



THE BOARD OF DIRECTORS' REPORT
TO THE CONGRESS OF COLOMBIA

JULY, 2003

BANCO DE LA REPÚBLICA

ISSN: 1657-799X

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Bogotá, D. C., July 30, 2003

*Honorable Chairmen and Members
Third Standing Constitutional Committees of
The Senate and
The House of Representatives
Bogotá*

Dear Sirs,

Pursuant to Law 31 of 1992, Article 5, the Board of Directors of the Banco de la República hereby submits for consideration by Congress a report on the country's macroeconomic results for the year to date. The report also presents the targets set by the Board for 2003 and the outlook for the different macroeconomic variables. The final section describes the composition of the international reserves and discusses projections for the Banco de la República's financial situation for the year 2003.

Yours truly,



Miguel Urrutia Montoya

Governor

INTRODUCTION

The purpose of the report hereby submitted to the Honorable Members of Congress is to describe the implementation of macroeconomic policy and the economy's performance over the first months of 2003. Special emphasis is laid on the policy aspects that are the direct responsibility of the Bank, namely, monetary, exchange-rate and credit policy. On this occasion the report also describes the functions that current legislation assigns to the Banco de la República. Some of these are not sufficiently well-known to the public, such as the functions of managing the international reserves as an integral part of the strategy for conducting monetary policy, ensuring the proper working of the system of internal and external payments, constituting a knowledge enterprise, and helping to recover and conserve the country's historical and art heritage. This report also discusses in detail use of the Bank's resources, its financial statements, and the projection for profits from the Bank's operations this year.

The different functions performed by the Banco de la República aim to ensure the economy's stability from the viewpoint of monetary policy, as an essential requirement for economic growth and social development. This is the greatest contribution the Bank can make to Colombian society, and its efforts and policies are directed to this end.

Chapter II, on macroeconomic policy, shows that monetary policy can improve the path of long-term economic growth by lowering inflation rates and making real and nominal interest rates stable, such being the ultimate aims of monetary policy. Price and interest-rate stability promotes social welfare and economic growth by improving market efficiency, fostering stability in employment and output, and creating a climate of greater certainty for companies and households to make sound long-term decisions on investment and saving. Such decisions in turn allow a greater deepening and development of the financial system and capital markets.

Chapter II also discusses the short-term counter-cyclical role played by monetary policy when economic output has been below potential. In this case, a loose monetary policy as applied by the Banco de la República in recent years helps to increase growth and reduce unemployment. The country's monetary policy, it is shown, has continued to be counter-cyclical even under the adverse external conditions faced by the economy from the middle of 2002, which were reflected in considerably stronger devaluation, a development that has affected all countries of the region.

Exchange-rate policy, too, has helped to restore economic stability by avoiding excessive volatility in the exchange rate. Given Colombia's floating-rate regime, however, it is only possible and expedient to offset such fluctuations partially. A floating regime has great advantages, for it

allows faster adjustments to the real exchange rate when the economy is subjected to an external shock, thereby helping to keep the exchange rate competitive and making it easier to conduct a counter-cyclical monetary policy. However, when the Board of Directors of the Banco de la República has felt certain that exchange-rate movements were excessive, it has responded firmly by intervening in the currency market with transparent and previously announced mechanisms and rules.

Chapter II also analyzes fiscal policy and its interaction with monetary policy. Although fiscal-policy management is not the responsibility of the Board, it has strong repercussions on the impact of monetary, exchange-rate and credit policies. In the long term, for example, the existence of an expected sequence of excessive fiscal deficits can reduce the credibility of monetary policy. In the short term, hefty fiscal imbalances can affect credit, capital and exchange markets and thereby impair the outcome of monetary policy. For Colombia's economic upturn to grow stronger and continue to be boosted by monetary policy, fiscal policy must of necessity remain decidedly oriented toward reducing the public deficit. Meeting the consolidated fiscal deficit target for 2003, set at 2.5% of GDP, will be a step in this direction. Moreover, keeping the fiscal deficit low in future is equally vital for stabilizing public debt. The government and Congress must spare no effort to reach this target. Attaining it will help to clear the outlook for the country's public finances and raise confidence in the economy at home and abroad, bringing benefits in terms of investment growth and access to external savings. Furthermore, monetary policy will become more effective once economic agents have no reason to expect high inflation rates, and a counter-cyclical policy may be adopted when necessary.

The report goes on to assess in Chapter III the performance of economic activity, employment and the balance of payments in the first half of the year and the outlook for them for the rest of the year. This assessment aims to show the environment in which the macroeconomic-policy decisions discussed in Chapter II had to be taken and to explain the impact they had on the different economic variables. With economic activity in the first months of 2003 unfolding in a much more favorable environment than in previous years-an environment characterized by greater confidence among local and foreign agents-, the favorable impact of recent years' loose monetary policy on economic growth began to show more clearly. The economy expanded by 3.6% in the first quarter of 2003, exhibiting a definite acceleration, largely produced by internal demand. It is quite likely that by the end of the year economic growth will be higher than the 2% initially forecast. The first quarter also saw a slight improvement in employment indicators, attributable to the better performance of economic activity.

Chapter IV analyses another of the Bank's functions, namely, ensuring the working of the country's payment system. It defines what is meant by a payment system and describes the part played by the Bank in helping the system function properly in accordance with legislation in force in Colombia. The chapter ends by pointing out the main risks facing the payment system and the possible actions the Bank would have to take to avert them.

Chapter V discusses in detail the Board's management of Colombia's international reserves, expanding on the analysis presented in the March Report to Congress. It sets forth the basic

principles governing such management, directed toward minimizing the impact of external shocks on the economy, and the administration criteria established for investing the reserves and ensuring their security, liquidity and profitability. A number of benchmarks are presented for comparing their current level with other countries'. The conclusion is that Colombia has sufficient international reserves to cover external obligations for at least a year, even if it were to face a complete shutdown of international credit markets. This level of reserves ensures access to external savings at reasonable interest rates, for it sends signals to potential investors and lenders that the country is in a position to honor its commitments, thus helping to raise confidence about Colombia in national and international circles.

The final chapter explains in detail how the Bank's resources have been used in recent years, describing the functions that the Bank performs. The Banco de la República not only carries out the duties of a central bank, it is also an economic knowledge enterprise, a banking-services enterprise, an industrial and precious-metal enterprise, a support services enterprise, a training enterprise and a cultural services enterprise. In the cultural field the Bank has also contributed to the recovery and conservation of part of the country's historical and art heritage.

