 2004, while tradables core

FIGURE 22

TRADABLES INFLATION



(*) Excluding food prices and prices of regulated goods and services.
Source: DANE, Bank's own calculations.

inflation (excluding food and unregulated prices) dropped from 7.3% to 5.6% in the same period (Figure 22). The appreciation in the last three months may have deepened this trend, although given the lags between exchange rate movements and consumer prices, the pass-through will probably take place over the next two or three quarters. The exchange rate has also had an impact on the PPI import inflation, continuing the same pattern but with a more accentuated trend.

Since the level of annual tradables inflation is close to the level of June 2002 (6.0% for the total and 5.0% excluding food and regulated prices), the pass-through of accumulated devaluation between the second half of 2002 and the first of 2003 is nearly complete. If any steep falls occur in tradables inflation in the next few months, they would be associated with the recent appreciation of the exchange rate.

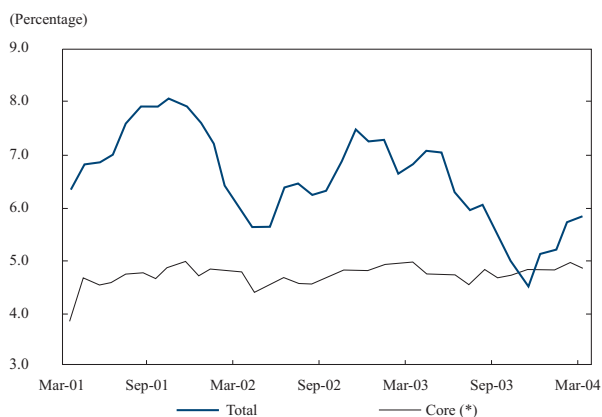
The spare capacity contributed to maintaining stable non-tradables inflation, excluding food prices and prices of regulated goods services (non-tradables core inflation); including these latter items, non-tradables inflation increased from November. However, this surge was temporary because it depended on the increase in primary food prices, as discussed later (Figure 23).

Until December 2003 two trends were distinguishable in the non-tradables group. First, annual rental inflation rose from mid-2001 in response to the reactivation of demand for housing and the stagnation of construction in previous years. Second, inflation of the rest of the non-tradables (not including food), after falling for several consecutive years, stabilized in 2003 at levels close to 5.0%. So far in 2004, however, annual rental inflation has not increased and remains at levels under 4.0%, below the forecast, while the inflation of the other non-tradables has marginally increased

The fall in tradables inflation and the stability of non-tradables inflation resulted in a decline in the core inflation indicators calculated by the Bank in the first quarter of 2004. The indicator that decreased most was the “nucleus inflation,” which fell from 7.9% in December to 6.5% in March. Meanwhile, non-food inflation and inflation excluding primary food, fuel and public services was situated at levels 6.1% of 5.6%, respectively, down around 1.0 and 0.9 percentage points. Overall, the core inflation indicators have continued to approach the inflation target range

FIGURE 23

NON-TRADABLES INFLATION



(*) Excluding food prices and prices of regulated goods and services.
Source: DANE, Bank's own calculations.

The spare capacity contributed to maintaining stable non-tradables inflation

The fall in tradables inflation and the stability of non-tradables inflation resulted in a decline in the core inflation indicators.

A source of cost-push inflation was the increase in the international prices of imported products, especially foods.

for 2004 (6.0% average in March 2004). This decline in all core indicators reflects, first, the effect of the exchange rate on tradable goods and, second, the weak inflationary pressures generated on the demand side.

The effect of these trends on total inflation was partially neutralized by price shocks on primary food and regulated goods and service services, not all of them completely predicted in the previous report. The unforeseen shocks included the higher prices of some primary foods – mostly vegetables (excluding potatoes), fruit and green vegetables - whose supply contracted more than normal because of low prices in the middle of last year. Education inflation also increased more than expected, apparently due to the introduction of the new tariff regulation regime for primary and secondary private education (Decree 2253 of 1995). In the previous report, the effect of this item was expected to

appear from 2005, given the methodology used by the National Statistical Administrative Department (DANE) to measure price increases in this sector (consulting the transition, fifth, eighth and tenth grade courses).

The prices of the rest of the regulated goods and services (fuel, transport and public services) continued to affect total inflation to a degree similar to the forecast. For all these sub-groups, annual inflation stayed very close to the target, although with a downward trend so far this year for public services. The largest share in the fall in inflation in this group was gas, whose annual inflation fell from 17.6% in December 2003 to 2.3% in March 2004. In contrast, the inflation of regulated public transport rose more than in March (11.0%) (Figures 24 and 25).

Another source of cost-push inflation was the increase in the international prices of imported products, especially foods such as cereals and oils. These hikes are additional to those presented in 2003 which affected consumer inflation at that time. By March, the impact of the shock had been partially offset by the appreciation of the exchange rate. However, part of the increase in external prices seems to have been transmitted to consumer prices, because their annual inflation remained at high levels in March (cereals 9.3% and oils and fats 7.8%), overtaking the forecast in the December report.

A number of indicators show a significant decline in inflation expectations for the end of 2004; for example, the Bank's quarterly expectations survey (see the

FIGURE 24

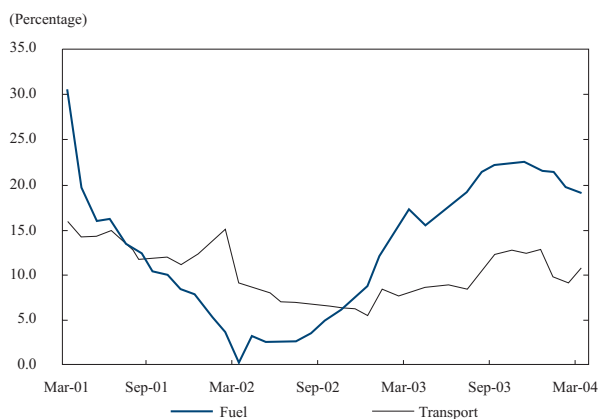
ANNUAL INFLATION OF PUBLIC SERVICES



Source: DANE, Bank's own calculations.

FIGURE 25

ANNUAL INFLATION OF FUEL AND TRANSPORT



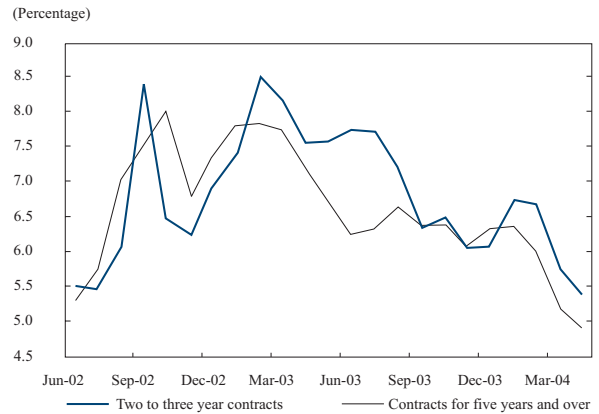
Source: DANE, Bank's own calculations.

