Inflation in March and the Outlook

First-quarter inflation was characterized by:

- A decline in total inflation and all core inflation indicators, especially non-food inflation.
- Fewer expectations of inflation in the first quarter of 2005, as indicated in surveys and by the differentials between fixed and variable TES interest rates.
- Lower non-tradable inflation, partly because of fewer inflationary expectations, but also perhaps because of the absence of significant pressure from demand.
- A reduction in tradable inflation associated with appreciation in the exchange rate.

The Colombian economy continued to grow amidst a favorable external environment. The world economy and that of our major trading partners was very vigorous, although 2005 is expected to see less growth than in 2004. Terms of trade remained high, and prices for certain export commodities might be even higher than last year.

The figures for gross domestic product (GDP) in the fourth quarter show continued economic expansion in 2004. They also indicate the GDP slowdown in the third quarter was mostly temporary and associated with supply shocks, as indicated in the last report. Average growth during the last six months was above 4%, and internal demand has been up by more than 5% since the third quarter of 2003.

In 2004, the most dynamic factors on the demand side were private investment and exports. The increase in investment placed it above the 1970 -2004 average as a percentage of GDP (17%). Household consumption continued to recover and, in per capita terms, reached the levels observed prior to the crisis in 1999.

Growth in potential GDP may have increased during the last two years, given the force of investment and the rise in total factor productivity. However, it is important to remember that potential GDP is something that cannot be observed and its estimate is plagued by a degree of uncertainty.

An analysis of various indicators shows conclusive evidence of a change in the output gap (difference between potential and actual GDP) compared with the last inflation report.
Some indicators point to a smaller gap. Use of installed industrial capacity saw an increase in January, but is still close to the historic average. Answers to questions about the importance of demand problems in industry suggest the gap continued to close up to January 2005. The percentage of companies with installed capacity utilization above the historic average remained on the rise. However, these indicators refer exclusively to industry and may ignore what happens in other sectors of the economy.

Other events suggest the output gap is not closing. Prices for non-tradables, particularly various services, would seem to indicate no quick narrowing of the gap. On the other hand, the unemployment rate is still above the level that is thought to indicate a possible acceleration in inflation.

Economic performance in the coming quarters will depend largely on what happens with the external context. The main sources of uncertainty in this respect are the trend in oil prices and adjustments in U.S. monetary policy.

Analysts agree as to how much the U.S. Federal Reserve (Fed) will have to raise interest rates, but remain uncertain about the pace at which these hikes might occur. The macroeconomic forecasts contained in this report assume the Fed will continue to adjust interest rates gradually and in the direction of a neutral stance on monetary policy.

If so, the main tendencies in capital flows towards the emerging economies would continue. These flows are characterized by broad liquidity on international markets, with no major surge in country-risk premiums. Nevertheless, this perception is dogged by uncertainty about how fast the Fed will adjust interest rates and what will happen in terms of the external deficit and the shortfall in tax revenue in the United States economy.

According to the latest forecasts on Colombia’s balance of payments, current account income in 2005 could exceed the prediction in the last report. On the one hand, terms of trade have increased and could remain up throughout 2005. Also, demand from our trading partners, especially Venezuela, might be more vigorous than it has been so far.

The trend in private capital flows will depend on the international situation and how international and domestic investors respond to the changes in U.S. monetary policy. If the rise in interest rates is higher than expected, net capital inflows could be less, and we might see net capital outflows, which would cause the exchange rate to increase in comparison with its current levels.

The results of the inflation forecast models and the central monetary policy simulation model show the target for 2005 is likely to be met (between 4.5% and 5.5%, with 5% as the specific goal) and inflation should drop towards the target range announced for 2006 (between 3% and 5%). This would be the case even with moderate peso devaluation and is consistent with a path in short-term interest rates (interbank rates-TIB) at levels equal to or slightly below the current ones (6.3%).
However, some models show that more than 4% growth in the Colombian economy in 2005, which implies a narrower output gap, would leave no margin for the TIB to drop below its present levels. In this case, the intervention rates used by Banco de la República should move towards a more neutral monetary stance in the coming year, as is the case with the central banks in most economies, both developed and emerging.

As mentioned earlier, supply factors (a larger stock of capital and more productivity) could imply an initially smaller gap or slower closure. This would make it possible to maintain the monetary stimulus with which the economy now operates. However, given the uncertainty about the state of the gap and how it will change, it is difficult to say which of these scenarios is more likely.

The same is true of the exchange rate. Forecasts for this variable are extremely sensitive to balance-of-payment scenarios. These vary as more relevant information becomes available and depending on the pace and duration of any adjustment in external interest rates. Again, this context makes it difficult to arrive at a definite projection on how the exchange rate will behave in the short and medium-term.

Finally, it is important to remember that the forecast models failed to predict a portion of the downturn in first-quarter inflation, which is why it still is impossible to determine if that trend is permanent or temporary.

Uncertainty about the extent of the output gap, how the exchange rate will behave in the future, and the depth of the recent decline in inflation necessitate having more information before making any change the country’s monetary policy.

For these reasons, at its meeting on April 22, the Board of Directors of Banco de la República (BDBR) decided to make no changes in the current monetary policy stance. This has the following implications:

1. No change in the structure of the Bank’s interest rates
2. Continued closure of the contraction window and auctions
3. Continued discretionnal intervention in the exchange market

Board of Directors
Banco de la República