Over the past ten years the Bank has made a very considerable adjustment in its expenses, striving for efficiency in each one of its functions. Thus, it has significantly reduced its labor costs and managed to make outsourcing even more efficient and transparent than in the past. Chapter VI presents the results of these efforts, gives a detailed description of the Bank's pay and pensions policy, and shows that its salaries, augmented by the different pay benefits it offers, are comparable with market levels for the highly qualified personnel it requires. Much of the adjustment in recent years has been made in the size of the Bank's payroll, without detriment to compliance with labor legislation. The Bank's financial statements for 2002 and its budget execution and projections for 2003 are discussed at the end of Chapter VI. They reveal that the adjustment process continues, and that the Bank is expected to generate profits amounting to 708.1 billion pesos. This is more than the 349.3 bn pesos forecast in March because the euro has performed better against the dollar than was assumed at the beginning of the year.

MACROECONOMIC POLICY

A. MONETARY AND EXCHANGE-RATE POLICY

1. Objectives

The operational objective of monetary policy in 2003 is to have consumer price inflation ranging between 5% and 6% by the end of the year, with a mean value of 5.5% for legal purposes. In the next few months a point target will be announced for inflation within the range of 3.5% and 5.5%. The concept of price stability, or long-term inflation, is compatible with a 2%-4% annual variation in the consumer price index (CPI).

The legal basis for the functions of the Banco de la República is enshrined in the Constitution of 1991 and Law 31 of 1992, which provide that the primary aim of the Board of Directors of the Bank is to control inflation, in coordination with overall macroeconomic policy. This legal mandate corresponds to what is known in economic literature as "a flexible inflation target." This means that the primary aim of monetary policy is to reach and maintain a low rate of inflation, in the form of a quantitative target, while striving to stabilize growth in aggregate output at around its long-term trend. The central bank's objectives combine the aim of price stability with maximum sustainable growth in output and employment.

The objectives of the Bank were established on the basis of the traditional decomposition of aggregate output into the economy's cycle and long-term trend components. The long-term trend is the (hypothetical)

output level that would result if all prices and wages in the economy were flexible. Its determinants are supply factors such as workforce growth and educational level, increase in physical capital, and overall efficiency in allocating and administering productive resources. The economic cycle is defined as temporary (short-term) deviations output from its trend level. Its chief determinant is the behavior of aggregate demand, which is particularly affected by macroeconomic (fiscal and monetary) policy and by external shocks (eg, unexpected changes in the terms of trade or capital flows). Hence, when actual output (spending) is higher than potential output inflation tends to rise and when it is smaller inflation tends to fall.

As explained below, central banks affect the behavior of aggregate demand by modifying their interest rates and the level of primary liquidity in the economy. When, for example, actual output is below its potential level and expected inflation is below target, central banks will reduce their intervention interest rates and provide greater liquidity to the economy. In this way they stimulate real demand and productive activity, at the same time as bringing expected inflation closer to the set target. By contrast, when the economy is operating above its potential capacity, they tighten monetary policy to reduce spending and bring inflation to levels consistent with their targets; otherwise, both inflation expectations and actual inflation will accelerate, and unmanageable macroeconomic imbalances (current account deficits, asset-price bubbles) will be created that will lead to the collapse of growth in output and employment. The central bank therefore plays a major part in curbing inflation and, as the authority responsible for monetary policy,

must help to make economic cycles smoother. It is not advisable to maintain a loose monetary-policy posture indefinitely, for it would cause inflation to go up and affect the economy's stability.

Nevertheless, it is important to bear in mind that, in an open or semi-open economy like Colombia's, there are limits to the capacity of monetary policy to affect aggregate demand or make economic cycles smoother. For example, with a floating exchange rate, monetary overexpansion will accelerate devaluation of the peso and thereby raise both inflation and inflation expectations. Expectations of rising devaluation and inflation will push interest rates up and cause aggregate spending to contract; thus, monetary overexpansion may lead to higher inflation and lower growth in output and employment, and monetary policy will be quite unable to reduce real interest rates in the medium or long term. All the same, monetary policy can make a substantial indirect contribution to long-term growth, since low inflation rates will create a climate of greater certainty for making investment and savings decisions and thus foster a deepening and enhancement of the financial system and capital markets. In the long run, therefore, achieving a low, stable rate of inflation is the best contribution that monetary policy can make to the objective of growth and job creation.

2. Monetary and exchange-rate policy instruments

The Banco de la República exerts an influence on the economy through interest rates on the short-term funds it lends or borrows, and through the net liquidity it provides to the financial system. The Bank may also intervene in the exchange market by buying or selling foreign currency. The main instrument of monetary policy are interest rates for monetary-expansion or monetary-contraction auctions. Changes in these rates affect prices and output through a channel known in economic literature as the "monetary-policy transmission mechanism." This is a long, variable process by which variations in the Bank's interest rates are directly transmitted to interest rates in the interbank market. Subsequently, owing to expectations of higher interest rates in future,

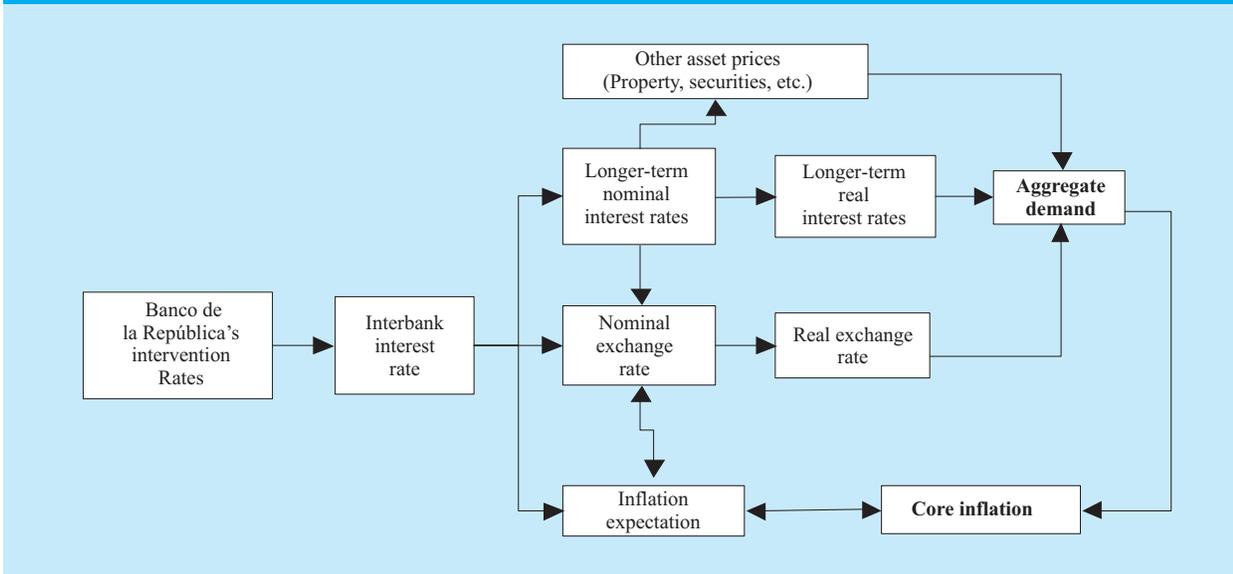
changes occur in the longer-term interest rates (Diagram 1). With prices and inflation expectations rigid in the short-term, movements in nominal rates are translated into changes in real interest rates.