Summary), and the estimate taken from the difference between TES-UVR rates and the fixed rate. In relation to the second indicator, the differential to March dropped below observed inflation for the first time since this information was available (Figure 26). Similarly, the Bank's monthly stockbrokers survey reveals declining expectations for December this year, which are already below 6.0%. Even so, the information to March still shows strong seasonality in core inflation in the first quarter, which suggests that the indexation mechanisms are still active and that inflation inertia is still high.

Lastly, with the information available to the end of 2003, wage growth did not present a problem for reducing inflation. To December, unit labor cost had fallen slightly according to the information from the DANE monthly manufacturing sample. In particular, real unit labor cost was 96.7%, down 4.5% from the level in December 2002 (Figure 27). Nominal wage growth above the inflation target was probably accommodated by increasing productivity, and did not generate additional inflationary pressures through industrial labor costs.

FIGURE 26

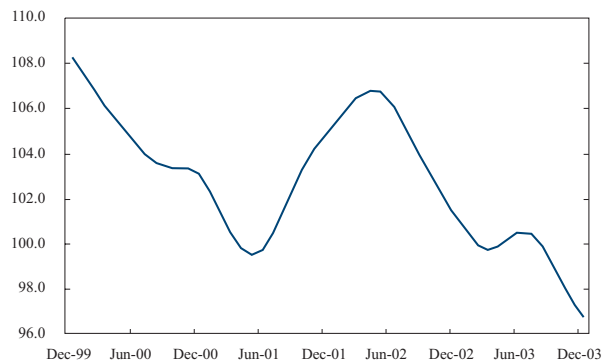
INFLATION EXPECTATIONS DERIVED FROM FIXED-RATE AND VARIABLE-RATE TES CONTRACTS (INFORMATION AT APRIL 16)



Source: Banco de la República.

FIGURE 27

REAL UNIT LABOR COST OF INDUSTRY (TREND COMPONENT)



Source: DANE.

ESTIMATING THE OUTPUT GAP

The output gap is the difference between the level of output observed in the current period and the economy's potential output; that is, what would be produced if there were full use of the factors. The economic theory has identified that according to the economic cycle, if the economy is operating above (below) its potential level, the output gap will be positive (negative) exercising inflationary (deflationary) demand pressures. So, the state of the output gap is a key variable in the monetary authority's decisions. However as potential GDP is an unobserved variable, there is a high level of uncertainty about the estimates made. This *Inflation Report* used two approximations to estimate the output gap: the production function approach and the Hodrick and Prescott filter.

I. Production function

The production function approach is estimated with information with annual frequency from 1984 based on the assumption of a Cobb-Douglas-type production technology in the following form:

$$(1) \quad Y_t = A_t K_{t-1}^\alpha L_t^{1-\alpha}$$

where the product of the current period is a function of the capital stock of the previous period, and of the employed in the current period. However, not all the capital stock is used and not all the economically active population employed. For this reason, the capital stock and the employed that enter the production function are corrected with the installed capacity utilization (Fedesarrollo's ICU) and with the unemployment rate in the current period; therefore, the production function can be written in the following form:

$$(2) \quad Y_t = A_t (UCI_t K_{t-1})^\alpha (PET_t TGP_t (1-TD_t))^{1-\alpha}$$

where PET is the population of working age, TGP the overall participation rate, TD the unemployment rate and Y_t is GDP; and where $(UCI_t K_{t-1})$ is the capital stock effectively used and $PET_t TGP_t (1-TD_t)$ is the number of persons employed. Assuming $\alpha = 0.4$, the Solow residual (A_t) is then estimated.

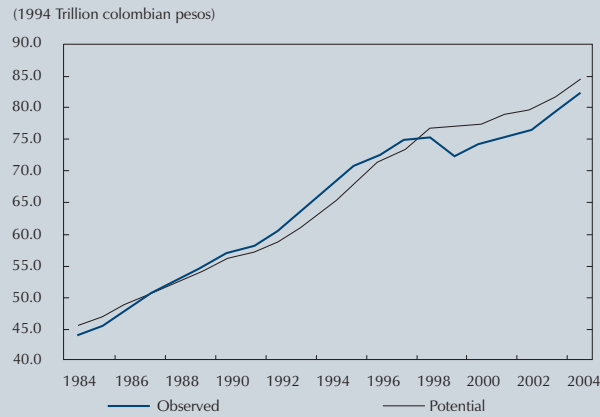
The potential output estimate uses an equation similar to the previous one, but with the following parameters:

$$(3) \quad Y_t^p = A_t (NAICU_t K_{t-1})^\alpha (PET_t TGP_t (1-NAIRU_t))^{1-\alpha}$$

where $NAICU$ and $NAIRU$ are the ICU rate and the non-accelerating inflation rate of unemployment, respectively.

The estimates show that potential GDP will grow 3.6% this year, that the economy is continuing to operate below its potential, and that the output gap is closing (Figure R1).

**FIGURE R1
PRODUCTION FUNCTION
OBSERVED GDP VS. POTENTIAL GDP**



Source: DANE, Bank's own calculations.

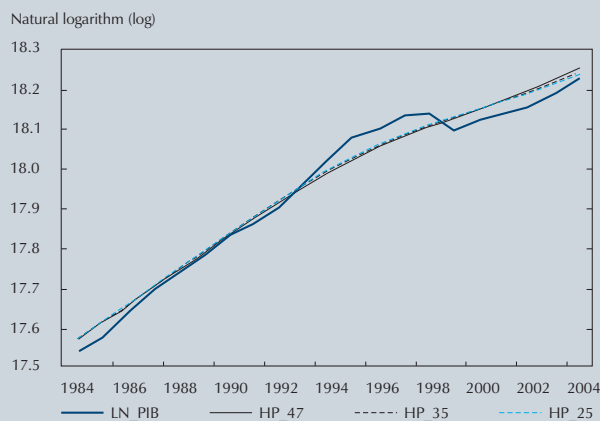
II. Hodrick and Prescott filter

The Hodrick and Prescott filter is a tool that breaks down a time series into its permanent and cyclical components. However, the disadvantage is that the result is very sensitive to the sample extremes (first and last observations).

The potential GDP estimate was made from annual figures since 1905. To overcome the disadvantages associated with the final values of the sample, three scenarios were constructed to project the GDP to 2010. The first scenario assumes a 4.7% GDP annual growth rate from 2005 (which corresponds to the average growth rate of the economy for the 1905-1998 period). The second scenario assumes a 3.5% annual growth rate (the rate from 1980 to 1998), and the third 2.5% from 2005.

The results of the three scenarios show that in 2004 the economy continues to operate below potential. In the scenario under consideration, potential GDP will grow between 2.3% and 3.0% in 2004 (Figure R2).

**FIGURE R2
HODRICK AND PRESCOTT FILTER
GDP AND POTENTIAL GDP**



Source: DANE, Bank's own calculations.

II. MACROECONOMIC OUTLOOK

In 2004 the economy can expand at a good pace, given the external conditions and the recovery of the internal demand. Excess capacity will accommodate growth without affecting the achievement of the inflation target.

The conditions are now right for the economy to continue expanding at a good rate during the rest of the year. The recovery of the US economy, now consolidated, should go on facilitating growth of external demand through its impact on the performance of regional economies and the sustained high prices for our main export products. Moreover, the higher levels of business and household confidence, and the domestic monetary policy of low interest rates should continue to stimulate domestic spending. In this context, a GDP expansion of around 4.0% is feasible this year, fuelled mainly by external demand and private investment but with a growing contribution from household consumption.

The higher levels of business and household confidence, and the domestic monetary policy of low interest rates should continue to stimulate domestic spending.

This year, the higher growth should not be an obstacle to meeting the inflation target because there will be considerable spare capacity during the rest of the year, reflected in a negative output gap that is larger than the forecast in the previous report. The recent appreciation of the exchange rate could result in a further fall in tradables inflation over the next three quarters. In the rest of the year, the exchange rate is not likely to radically reverse its current trend, given the expected increase in the supply of foreign exchange from growing exports, remittances and the net capital inputs (including higher net private borrowing, at least short-term).

In the long run on the external front, the main factor will be what happens to monetary policy in the United States.

In the long run on the external front, the main factor will be what happens to monetary policy in the United States. Everything seems to point to an increase in the Federal Reserve interest rates this year. The US economy is recovering vigorously and the latest price data shows that the dangers of deflation are now more remote. If this is the case, the effect on the emerging economies, and on Colombia in particular, will depend on the timing and the size of the increase. This report expects moderate rises in the second half of this year, which should not significantly alter the country's risk perception. In 2005, further increases are expected in external rates bringing them closer to their historical levels. However, given that these adjustments will be made in the context of solid growth of external

demand with relatively favorable terms of trade, they could be assimilated by the economy without checking growth or limiting sources of external financing. Even so, the outlook for the US economy, and interest rates in particular, over a longer horizon is still highly uncertain in view of the current fiscal and external imbalances in that economy.

Everything seems to point to an increase in the Federal Reserve interest rates this year.

Domestic economic performance in 2005 will continue to be linked to the confidence shown by investors and local consumers. This, in turn, will depend on factors such as the achievements of the security policy, and progress in the area of structural reforms designed to guarantee a sustainable fiscal situation in the long run. Finally, the possible achievement of a free-trade agreement with United States would substantially affect the performance of the Colombian economy over the next few years.

A. GROWTH, PRICES AND INTERNATIONAL INTEREST RATES

As stated three months ago, the global economy is expected to maintain the upturn observed since the middle of last year for the rest of 2004. The latest forecasts for most economies are higher than three months ago (Figure 5). For the United States the outlook continues to be favorable : the increase in the industrial production

TABLE 5

GROWTH FORECASTS (PERCENTAGE)

	Observed 2003	Forecast made at:			
		April 5,2004		January 8, 2004	
		2004	2005	2004	2005
Developed countries					
Estados Unidos	3.1	4.6	3.7	3.1	4.4
Eurozone	0.4	1.8	2.5	1.0	2.4
Japan	2.7	2.8	1.6	2.7	2.1
Latin America					
Argentina	8.7	6.7	4.1	7.3	5.3
Brazil	(0.2)	3.4	3.6	0.1	3.4
Chile	3.3	4.7	5.1	3.3	4.6
Mexico	1.3	3.2	3.6	1.2	3.4
Peru	4.0	3.9	3.8	4.0	3.9
Ecuador	2.6	4.7	3.8	2.6	3.9
Venezuela	(9.2)	7.1	4.2	(10.5)	6.4
Colombia's main trading partners					
	1.7	4.2	3.5	1.7	4.1

(*) Growth weighted by total exports accumulated from January to October 2003. Represents 78% of total exports.
Source: Observed IMF and Datastream forecasts

As stated three months ago, the global economy is expected to maintain the upturn observed since the middle of last year for the rest of 2004.

index, installed capacity utilization, and consumer confidence - although the last two continue at low levels - point to a strengthening economy in the coming months and an improvement in the outlook for consumers. Growth of 4.6% and 3.7% is forecast for 2004 and 2005, respectively. Despite this optimistic scenario, there are still risks related to the high deficits on fiscal and current accounts. Also, high oil prices could become a factor that slows the growth path of both the US and world economies.

Although core inflation surged in March, the Federal Reserve is expected to maintain its rates unchanged for some months more, waiting for more convincing signs that the economy could face demand-pull inflation in the short term. So far these signs have not been clear: the use of installed capacity is still at historically low levels despite the recent increase, and productivity continues to rise. Most analysts believe that US interest rates will stay at current levels at least until August, and that any rises in later months of the year will be moderate.

In the Eurozone the outlook is for a more gradual recovery, with forecasts of 1.8% for 2004 and 2.5% growth for 2005. According to the April Monthly Bulletin³ the growth of world demand and low interest rates will favor both external and domestic demand in the medium and long term. Inflation is expected to remain under control on a path compatible with the 2.0% long-run target. The risks for the recovery of the region stem from the fiscal imbalances in some countries, which prevent them from taking fiscal measures to create incentives for economic activity.

In Asia the outlook for this year continues to be favorable. Emerging Asia is set to grow 7.2% in 2004 and 6.8% in 2005⁴, according to the latest forecasts, the strong growth of economic activity in recent years will be maintained. These forecasts are based on domestic demand and the pickup in global demand.

In these conditions, economic growth in Latin America should continue fuelled by robust world demand, the rising international prices of the region's exports products, and the low interest rates in developed countries, which are not expected to change for some months. Colombia's main trading partners are expected to grow 4.2% in 2004, slightly more than the figure given three months ago (4.1%). However, there are factors that could affect this economic recovery: a sudden significant increase in external interest rates could reduce capital flows into the region and slacken external demand. And the higher international prices of the commodities imported by Latin America could generate cost-push inflation.

Economic growth in Latin America should continue fuelled...

³ *Monthly Bulletin*, European Central Bank, April 2004.

⁴ *World Economic Outlook*, *International Monetary Fund*, April 2004.

In Venezuela, economic activity should improve in 2004, although the trend in the economy depends on the recovery of investor and consumer confidence, together with corrective measures to restore fiscal sustainability. In Ecuador the fiscal and structural reforms required for achieving sustainable growth have still not been approved. These two countries are highly vulnerable to falls in international oil prices. The growth forecasts for 2004 for Venezuela and Ecuador are 7.1% and 4.7%, respectively.

...with the exception of a sudden significant increase in external interest rates .

International commodity prices should go on rising. The current forecast for international crude oil prices for the year (US\$30 to US\$32 per barrel WTI) is higher than the forecast of three months ago for various reasons: the geopolitical situation in Iraq continues to generate uncertainty about the speed of recovery of its production, most OPEC member countries are producing at full capacity, and world demand is steadily rising.