Changes in real interest rates directly affect the consumption and investment decisions of private-sector agents. They also alter the prices of assets such as the exchange rate, real estate and equities. Moreover, these changes modify consumption and investment plans, and the incentives offered to the financial system for lending intermediated resources. The exchange rate produces a direct and relatively rapid effect on inflation by modifying the domestic prices of imported or exported goods and services included in the CPI basket. With prices rigid in the short term, variations in the nominal exchange rate are transmitted to the real exchange rate, thereby modifying the demand for exports and for goods competing with imports.

Modifications in consumption, investment and net exports alter aggregate demand. Since the economy's output is determined in the short term by aggregate demand, the above effects are reflected in changes in output and employment. If the resulting level of output is higher (lower) than the economy's maximum capacity for producing goods and services (the so-called "potential output"), there will be upward (downward) movements in inflation. In general, if output is higher than the "potential" level, inflation will tend to accelerate, and conversely an output level below potential will lead to lower inflation.

Besides producing an impact through aggregate demand and the exchange rate, monetary policy affects prices through changes in inflation expectations. Inflation expectations have an effect on current and future inflation insofar as economic agents price the goods and services they produce on the basis of expected inflation. Inflation expectations themselves depend among other things on past inflation and on both current and expected monetary-policy stances (Diagram 1). Accordingly, if the monetary authority announces an inflation target and takes credible measures conducive to it, inflation

DIAGRAM 1
MONETARY POLICY TRANSMISSION MECHANISMS

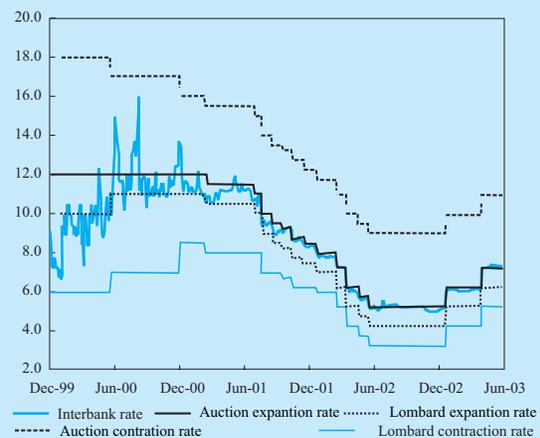


expectations will be more likely to move toward the target.

The monetary-policy transmission channels described above are magnified or attenuated by credit-market behavior. In effect, if companies and households have no other major source of financing than bank credit, and if credit is not an easily substitutable asset on the balance sheets of banks, monetary expansion will have a more powerful effect on aggregate demand. For monetary expansion will not only increase the total quantity of lendable funds but will also increase the supply of bank credit by reducing the return on alternative uses. However, when the solvency of private-sector agents and of the financial system itself is at a very low point (eg, after a severe recession), the effect of monetary-policy easing may prove insufficient for bringing about an instantaneous economic upturn. This is because the perception of risk in the economy is so high that credit supply contracts and fails to respond to the additional provision of liquidity by the central bank. The liquidity is invested in "low-risk" papers such as public-debt securities. This situation is referred as a "credit crunch".

Experience shows that changes in the Bank's intervention interest rates have a strong, rapid effect on the (very short-term) interbank interest rate (Figure 1). Changes in monetary-policy stance do not affect longer-term interest rates with the same force and speed, partly because such rates depend also on market expectations about future actions by the central bank. The banks' deposit rates are influenced

FIGURE 1
INTERBANK RATE AND BANCO DE LA REPÚBLICA'S INTERVENTION RATES (PERCENTAGE)



Source: Banco de la República.

by the need for funds to lend, which in turn depends on the profitability of the credit business. The pass-through of central-bank action to prices and output usually takes between six and eight quarters.

The Board of Directors of the Bank is also the country's exchange authority. As such, it may intervene at any time in the currency market for the purpose of meeting inflation targets or mitigating external shocks. After abandoning the exchange-rate band, the Board designed mechanisms for making transparent, pre-announced interventions with clearly defined objectives. These mechanisms are the following three types of auction of options (rights) to buy or sell foreign currency from or to the Bank:

- i) Auction of options for deaccumulation of international reserves. This mechanism has been created to contain inflationary pressure from a temporary over-devaluation of the peso unconnected with the fundamental determinants of the exchange rate. It should be noted that, as designed, this mechanism is used by the Bank to sell foreign currency when the exchange rate presents a devaluatory trend.
- ii) Auction of options for accumulating international reserves. This mechanism has been designed to strengthen the country's external position without jeopardizing the attainment of inflation targets. The aim is to maintain adequate levels of foreign liquidity to ensure the country's international payments and facilitate future external financing for the economy. As designed, this mechanism is used by the Bank to buy foreign currency when the exchange rate presents a revaluatory trend.
- iii) Auction of options to control volatility. This mechanism is activated when the exchange rate shows pronounced deviation from its short-term trend (for example, because of liquidity problems in the exchange market).

Given the pre-announced nature of these auctions, the markets are aware of the circumstances in which the Bank may intervene in the exchange market.

3. Monetary and exchange policy decision-making and implementation

The Bank's interest-rate decisions are taken on the basis of a thorough assessment of the economy. The purpose of the assessment is to determine whether expected inflation is consistent with meeting the inflation targets. Since the central bank's intervention interest rates produce no immediate effect on output or prices, its interest-rate decisions depend on foreseeing the economy's behavior. This is a highly complex task, performed by the Board once a month on the basis of the Bank's *Inflation report*.

The *Inflation report* analyzes recent price trends and the main determinants of inflation (eg, movements in monetary and financial aggregates, the exchange rate, wages, the gap between actual and potential output, and external demand). It also presents forecasts of different inflation measures for one to two years ahead, based on technical statistics, available information regarding the current state of the economy, and the Bank's view of the monetary-policy transmission mechanism. On the basis of such analyses, the Board defines the posture of monetary policy (eg, modification of intervention interest rates). The Inflation Report is published on a quarterly basis

When the Board concludes that intervention rates need to be changed, it usually makes the changes gradually. It does so because of uncertainty about both the future behavior of the economy (which is constantly subject to unforeseeable external shocks) and the parameters of the statistical models used. In some cases however the Bank has to act drastically, especially in the face of strong external shocks and when the economy's forecast behavior is clearly seen to deviate from the inflation targets, producing adverse effects on market expectations.

Consumer prices vary every month. Sometimes however they fluctuate strongly in response to changes in commodity supply, taxes, subsidies or controlled prices. These are supply shocks not necessarily needing a change in monetary-policy stance, which as we have seen affects demand in the economy. To analyze such price shocks, the Bank has devised so-called "core inflation" measures.

These measures are usually CPI sub-baskets or transformations intended to isolate the effect of "supply" changes such as those referred to above. The Bank currently uses three core-inflation indicators. They are monitored, evaluated and forecast as a basis for monetary-policy strategy and Inflation Report analysis. Their significance can be appreciated from the fact that the Board may refrain from adjusting the Bank's intervention interest rates when inflation rises (even strongly), if the rise clearly stems from a transitory "supply shock" that does not jeopardize the long-term inflation trend.

The Board has set no exchange-rate targets since September 1999. But the extent to which the Colombian economy has been opened up makes nominal exchange-rate behavior an important consideration for the Bank in defining its monetary-policy stance. As mentioned in discussing the monetary-policy transmission mechanism, independent exchange-rate movements caused, for example, by shocks or changes in investor sentiment affect prices directly and indirectly, and in some cases their effect on inflation and inflation expectations may even be large. When this happens and jeopardizes meeting inflation targets, the central bank will modify its monetary-policy stance. This action in itself is in no way intended to stabilize the exchange rate; it is exclusively prompted by the central bank's aims of stabilizing inflation and reducing deviations of output from the potential level.

Exchange-rate shocks are a natural and unavoidable phenomenon in inflation targeting as applied in Colombia. The exchange rate is, by its nature, a highly volatile asset price, affected by numerous factors,

including inflation expectations. Hence, greater monetary-policy credibility, understood as the existence of inflation expectations consistent with meeting the inflation targets, will diminish one major source of shocks to the exchange rate.

Exchange markets characteristically generate both permanent and transitory exchange-rate changes that are very difficult to identify and differentiate and sometimes even irrational. In such circumstances, central banks tend to respond gradually to developments in exchange markets. But when exchange-rate behavior indicates without much doubt that the credibility of monetary policy is at stake, the monetary authority may react strongly by modifying interest rates or intervening in the exchange market or doing both.

It should be noted that conduct of monetary and exchange policy is coordinated between the government and the Banco de la República. Coordination is ensured by the fact that Minister of Finance and Public Credit sits on the Bank's Board of Directors and his delegates attend the meetings of the Bank's Monetary and Exchange Intervention Committee, which makes decisions on liquidity supply, and the weekly meetings of the Open Market Committee, which monitors the behavior of monetary and exchange markets. The Bank's decisions regarding the provision of peso liquidity to the market have to be consistent with the National Treasury's investment decisions, and thus call for a high degree of coordination between the two entities.

B. FISCAL POLICY AND ITS INTERACTION WITH MONETARY POLICY

The conduct and outcome of monetary policy are not independent of fiscal policy. The impact of monetary policy on the economy is conditioned by fiscal policy in both the long and the short term. For example, in the long term, the existence of an expected

sequence of excessive fiscal deficits may reduce monetary-policy credibility, because private agents will anticipate a large monetary expansion in future, intended for the purpose of "watering down" public debt when it becomes unsustainable¹ or directly financing the fiscal deficit. In these circumstances, expectations about future inflation will remain high, no matter how contractionary monetary policy may be in the short term to bring inflation down to low, stable rates. Monetary policy is then said to be "dominated" by the fiscal situation. In the presence of some price rigidity, the combination of high inflation expectations (resulting from the fiscal situation) and contractionary monetary policy will entail costs in terms of economic activity and employment. Naturally, this situation becomes a short-term problem if the level of public debt is high and, given the expected deficits, will rapidly reach the point of being unsustainable.

Fiscal policy also conditions the outcome of monetary policy in the short term, through its impact on the credit, capital and exchange markets. In an economy with limited access to external financing,

the existence of a large fiscal deficit puts strong pressure on domestic savings, which in turn is reflected in higher real interest rates in the credit and capital markets, and in the resulting displacement of private spending (consumer or investment). Monetary policy could ease this situation in the short term by a liquidity expansion that transitorily reduces interest rates. But such an expansion would signify future interest-rate rises². And even if the monetary authority announces a non-accommodating policy, its credibility would be impaired (higher inflation expectations) by public perception that monetary policy may come under pressure to mitigate the impact of public-deficit financing on interest rates. Even where monetary policy is eased, it may not prove very effective in boosting aggregate demand if the additional liquidity provided is channeled to public-deficit financing instead of being directed to private-sector credit supply. In this way, fiscal policy conditions the results and the very decisions of monetary policy.

¹ Provided it has been issued at fixed nominal interest rates.

² This accommodating monetary policy may even prove ineffective in reducing interest rates that are relevant to public financing (usually long-term rates), because monetary expansion raises inflation expectations and hence longer-term nominal interest rates.

COMMUNICATION OF THE DECISION OF THE BANCO DE LA REPÚBLICA'S BOARD OF DIRECTORS

Decisions by the Banco de la República's Board of Directors on monetary and exchange policy are published immediately after the monthly meeting at which the Inflation Report is analyzed. To this end, a press release is distributed to markets and economic journalists. This is done even when the Board decides to leave the Bank's intervention interest rates unchanged or to take no action in the exchange market. Sometimes a press conference is called to explain the Board's decision in greater detail. The press conference is attended by the Minister of Finance in his capacity as Chairman of the Board, and the President of the Bank.

The Board's decisions are mainly explained through Inflation Reports, Reports to Congress, press releases, conferences, and through presentations at academic events by members of the Board and the Bank's technical team.