Lastly, coffee prices could recovery gradually since stocks are expected to fall in 2004 and 2005, as mentioned in previous reports. The report on the coffee market for March 2004 of the International Coffee Organization projects a drop in production and export levels for the 2003/2004 crop from previous years.

B. PROJECTIONS OF BALANCE OF PAYMENTS, EXCHANGE RATE AND TRADABLES PRODUCTION

According to the latest balance-of-payments projections, in 2004 the current account deficit is expected to increase to 2.2% of GDP against 1.8% in 2003 (Table 6).

In 2004 the current account deficit is expected to increase to 2.2% of GDP.

The larger deficit occurs despite an expected 11.2% rise in exports, higher than the year before (9.8%) in the wake of faster growth of imports (15.1%) fuelled by stronger economic growth, and real revaluation of about 7.0% which the model projects for 2004. Also, a smaller increase in income from current transfers from abroad is forecast, 3.6% against 18.1% in 2003.

TABLE 6

CURRENT ACCOUNT
(MILLIONS OF DOLLARS)

	2002	2003 (pr)	2004 (proj)
Balance on current account	(1,488.1)	(1,417.5)	(1,978.0)
As percentage of GDP	(1.8)	(1.8)	(2.2)
Trade balance	233.7	265.1	(221.7)
Exports	12,311.2	13,523.2	15,038.8
Imports	12,077.5	13,258.1	15,260.4
Services	(1,458.8)	(1,499.3)	(1,632.1)
Factor income	(2,848.2)	(3,361.1)	(3,423.4)
Current transfers	2,585.1	3,177.9	3,299.1

(pr) Preliminary.
(proj) Projection.
Source: Banco de la República.

For the first time since 1998, no net outflow of external capital (not including foreign direct investment).

The Table 7 shows the main assumptions of the balance-of-payments projections for 2004.

In 2004, net foreign investment could reach a level similar to 2002 after a fall of over US\$400 million in 2003. This recovery is mainly due to a decline in investment by Colombians abroad, and higher foreign investment in some sectors such as oil. The figures for the net external financing of the non-financial public sector could also increase in 2004 from US\$784 million in 2003 to US\$1.54 billion due to the reduction in amortizations and despite the fall in disbursements.

TABLE 7

SOME ASSUMPTIONS
OF EXTERNAL VARIABLES

	2002	2003	2004 Proj.
Annual changes (%)			
GDP trading partners 1/	1.5	1.7	4.2
External inflation 2/	2.4	1.8	2.0
Levels			
Price			
Oil (US\$ / barrel)	24.2	29.0	31.2
Coffee (US\$ / pound)	0.7	0.7	0.7
Ferro nickel (US\$ / pound)	1.1	1.4	1.9
Gold (US\$ / troy ounce)	310.2	362.5	423.8
Coal (US\$ / ton)	30.8	28.1	31.6
90-day CD rate (%) (%) 3/	1.7	1.1	1.3

(proj) Projection.

1/ Growth weighted by total accumulated exports from January to October 2003. Represents 78% of the country's total exports.

2/ US inflation.

3/ Annual average in United States.

Source: Banco de la República - SGEE.

In the private sector, for the first time since 1998, no net outflow of external capital (not including foreign direct investment) is expected because of low international interest rates, a favorable environment for the emerging economies, and better outlook for the Colombian economy. In 2003, these outflows totaled US\$433 million.

As a consequence of these flows, and of the accumulated return on the international reserves and the interventions that the Bank plans to make in the exchange market, the international reserves are expected to increase by US\$712 million in 2004, bringing the balance to US\$11.72 billion at the end of the year.

As mentioned earlier, the balance-of-payments projections give a real average appreciation of 7.2% in 2004, equivalent to a nominal appreciation of 6.0%. The forecast for the exchange rate, however, is still very

uncertain: there is uncertainty about the timing and size of the increase in the Federal Reserve rates, consistent with the recovery of economic growth in the United States and the disappearance of fears of disinflation in the economy. There are also doubts about the effect that these increases could have on capital flows into the emerging economies. This report assumes that the Federal Reserve raises its interest rates moderately in 2004, which maintains the momentum of external demand, the favorable level of the terms of trade, and net flows of private capital into Colombia. Treasury bonds rates are expected to increase more in 2005 (about 200 bp).

In the central scenario...

The trend in the exchange rate in 2005 will depend crucially on the government's external borrowing policy. The current forecast assumes that net external borrowing by the non-financial public sector in 2005 will be lower than the 2004 projection. However, based on the same international scenario, if the government decides to increase its external borrowing, the trend in the exchange rate could vary substantially in relation to the base scenario (5% nominal average devaluation in 2005).

In the central scenario assumed in this report, tradable goods production continues to grow strongly in response to favorable conditions of external demand. On the information available at the time of writing the report, the outlook for tradable goods production can be maintained. International commodity prices, which have remained at high levels, stimulated production in the agricultural sector (such as coffee) and in the mining and quarries sector, particularly coal and gold production. Also, the recovery of non-traditional industrial exports to Venezuela and other destinations has stimulated the manufacturing industry. For 2004, 2.8% growth is forecast for the agriculture sector (against 2.4% in 2003), 4.6% for mining (11.8% in 2003), and 5.1% for manufacturing industry (4.2% in 2003).

...tradable goods production continues to grow strongly in response to favorable conditions of external demand.

C. DOMESTIC DEMAND AND NON-TRADABLE GOODS PRODUCTION

For 2004 the Bank of the Republic revised its forecast for GDP upward from 3.7% (in the December report) to 4.0% (Table 8) due to a better prediction of the trend in domestic demand, particularly household consumption.

Household consumption is expected to increase around 3.5% .

The upward revision of the forecast for household consumption is explained by the good result of food sales in January (information from the retail trade sample

shows that real food sales grew over 7.0%, the highest rate since 2000). According to DANE, non-durable goods consumption (which represents 40% of household consumer spending) has grown at a slower rate than the population since 1996, appreciably affecting the growth of private consumption. For this year, assuming a better performance of non-tradable goods, household consumption is expected to increase around 3.5%.

TABLE 8

GDP GROWTH, ACCORDING TO DEMAND
(PERCENTAGE)

	2001	2002 (p)	2003 (p)	2004 (e)
GDP	1.4	1.6	3.7	4.0
Imports	11.6	0.5	9.5	6.4
Finals supply	2.9	1.4	4.6	4.4
Total consumption	1.8	1.7	2.1	2.9
Households	1.9	2.1	2.4	3.4
Government	1.7	0.6	1.3	1.3
GCF	9.3	7.5	18.7	13.0
GFCF	13.8	6.9	13.1	8.7
Domestic demand	2.9	2.6	4.7	4.6
Exports	2.7	(4.4)	4.2	3.0
Final demand	2.9	1.4	4.6	4.4

(p) Provisional.
(e) Estimate.
Source: DANE and Banco de la República.