RESEARCH, MODELS, AND PRODUCTION OF STATISTICS

The successful conduct of monetary policy depends on the knowledge and quantification of monetary-policy transmission channels and on the ability to predict economic trends and events, which requires constant, detailed analysis of the working of Colombia's economy. For this purpose, it is essential to carry out economic research, develop simulation and forecasting models, and generate statistics of high technical quality.

In investigating monetary-policy transmission mechanisms, the effect of changes in primary liquidity or the Bank's intervention rates on longer-term interest rates is analyzed. "Output gap" estimates are made using different statistical methodologies, and the effect on prices is calculated. The pass-through of exchange-rate variations to import prices is assessed, as is the pass-through from import prices to headline CPI. Money-demand functions are estimated and the relation between the various monetary aggregates and prices is examined for the short term and long term. The behavior of credit and its determinants is monitored, including the effect of credit on the speed and efficiency of monetary-policy transmission.

In addition, theoretical inflation models are built, and the estimates obtained with them for Colombia are used to make forecasts for the quarterly Inflation Reports, on the basis of available information and characterization of the monetary-policy transmission mechanism. All the foregoing is accompanied by theoretical and empirical work on the determinants of economic growth, the role of the financial system, movements in public finances, the working of the labor market and the macroeconomic and microeconomic determinants of employment and unemployment in Colombia.

Empirical research is supplemented by conceptual studies on designing and implementing monetary policy. Special stress is laid on analyzing inflation targeting, including other countries' experience with this and other monetary strategies.

Much of the research work is published in the Bank's reviews or in the Borradores de Economía series. So far this year 12 studies have been published by the Bank or other national institutions, and eight articles are in due to come out in international reviews or books. On the basis of the research work, the Bank's technical team and directors take part in research networks and economic-policy discussion at national and international levels, and permanent contact is maintained with the central banks of developing countries as with central banks having a longer tradition and more experience in managing monetary policy in the world.

The Bank also produces a substantial part of the country's economic statistics, the most important being monetary, credit and exchange-rate statistics. This data serves as a basis for the Board of Directors' economic-policy decision-making and is also used by other public- and private-sector entities and analysts. The statistics are published on the Bank's website and in numerous periodic publications freely accessible to any Colombian or foreign individuals or entities needing them. Continuous efforts are made to improve the quality and timeliness of information, with Colombia ranking high among the group of developing countries in this respect.

a. Financial statistics

Financial statistics include information on monetary aggregates, credit, interest rates, exchange balance and the country's international reserves. This information is prepared on a daily, weekly and/or monthly basis and is drawn from different sources, ranging from the financial system's balances to the Bank's internal accounting.

b. Economic indicators

Numerous economic indicators are produced at the Bank in accordance with international standards. The most commonly used both within the Bank and outside it include the producer price index, the real exchange-rate index, lending and deposit rates, terms of trade, the Real Value Unit, and economic expectations indicators.

c. Customs and exchange statistics

The Banco de la República produces statistics on Colombia's payments, financial transactions and investments flows with other countries. These statistics are compiled on a quarterly and yearly basis in a detailed manner in the country's balance of payments. To this end, information is obtained from the National Tax and Customs Administration (DIAN) and the National Statistics Agency (DANE) on exports and imports, and from official registers on external borrowing and foreign investment in Colombia and by Colombians abroad; numerous surveys are conducted; and the balance sheets and financial reports of firms are processed, among other things. Monthly statistics of public external debt are prepared from data provided by the Ministry of Finance and Public Credit, the World Bank and the Inter-American Development Bank, supplemented by surveys of sector entities. Private-sector debt is estimated from exchange registrations effected at the Banco de la República's International Exchange Department and from weekly reports by financial entities to the Bank's Economic Studies Division (SGEE). This information is of vital importance to economic-policy decision-making. It is widely used in historical analyses and economic forecasting, and its timely publication is crucial to maintaining access to foreign funds open for public- and private-sector agents.

d. Financial accounts

Financial accounts are an analytical tool for learning about the financial interrelations between the different sectors of the economy (families, firms, government, external sector) and identifying by sector what kind of financial instruments are used in placing resources or in financing. These statistics are prepared from information obtained from almost 12,000 real-sector enterprises and 500 financial-sector entities, supplemented by information compiled by the National Accounting Office on national, provincial and municipal public entities.

e. Public-sector statistics

Every quarter the Bank's Public Sector Section draws up and reports the combined public-sector fiscal balance on information regarding the sources of financing. The estimates are used to monitor the country's fiscal performance under the recent IMF accords. They are based on the main instruments used by the combined public sector for financing its financial imbalances (ie, bank credit {information from the Banking Superintendency}; foreign credit and bonds issued abroad {information on the balance of payments from SGEE and the Finance Ministry's Public Credit Office}; and portfolio movements {information from the Bank's Exchange Department and the Finance Ministry's Treasury Office}). Included in the combined public-sector balance are the Bank's cash profits and Fogafin's cash balance, with each entity providing the relevant information. Accrual-based operations are also included, on information from the Finance Ministry's Budget Office.

The Bank's Public Sector Office also prepares other fiscal statistics and indicators, for different purposes. On the basis of flows information from the Finance Ministry's Treasury Office, it publishes a quarterly report on the government's fiscal situation. On regional financial information compiled by the Bank's Medellín branch, it prepares a half-yearly report on the evolution of regional public finances. Drawing on various sources of information (especially the Banking Superintendency, the Finance Ministry and the Bank), it draws up a statistical bulletin on public-debt movements. And, with information from the Higher Fiscal-Policy Council, the National Planning Department and the Comptrollership General, the Public Sector Office keeps a database on the country's public finances, which allows it to put out various indicators for multiple purposes.

In an economy having sufficient access to external financing, a similar situation would arise but through a different channel. Public-deficit financing puts pressure on domestic interest rates, thereby attracting external capital, or public financing itself is directly carried out with external savings. In this case the currency will appreciate in nominal and real terms. Since appreciation harms the sectors that produce tradables (exports or import substitutes), the monetary authority will be pressed to adopt a looser stance that will lower interest rates and reduce the value of the currency. The outcome, once again, is higher inflation or lower monetary-policy credibility (higher inflation expectations).

In the longer run, with higher public spending especially concentrated in nontradable goods and services (ie, greater spending on personal services), nontradable prices will tend to rise faster than the prices of tradable goods. The sectors producing tradables will be harmed and will press the monetary authority to offset this development through greater depreciation of the currency. Here again, fiscal policy conditions the outcome and conduct of monetary policy.