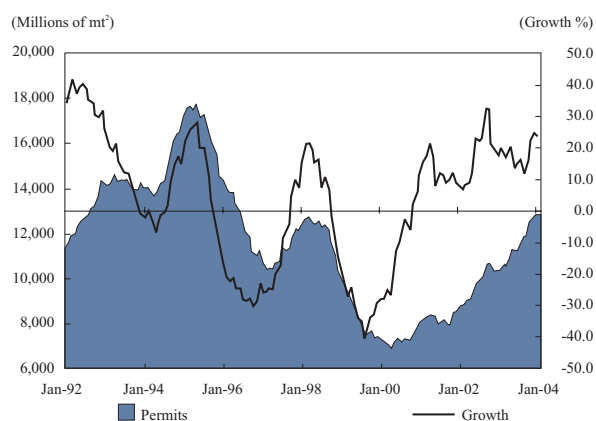
On investment, the preliminary information for the first quarter of 2004 shows that corporate performance has improved. The financial system continues to report increased earnings, along with firms in the productive sector that report to the Securities Superintendency. The announcement of the negotiating process for the free trade agreement with United States, and the signing of an integration agreement with Mercosur confirm expectations of a good performance by investment this year.

Investments in buildings should maintain a growth rate similar to last year. The recent trend in building permits has been favorable and the current level is comparable to 1992, prior to the mid-1990s boom (Figure 28). In addition to residential construction, building permits show an important shift toward industry, offices, commerce and hotels possibly reflecting the development of investment projects in various economic activities.

Based on these elements, the growth forecast for non-tradable goods production was revised upward with respect to the previous report, because household consumption is expected to perform better. Commerce and transport services could grow at rates higher than 5%. The recent trend in construction indicators creates confidence that they will continue to grow at two-digit rates. Given that these sectors are labor intensive, employment should continue to improve.

FIGURE 28

BUILDING PERMITS
(LAST 12 MONTHS)



Source: DANE.

D. MONEY AND CREDIT MARKETS

In the short and medium term, money and credit markets will be determined by the following factors:

- ✧ Expansion of aggregate demand.
- ✧ The public deficit and its financing.
- ✧ Balance-of-payments flows.
- ✧ Monetary policy stance.
- ✧ The Bank's reserve accumulation auctions, and parallel monetary sterilization operations.

The economy's external savings are expected to increase from 1.8% in 2003 to 2.2% in 2004, accompanied by a reduction in the consolidated public-sector deficit from 2.9% to 2.5%. Consequently, net private sector lending to the rest of the economy falls from 0.9% to 0.5% of GDP. This implies a greater space for financing investment and private consumption, in accord with their larger contribution to economic growth in 2004.

Given these changes in the macroeconomic balance, and assuming growth of the private-sector loans similar or higher than nominal GDP (around 10%), lending to the private sector could increase at a higher rate than in 2003. As indicated in the last *Inflation Report*, this expansion of private lending would not threaten financial stability or the achievement of the inflation targets. Lending, as a proportion of GDP, is still very much below the historical trend for overall loans and by type (commercial, consumer and mortgage). However, higher corporate retained earnings could be reflected in slightly lower growth of commercial loans, which seems to be the case in the first quarter of the year. Similarly if exchange conditions do not vary drastically, as assumed in this report, the trend toward higher net external borrowing by the private sector can be expected to continue, as observed in recent months. In any event, in the coming months the availability of financing should continue to expand. For 2005 financing conditions will depend mostly on the size of the fiscal deficit and the structure of its financing between domestic and external.

At current levels of intervention rates, the monetary aggregates could grow at a rate consistent with 10% nominal expansion of GDP. It is even possible that in 2004, expansion of narrow monetary aggregates, particularly base money, could continue to be higher than nominal GDP, as has occurred in recent years. This is explained basically by stronger effective demand due to lower inflation, and by the effect of

Implies a greater space for financing investment and private consumption.

For 2005 financing conditions will depend mostly on the size of the fiscal deficit and the structure of its financing between domestic and external.

The Bank's announcement of exchange intervention through reserve accumulation option is not inconsistent with the level of intervention rates required to guarantee compliance with the inflation target.

the financial transactions tax and the many changes in its rate (this year it was raised from three to four per mil). The expansion rate of base money is not a sufficient indicator of surplus liquidity in the economy because the M3 aggregate has been growing at stable rates not very different from nominal GDP.

Lastly, the Bank's announcement of exchange intervention through reserve accumulation option auctions up to US\$700 million is not inconsistent with the level of intervention rates required to guarantee compliance with the 2004 inflation target and the path announced for 2005. For this reason, the Bank announced the sterilization of 50% of the monetary effect of the reserve accumulation. This measure also shows that the decision on exchange intervention does not involve giving up control of short-term interest rates as the main instrument of monetary policy.

E. INFLATION FORECASTS

The STF for non-food inflation for June was 5.6%, and for food inflation is 5.2%.

The forecasts for inflation, devaluation and output gap for 2004, 2005 and 2006 are presented below, along with the key assumptions used to make these forecasts. As mentioned in previous reports, the Bank makes its forecasts in two stages. First, short-term forecasts (STF) are obtained from satellite models that usually have high predictive power over horizons of one and two quarters. The results obtained for variables such as food and non-food inflation, and from devaluation feed the central model (TMM) which predicts over one, two and three years for these and other variables, and shows the interest rate path that is compatible with long-term price stabilization.

1. The short-term forecast

The STF for inflation is produced over horizons of one and two quarters. The March forecast presented in the December report was 6%, very close to the figure finally observed. The new STF for non-food inflation for June was unchanged from the December report at 5.6%. The satellite models produced the same forecast for non-food inflation as for September.

For food inflation, the new STF to June is 5.2%, a little higher than the forecast made three months ago (5%) due to the underestimate of March inflation in the satellite models (the STF for food to March was 5% against 6.6% observed). Despite this, the current STF repeated its prediction of lower inflation for June due to the temporary stabilization or reduction of the prices of various primary food products

(mostly fruit and vegetables) in April and May. For the third quarter, STF for food is 6.2%. It should be borne in mind that the uncertainty of food inflation forecasts is relatively high compared with non-food inflation, because of the shocks that characterize primary markets.

Growth forecasts for GDP for 2004 increased to 4%.

Growth forecasts for GDP for 2004 increased to 4% (against 3.8% in the previous report), which imply annual growth of 4.6% and 4.3% for the quarterly GDP of the first and second quarters of the year. These forecasts implicitly assume a slight fall in the growth rate for the third and fourth quarters, due entirely to supply factors rather than weaker demand. Specifically the high growth of coal production in the second half of 2003 establishes a high basis of comparison for the second half of the year. In terms of output gap, this means that levels of -1.80% and -1.76% are expected for the second and third quarters, not very different from the estimates for the end of 2003 (-1.83%).

As detailed in a previous section of this report, the balance-of-payments model produced a nominal average appreciation of 6% in 2004. The STF for the exchange rate compatible with this rate is 2,670 pesos per dollar for the average of the second quarter and 2,700 pesos for the third.

Nominal average appreciation of 6% in 2004.