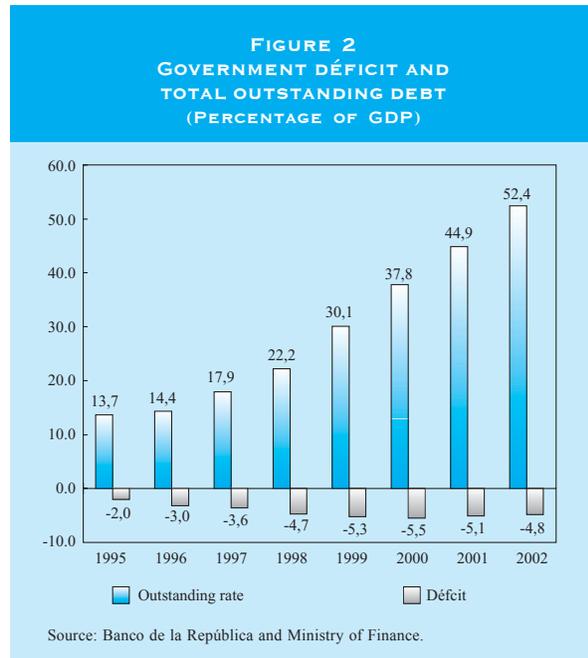
In Colombia, fiscal policy has been conditioning monetary policy for a decade, through all the channels described above.

The fiscal deficit has decreased since 1999 but is still too big for public debt to be stabilized. As can be seen from Figure 2, public debt has grown fast in recent years³: as a percentage of GDP, it is now over 52% for the central government and 62% for the consolidated non-financial public sector⁴. A significant rise in this indicator would spell problems for the country's monetary-policy management and macroeconomic stabilization.

In order to ease this situation, improve the efficiency of monetary policy, and avoid macroeconomic

³ It is noteworthy that part of this growth has resulted from the peso's real depreciation since 1999. While this depreciation may have become permanent, the fiscal situation is more fragile although the deficit has narrowed.

⁴ This is the gross amount of public debt.



destabilization, it is essential that fiscal policy be resolutely oriented toward reducing the public deficit. Meeting the fiscal-deficit target of 2.5% of GDP in 2003 will be a step in this direction.

To stabilize public debt it is equally vital to meet the consolidated fiscal- deficit target for 2004 and to keep this deficit low in future. The government and Congress must spare no effort to reach this target. Attaining it will help to clear the outlook for the country's public finances and raise confidence in our economy at home and abroad, thus bringing benefits in terms of investment growth and access to external savings. In addition, monetary policy will become more effective once economic agents have no reason to expect high inflation rates, making it easier for the monetary authority to keep inflation low and stable and conduct a counter-cyclical policy when necessary.

C. MONETARY AND EXCHANGE POLICY IN 2003

1. Background

GDP has been running systematically below potential since 1999 because of a set of mainly external shocks

(to the terms of trade and capital flows) that have beset the region's economies. The shocks affected agents' confidence in the Colombian economy in a context of increasing fiscal deterioration that has existed since the first half of the 1990s (Figure 3).

In this context the Banco de la República has applied an anticyclical monetary policy, as illustrated by three specific facts: i) The Bank's intervention interest rates were cut once in 2000, eight times in 2001 and a further five times in 2002. The auction expansion rate fell from 8.5% in December 2001 to 5.25% in December 2002, resulting negative by 1.7% in real terms. ii) In 2002 growth in the monetary base averaged 19.2%, far higher than nominal GDP growth (about 8%). Something similar had occurred in 2001 (15.7% v. 7.5%). iii) In 2002 the Bank handed over profits of 1.3 billion pesos to the government. In 2001 it had handed over some 1.5 bn pesos and in 2000 a sum of 0.5 bn pesos.

These policies caused the deposit rate (DTF) to drop from 11.4% in December 2001 to 7.7% in December 2002 and to 7.8% in June this year. In real terms, discounting inflation, the DTF rate fell from 3.5% in December 2001 to 0.7% twelve months later. This resulted in lower lending rates. Between December

2001 and December 2002, the average rate for ordinary loans fell from 18.3% to 14.9%, and for consumer loans from 31.3% to 27%. Over the same period, the real rate for ordinary loans dropped from 9.8% to 7.4% and for consumer loans from 22.0% to 18.7%. At the same time, inflation remained on a downward path, behaving in a manner consistent with the inflation target until the third quarter of 2002.

Monetary policy may therefore be said to have taken into account the behavior of output and employment in the very design of its inflation-targeting strategy, by setting very gradual inflation-curbing targets, defining them increasingly earlier each year-with indication of guideline ranges for future targeting-, and by not responding to negative supply shocks that were not attended by higher inflation expectations.

Monetary policy was able perform this anticyclical function thanks to the falling trend of core inflation, with the result that up to the third quarter of 2002 both actual and expected inflation were consistent with meeting the Board's targets.

External conditions, too, were favorable for applying an anticyclical monetary policy, because of the cuts made in US interest rates from the beginning of 2001. Moreover, for most of this period the Colombian public sector had relatively easy access to external financing and was even able to prefinance \$1,800 m of its external-fund needs for 2002. Consequently, public-deficit financing did not put pressure on domestic sources beyond levels compatible with the period's typically low interest rates.

2. Monetary and exchange policy conditions and decisions in 2003

At the end of 2002 consumer inflation was 6.99%, almost one percentage point above the target, and producer inflation stood at 9.3%. They had risen by 1.0 and 2.5 percentage points respectively between September and December (Figure 4). Over this same period the average of the core-inflation indicators

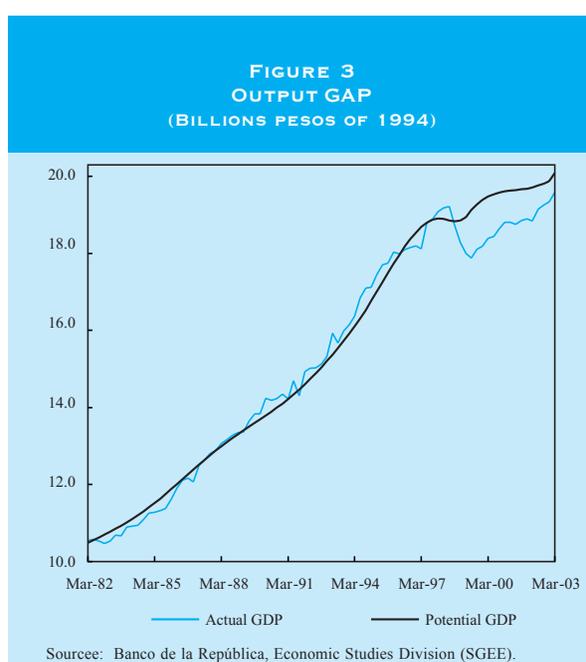
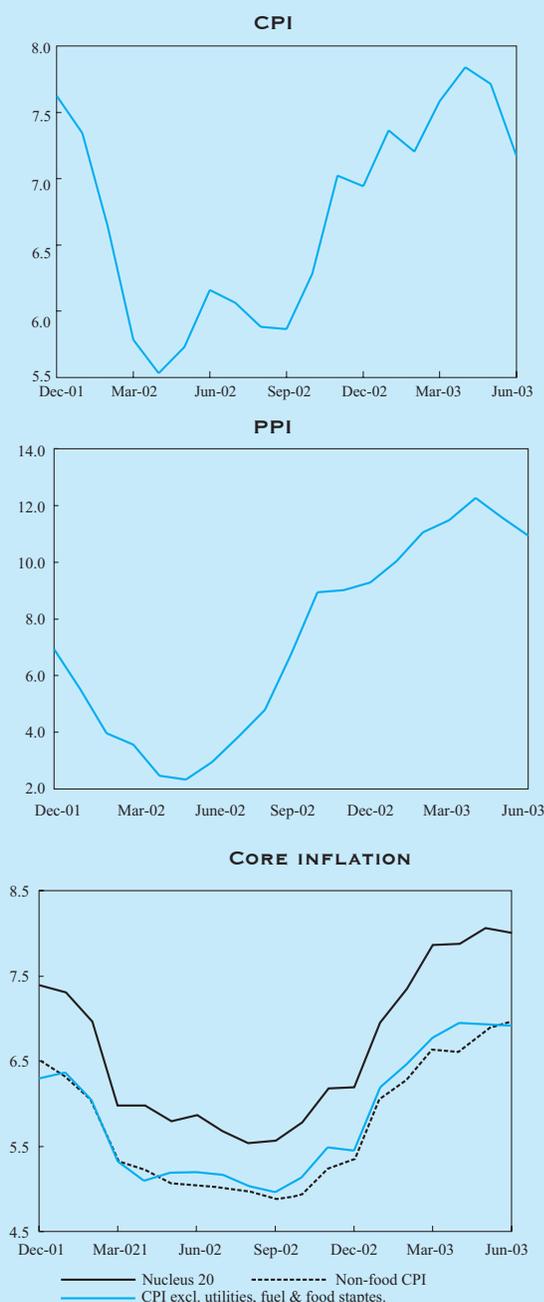


FIGURE 4
ANNUAL CONSUMER, PRODUCER AND
CORE INFLATION
(PERCENTAGE)



Source: DANE, Calculation by Banco de la República.

devised by the Bank rose from 5.1% to 5.6%, at annual rate. These rises occurred despite the fact that the economy was operating below capacity, as indicated earlier.

Core inflation and producer inflation accelerated mainly because high rates of devaluation in the second half of 2002 affected the prices of tradables and imported inputs, and also because international prices for fuel and imports of raw materials were on the rise.

The economic situation at the beginning of this year therefore suggests that: i) monetary policy suffered a loss of credibility because, for the first time since 1998, the inflation target was not met although the core-inflation indicators' average was under 6.0% at the end of 2002; ii) strong devaluation affected prices, jeopardizing attainment of future inflation targets; and iii) rising headline inflation together with stronger devaluation risked exacerbating inflation expectations, deflecting them from the target.

Moreover, fuel prices, electricity charges and value-added-tax rates on some products were expected to be raised in 2003. At the same time real interest rates had fallen sharply in 2002, down to negative levels.

All these factors put the credibility of monetary policy at risk, which could have resulted in greater volatility of output and inflation, with negative long-term effects on job creation and economic activity. In this context, in January the Board decided to raise the Bank's intervention rates, and in mid-February announced its readiness to intervene in the exchange market with up to \$1 billion of international reserves. It also announced an auction of options in March to reduce reserves by \$200 m; options worth \$145 m were exercised.

As a result of these initial monetary-policy actions, the interbank rate rose by 100 basis points, while the DTF deposit rate remained relatively unchanged. In addition, devaluation braked immediately after the announcement of intervention in the exchange market, albeit at high rates of exchange (averaging 2,959 pesos to the dollar in March).

The deposit rate's behavior showed that monetary conditions early in the year were so loose that the

rise in the Bank's intervention rate did not pass through at all to the other rates in the economy (except the interbank rate). Besides, the exchange rate's response to announcements of intervention in the exchange market, and to the auction held to reduce reserves confirmed that the peso's rapid devaluation at the start of the year was not attributable to fundamental economic factors but to over-pessimism on the part of agents.

Inflation results in March confirm the need for further action by the central bank to check the rise in inflation and inflation expectations. At annual rates, the Bank's core-inflation indicators averaged 7.1% in March, up from 6.3% in January, while producer inflation stood at 11.5% in March, a steep rise from 2.3% ten months earlier. This occurred while the economy was still operating below capacity.

The fact that core inflation and producer inflation accelerated despite the exchange rate having remained stable from mid-February suggests that a devaluation rate inconsistent with the Bank's inflation targets was implicit in that exchange-rate level and had a lagged effect on inflation. But the greatest danger to the Bank's price stabilization policy was not just the overshooting of the target caused by devaluation, but also the pick-up in inflation expectations.

In effect, there was evidence that inflation expectations were rising sharply and threatening to have a permanent effect on the future course of inflation. According to the Bank's quarterly expectations survey, in March respondents' forecasts for inflation by December 2003 averaged 7.9%, far above the 6.6% they had predicted in January. Similarly, the percentage of respondents believing that the 5.5% target for 2003 would met was dramatically lower in April (16.1%) than three months earlier (42%). In these circumstances, the Board decided to call a second auction for April to reduce international reserves by \$200 m and raised its intervention rates by 100 basis points on April 24, 2003.

The exchange rate began to fall from the beginning of April and by June averaged 2,827 pesos to the dollar, giving a 19.8% average devaluation at annual rate (Figure 5). The call options auctioned were not exercised because of the peso's appreciation.

Other economies of the region registered a similar exchange-rate behavior as risk indicators declined and foreign-capital inflows picked up.