2. Results of the central model (TMM).

The results presented below relate to a scenario in which the interest rate is determined endogenously to ensure compliance with the 2004 target range (between 5% and 6%), and the targeted range for the next few years (between 3.5% and 5.5% for 2005 and convergence with 3% inflation in the long term).

The analysis presented in the previous sections indicates that inflation depends on two fundamental factors in the medium and long term. First, the trend in the exchange rate, which will determine the trend in tradables inflation and influence the formation of expectations; second, the speed of closure of the output gap and its effect on non-tradables inflation.

Movements in the exchange rate will be closely linked to the way the international situation develops. This report assumes that external interest rates have reached their minimum level and that during the second half the US monetary authorities will begin a strategy of gradual increases to guarantee inflation stabilization. The TMM assumes rate increases of 50 bp in the second half of 2004, and 200 bp in 2005. From 2006 the external interest rates converge at their long-term level (2.0% for real rates). For 2004 these increases are less than the ones expected three months ago, taking into account the low inflation in the United States in the first quarter despite the March surge, the zero reduction in unemployment in the same period and signs of strong growth of productivity. However, this does not mean that the probability of a change in Federal Reserve policy this year has declined.

The TMM assumes rate increases of 50 bp in the second half of 2004, and 200 bp in 2005.

... does not substantially affect the risk perception for the region.

The model assumes that the increase in external rates this year does not substantially affect the risk perception for the region, given the gradual character of the increase. Also, the rate adjustments take place in a context of economic recovery with relatively high terms of trade and strong growth of dollar exports. For 2005 the exchange outlook is less clear because further increases in external rates and the current account and fiscal deficits in the US economy could deter investment decisions in emerging economies by negatively affecting expectations of global growth. At local level, the fall in oil exports (both price and volume) contributes to generating devaluation pressures. This scenario is reflected in higher nominal devaluation rates for 2005 and 2006 (5.3% and 11.3%, respectively) in line with the results of the TMM (Table 9). However, these nominal average devaluation rates are higher than those produced by the balance-of-payments satellite model.

As explained earlier, the higher growth of the output in 2004 would imply a narrowing of the output gap, but at lower rates than forecast in the previous report. This is explained by the assumption of higher growth of potential GDP this year in

TABLE 9

RESULTS OF CENTRAL MODEL (TMM)
BASIC SCENARIO
(PERCENTAGE)

	Inflation			Output gap	DTF	Average annual evaluation
	Total	Non-food	Food			
Mar-04	6.27	6.09	6.72	(1.80)	7.79	5.80
Jun-04	5.60	5.60	5.60	(1.76)	7.59	(1.25)
Sep-04	5.78	5.60	6.20	(1.40)	7.79	(4.51)
Dec-04	5.65	5.68	5.58	(1.12)	8.16	(6.00)
Mar-05	5.66	5.85	5.21	(0.92)	9.09	(3.89)
Jun-05	5.88	5.84	5.98	(0.84)	9.55	(0.88)
Sep-05	5.25	5.27	5.21	(0.81)	9.73	2.12
Dec-05	4.90	4.92	4.85	(0.86)	10.06	5.28
Mar-06	4.75	4.76	4.72	(0.97)	10.41	7.36
Jun-06	4.70	4.70	4.70	(1.09)	10.72	8.94
Sep-06	4.70	4.68	4.73	(1.19)	10.92	10.54
Dec-06	4.72	4.71	4.76	(1.25)	11.02	11.32

Source: Banco de la República.

view of the increased investment observed in 2003 and the forecast for the first half of 2004, the slower fall in the unemployment rate so far this year, and possible higher growth of industrial productivity. So, demand-pull inflation is likely to be less important in expectations during 2004 than estimated in the last report.

In 2005 and 2006, the forecast for the gap continues on negative ground, after expanding with respect to three months ago (Table 9). Despite this, the gap should continue closing gradually in 2005, so its role as moderator of possible demand-push inflation will gradually decrease.

As in the December report, the role of expectations and inflation inertia continues to be fundamental for identifying possible inflationary pressures in 2004 and in following years. Although the inflation targeting policy has gained credibility, the process of formation of expectations still has a high adaptive component, which uses past inflation as reference; accordingly, expectations adapt very slowly and only in response to the fall in observed inflation. Another factor is the persistence of many indexation mechanisms, which explains the high component of inertia in inflation.

The role of expectations and inflation inertia continues to be fundamental...

Lastly, this report again includes some new supply shocks related to adjustments in regulated prices, mainly fuel and public services. The forecasts for fuel are based on the official programming of readjustments for the rest of the year, which envisages the same intensity as in the first three months of 2004.

According to the Bank's central model, the nominal DTF (fixed-term deposits) will be 8.2% at the end of 2004 compatible with the 2004 target range and with the range in which the 2005 target will be defined (Table 9). In this case, the DTF rates could remain around current levels to guarantee compliance with the target for this year and reduction of inflation to an average of 3% in the long term. This result is subject to an expected 6% appreciation in 2004, a relatively small depreciation in 2005, and the maintenance of a negative output gap of the size mentioned earlier.

For the assumptions and predictions already mentioned, the Bank's central model predicts total inflation of 5.7% at the end of 2004, 4.9% for 2005 and 4.7% for 2006. For non-food inflation, the respective figures are 5.7%, 4.9% and 4.7% (Table 9). In relation to food, an annual inflation of 5.6% is expected for 2004; and from 2005 the TMM assumes that food inflation gradually converges with non-food inflation, assuming the absence of supply shocks on the prices of this set of goods.

... for identifying possible inflationary pressures in 2004 and in following years.

3. Balance of risks

The construction of the balance of risks for inflation this year and next was based on the following considerations:

- ✘ The exchange rate forecast for 2004 contains no bias in any specific direction; that is, the probability of observing a nominal appreciation greater than 6% is equal to the opposite case. However, the balance-of-payments model predicts a greater probability of a devaluation of less than 5% in 2005.
- ✘ Although the output gap for 2004 expanded with respect to the December report, it is considered that the probability of underestimating the speed of the closure this year is higher. This would occur, for example, if the economy grows above the 4% rate established in the base scenario. An upward bias – a smaller gap – is considered in the 2005 forecast.
- ✘ For the end of 2004, food inflation could be higher than the assumption in the central path prediction (5.6%). In 2005 no bias of any kind was defined.
- ✘ The judgments on the level of uncertainty associated with the projections (represented in the standard deviation of the historical residuals of the prediction) were unchanged from the last report. And the uncertainty of the prediction of the change in the exchange rate is still considered high.

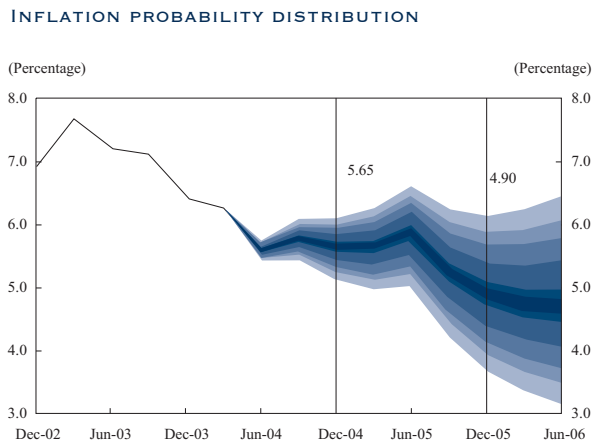
Shows an 88% probability of inflation in 2004 between 5% and 6%, and 6%

Taking this into account, the Figure of the inflation probability distribution for 2004 (Fan Figure or confidence interval) shows an 88% probability of inflation in 2004 between 5% and 6%, and a probability of around 80% of inflation in 2005 below 5.5%. The confidence interval around the TMM central prediction for 2004 moves upwards in relation to three months ago (Figure 29). This, however, is due to the higher food and non-food inflation, predicted by the central model for this report, which, as already explained, had to do with the introduction of the STF for September. Despite this, the confidence interval for 2005 stayed in the range presented in the December report.

The confidence interval has a small downward bias in 2005 against the central prediction path due to the higher probability assigned to a devaluation below 5% for 2005. This bias counteracts the upward bias imposed on the inflation estimate for imported goods.

Due to the inherent limitations of the central model, the balance of risks did not include the full extent of two other factors that affect inflation in 2004 and 2005. The first is favorable and is related to the trend in prices of fuel and public services such as gas, given the appreciation of the exchange rate in 2004 and the small

FIGURE 29



Source: DANE, Bank's own calculations.

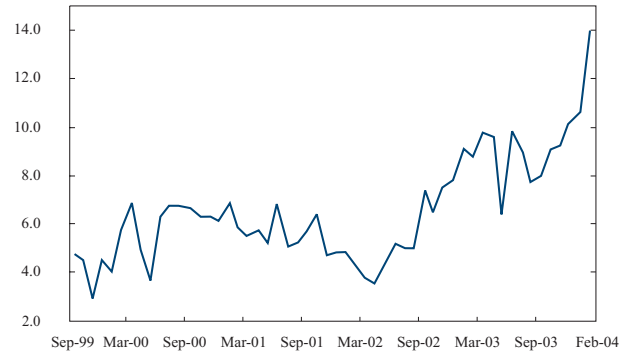
devaluation in 2005. The expected adjustments in these prices were obtained from official projections at the start of the year which forecast a higher exchange rate for this year and next.

Lastly, the TMM did not pick up the higher risk that could be developing from the increase in the prices of both imported and domestic raw materials. In the opinion of industrialists, this factor is an increasingly important problem for the expansion of production (Figure 30). In part, this could reflect the declining importance of other problems such as security and demand. However, in an expansionary phase like the current one in the Colombian economy, it is usual for bottlenecks to begin to appear in the form of sharp rises in input prices. If this is the case, toward the medium and long-term, the cost channel will begin to play a leading role in the determination of inflation and its future trend.

FIGURE 30

PROBLEM OF COST AND SUPPLY OF RAW MATERIALS

(Percentage)



Source: ANDI.

LOCAL AND EXTERNAL ANALYSTS' PROJECTIONS OF THE KEY MACROECONOMIC VARIABLES

A review of the latest projections by local and foreign analysts of the key variables of the Colombian economy for 2004 and 2005 is given below. When consulting the projections, it should be borne in mind that the analysts already knew the observed inflation at March 2004.

I. Projections for 2004

As Table 1 shows, both foreign and local analysts are optimistic about the performance of the economy. For 2004 they expect, respectively, that GDP will grow 4.1% and 3.8%. It is worth mentioning that the foreign analysts corrected their growth projection for this year. In the last report, they predicted 3.3% growth, 0.8 percentage points below their current forecast.

For inflation, local analysts corrected their forecasts downward by an average of 10 bp for 2004. On March 2004 data, they forecast 5.8% inflation in December, while, the foreign analysts expect inflation to average 6.1%.

TABLE A1
PROJECTION OF MAIN MACROECONOMIC VARIABLES FOR 2004

	Growth of real GDP %	Inflation CPI %	Nominal exchange rate (end of) %	Nominal DTF 1/ (CPS)	Deficit (% GDP)		Unemployment rate %
					Fiscal	Current act.	
Local Analysts							
Revista Dinero	4.0	5.8	2,810	8.2	(2.8)	n.d.	14.2
Suvalor-Corfinura	4.0	5.5	2,800	7.8	(2.5)	n.d.	n.d.
Corfivalle	3.6	5.8	2,800	9.0	(2.8)	(1.8)	14.5
ANIF	3.6	6.0	2,793	8.2	(2.7)	(2.1)	14.0
Fedesarrollo	3.7	6.0	2,911	n.a.	(2.8)	(2.1)	14.0
Average	3.8	5.8	2,823	8.3	(2.7)	(2.0)	14.2
External Analysts							
Goldman Sachs	3.8	6.0	2,880	8.1	(2.8)	(2.0)	13.3
IDEA Global	4.8	5.7	2,750	8.0	(2.6)	(0.3)	12.5
J. P. Morgan Chase	3.8	6.1	n.a.	n.a.	(2.7)	(2.1)	n.d.
Deutsche Bank 2/	4.0	6.3	2,750	8.3	(5.4)	(1.7)	14.6
Average	4.1	6.0	2,793	8.1	(2.7)	(1.5)	13.5

CPS: Consolidated public sector

n.a. not available

1/ Average for year

2/ The Deutsche Bank data for the fiscal deficit relates to central government is not included in the average.

Source: Analysts and Report How they see us abroad? SMT April 23, 2004.

On the exchange rate, local analysts estimate that the representative market rate will end the year at 2,823 pesos per dollar, over 200 pesos below the figure in the last report. The foreign analysts also made a downward correction to their forecast for the representative market rate for 2004 to 2,793 pesos per dollar, 182 pesos less than the figure in the last report.

Lastly, local analysts expect the DTF rate to end 2004 at 8.3%, 30 bp below the last quarter. The foreign analysts' prediction is 8.1%, 20 bp higher than three months ago.

II. Projections for 2005

Table 2 presents the forecasts for growth, inflation and representative market rate for 2005. Both local and foreign analysts expect the economy to maintain its growth rate in 2005. However, both groups consider that inflation could fall during the year. While locals expect the cost of living to rise 5.3% by the end of 2005, the foreigners forecast 5.2%.

Both local and external analysts predict a positive devaluation in 2005; the locals forecast a representative market rate of 3,133 pesos per dollar while the foreigners estimate a year-end rate of 2,897 pesos.

TABLE A2
PROJECTION OF MAIN MACROECONOMIC VARIABLES
FOR 2005

	Growth of real GDP %	Inflation CPI %	Nominal exchange rate (end of)
Local Analysts			
Revista Dinero	3.9	n.a.	n.a.
Suvalor-Corfinura	3.5	5.3	3,264
Corfivalle	3.7	5.5	3,030
Fedesarrollo	4.0	5.0	3,106
Average	3.8	5.3	3,133
External Analysts			
Goldman Sachs	3.4	4.9	3,050
IDEA global	5.0	5.0	2,850
J. P. Morgan Chase	4.0	5.3	n.a.
Deutsche Bank	3.6	5.4	2,790
Average	4.0	5.2	2,897

CPS: Consolidated public sector

n.a. not available

Source: Analysts and Report How they see us abroad? SMT April 23, 2004.

MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS

Background: *Inflation Report, December 2003*

The December 2003 inflation report considered that inflation in 2004 and 2005 would depend mainly on two factors: i) the speed of the closure of the output gap and its effect on non-tradables inflation, and ii) the size and duration of the exchange appreciation and its effect on tradables inflation.

The inflation forecasts given in that report were based on assumptions of a one percentage point closure of the gap in 2004 (-1.36% average in 2004), and nominal average appreciation of 0.5% in this year, followed by over 7% depreciation in 2005.

On these conditions, the results of the central prediction model (TMM) show a high probability of achieving the targeted inflation range between 5% and 6% in 2004, irrespective of the monetary policy stance. However, the probability of achieving inflation rates for the following years within the announced range (between 3.5% and 5.5%) was higher if the 90-day CD rates rose about 100 bp during the year and during 2005.

The most important factor that explained the TMM result of higher domestic interest rates in 2004 was the trend in the output gap. If the CD rates do not change in 2004 and 2005, the closure of the output gap (from the first quarter of 2005) will begin to generate inflationary pressures that will result in increased expectations and more persistent inflation. On this basis, total inflation increases in 2005 (5.1% vs. 4.8% in the scenario with higher rates), and especially in 2006 (5.5% versus 4.6%). To prevent inflation anchoring at the 5% target or more, incompatible with the convergence to long-term inflation levels, the model predicted that interest rates would begin to rise from 2004. It should be recalled that monetary policy operates with lags, so that the movements in nominal short-term interest rates have more impact on inflation after an estimated period of six to eight quarters.

In this context, the December report mentioned the possibility that increases would be required in the intervention rates during the year to increase the probability of achieving inflation within the range announced for 2005 and to continue the gradual convergence toward the desired long-term inflation levels. At the same time, the report explicitly stated that only an exchange appreciation in 2004 higher and longer than expected could change the projected interest rate path toward a monetary policy stance that is more neutral or, even, more lax (rate cuts). This is due to the effect that a higher sustained appreciation would have on inflation forecasts over the time horizon in which monetary policy is most powerful.

Based on these considerations, the Board did not change the intervention rates at its January meeting, but did change the cash position limit of exchange market intermediaries, which in future cannot be negative. This measure, together with the options auction for reserve accumulation for US\$200 million held on January 9, 2004, was aimed at moderating movements in the exchange rate without altering the trend determined by market forces.

Monetary policy decisions in the first quarter of 2004

The trend in various external indicators and indicators of the productive sector in the first quarter of 2004 confirmed the growth trend identified in the December Report on Inflation. The economy continued to pick up thanks to external and domestic conditions that favored the good performance of the tradable and non-tradable sectors.

However, the exchange appreciation in the first quarter was higher than forecast in the December report due to lower capital outflows by residents, new portfolio inflows, and the continuous improvement in prices and volumes exported relative to projections.

Based on these trends and new information, the forecasts relevant to the definition of monetary policy were adjusted by the Bank's technical staff. The GDP growth forecast for 2004 was increased (4% against 3.8% in the last report). The nominal average appreciation expected for 2004 was also increased to 6% in line with the balance-of-payments projections, although with a surge in the exchange rate in 2005. From February the estimate of the output gap was modified from the December report. Potential GDP growth was recalculated for 2004 using a production function model that incorporates new estimates for the natural unemployment rate and stable-inflation capacity utilization. The result of these exercises was that, although the output gap continues to close gradually during the year, it does so more slowly than was predicted in the December report.

These elements (higher appreciation and the slower closing of the output gap) reduced inflation forecasts for 2005 and 2006. This implied that it was possible to achieve inflation levels compatible with the announced target ranges for 2004 and 2005 with lower interest rates than those projected in the December report. This occurred despite the forecast increase in food inflation in 2004, a trend that was not captured by the food inflation models in the first quarter of the year, and the higher short-term forecasts (to June and September) of non-food inflation.

The trend revealed by information on inflation expectations was favorable: the credibility of the inflation target in the January quarterly survey overtook the rates in the same month of previous years, and expected inflation for December 2004 dropped to near the targeted range ceiling for the year (between 5% and 6%). The results of the monthly expectations survey also confirmed the downward trend in inflation expectations since the last quarter of 2003. Finally the labor market analysis did not suggest cost-push inflation from wages. The information available showed strong growth of productivity in the industrial sector, while the nominal wage increases agreed in collective bargaining agreements, although above the upper range of the target, continue their downward trend without increasing unit labor costs, given the trend in productivity.

In this context, it was possible to adopt a more lax monetary policy stance (rate cuts). Based on these considerations at its meetings in February and March, the Board took two decisions that modified the monetary policy stance

First, the Bank's intervention rates were cut by 50 bp (25 bp in February and again in March). Consequently, at the end of the quarter intervention rates were as follows: expansion minimum 6.75%, Lombard expansion 10.50%, contraction maximum 5.75% and Lombard contraction 4.75%

TASAS DE INTERVENCIÓN DEL BANCO DE LA REPÚBLICA
(PORCENTAJE)

Fecha	Lombarda		Subasta	
	De contracción		De expansión	
2001 17 de Dic.	6.25	7.50	8.50	12.25
2002 21 de Ene.	6.00	7.00	8.00	11.75
18 de Mar.	5.25	6.25	7.25	11.00
15 de Abr.	4.25	5.25	6.25	10.00
20 de May.	3.75	4.75	5.75	9.50
17 de Jun.	3.25	4.25	5.25	9.00
2003 20 de Ene.	4.25	5.25	6.25	10.00
29 de Abr.	5.25	6.25	7.25	11.00
2004 23 de Feb.	5.00	6.00	7.00	10.75
23 de Mar.	4.75	5.75	6.75	10.50

Fuente: Banco de la República.

Second, the Board considered that the appreciation episode, which began in late 2003, was transitory, and acting prudently, decided to make an additional accumulation of international reserves in case of possible reversals in capital flows and adjustments in the exchange rate that could affect inflation in the medium and long term. The Board announced additional purchases of international reserves up to US\$700 million in the exchange market between April and July 2004 through the auction mechanism, with amounts announced monthly. An options auction for US\$200 million was called for April.

The Board also announced that part of the foreign exchange purchases would be offset in the secondary market through the outright sale of TES for up to 50% of the reserve purchases. This measure would ensure that growth of monetary aggregates was consistent with maintaining short-term interest rates at the levels required to guarantee compliance with the 2004 inflation target, and to lead medium-term inflation toward the announced range (between 3.5% and 5.5%).