In Colombia, despite the drop in the exchange rate, the strong depreciation accumulated since mid-2002 has continued to produce lagged increases in domestic prices. In June, consumer inflation in tradables stood at an annual rate of 8.7%, a steep climb from 6.6% in December. In the past two months however tradables inflation has fallen off slightly, which suggests that pressure from devaluation has begun to ease; it may continue to do so if the exchange rate does not increase significantly over the rest of the year (Figure 6).

Annual consumer inflation rose sharply until April, reaching 7.8%. But in the past two months (May and June) it has come down appreciably (to 7.2% in June), thanks largely to lower food prices (Table 1).

FIGURE 5
NOMINAL ANNUAL DEVALUATION
(PERCENTAGE)



Source: Banco de la República.

In contrast, core inflation continued to climb during the second quarter, though far more slowly than in the months since last October. In June the Bank's three core-inflation indicators averaged 7.3%, up by 20 basis points on March.

Higher core inflation in the second quarter, as in the first, is not attributable to demand pressure. The different measures of industrial capacity utilization were below historical averages, and various estimates of potential GDP suggest that potential GDP remains higher than actual GDP. This opinion is borne out by the fact that inflation was low for some CPI groups, such as education, culture and entertainment, rent and services in general, that are more liable to respond to demand pressure (Table 1).

Regarding the second half of the year, the lagged pressure from devaluation is expected to be present still. But, if the exchange rate remains stable, it should keep on waning, so that most of it will have vanished by the end of this year or the beginning of next.

Besides the inflationary effects of devaluation, pressure is also expected from regulated electricity,

gas, fuel and transport prices. On information from the respective regulators, these administered prices are expected to continue to be raised by more than the inflation target and therefore constitute sources of above-target CPI increases.

Higher inflation expectations are the greatest risk facing the Bank's price stabilization policy for this year and next. Although inflation is currently forecast to register a large drop in the last quarter of this year, the rate up to September is predicted to be close to 7.0%. Core inflation is unlikely to run under 7.2% and may even edge up in the following months. In these conditions, inflation expectations may resurge in such a way as to affect the path of inflation in 2003 and 2004 negatively, generating new pressures on monetary policy. A change of stance would thus be called for to maintain credibility and achieve macroeconomic stabilization.

3. The anticyclical nature of monetary policy in 2003

Although the Bank's intervention rates have been raised this year, monetary policy has remained counter-cyclical and contributed to the upturn in economic activity and employment. This is evidenced by the fact that in real terms the Bank's rates have stayed negative. The Bank's minimum one-day auction expansion and contraction rates currently stand at 7.25% and 5.25% respectively (Table 2), corresponding to -0.9% and -1.83% in real terms. As mentioned above, these rates closely guide the behavior of the interbank rate, now running at 7.4% (or 0.13% in real terms).

Moreover, the monetary base continues to grow at a faster pace than nominal GDP: at annual rates, the monetary base expanded by 18.6% in the first half of 2003, compared with a GDP growth of about 10.0% (Figure 7 and Table 3).

Between July 2002 and June 2003, the monetary base's expansion (1,569 bn pesos) stemmed from the same sources as in 2002, though in the latest

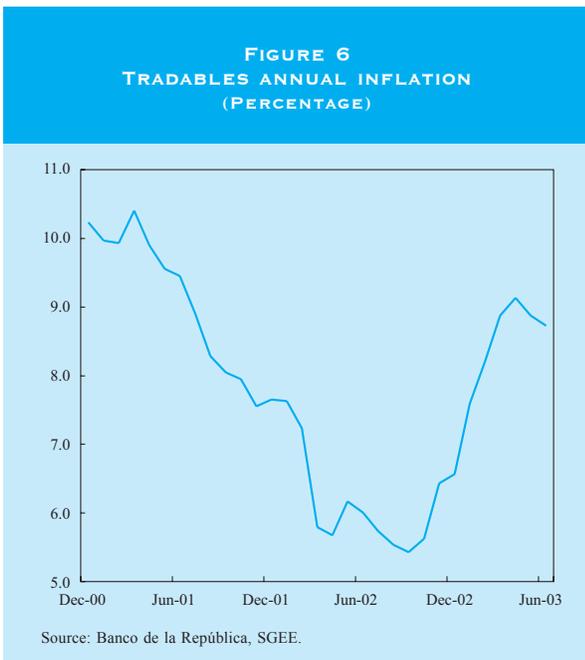


TABLE 1
INFLATION INDICATORS
(ANNUAL PERCENTAGE GROWTH)

	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03
I. CPI	5.9	6.2	6.0	7.0	7.6	7.2
Food	7.2	9.2	8.6	10.9	9.9	7.7
Housing	3.8	4.2	3.8	4.1	5.6	6.0
Clothing	2.2	1.1	0.9	0.7	0.9	1.4
Health care	9.3	9.7	8.9	9.2	9.7	9.1
Education	9.3	6.7	6.4	6.5	4.9	5.0
Culture and entertainment	7.0	5.9	4.7	5.3	4.1	4.8
Transport	5.8	5.0	5.1	5.9	9.5	10.7
Diverse expenditures	6.7	6.8	7.7	9.0	9.0	8.1
II. Core inflation 1/	5.6	5.3	5.1	5.6	7.1	7.3
Non-food CPI	5.3	5.0	4.9	5.4	6.6	7.0
Nucleus 2/	6.0	5.8	5.6	6.2	7.8	8.0
CPI excl. food staples, fuel & utilities	5.4	5.1	5.0	5.3	6.8	6.9
III. PPI	3.6	2.9	6.8	9.3	11.5	10.9
By use or economic destination						
Intermediate consumption	2.9	1.2	6.2	9.9	13.1	12.4
Final consumption	4.3	4.6	6.3	7.3	7.5	8.0
Capital goods	2.4	2.8	10.8	15.6	19.6	15.4
Building materials	5.0	5.0	6.4	7.8	11.7	11.7
By origin						
Domestically produced and consumed	4.4	3.4	5.5	7.1	8.3	8.6
Imports	0.8	1.6	10.7	16.0	21.7	18.3
Exports 3/	(7.1)	(2.4)	15.5	28.5	34.7	18.7
By industrial activity (CIU)						
Farming, forestry & fishing	2.4	2.1	6.8	9.2	7.8	8.7
Mining	1.7	2.1	22.4	33.3	37.7	26.6
Manufacturing	3.9	3.2	6.3	8.6	11.6	11.1

1/ The average of the three core-inflation indicators calculated by the Banco de la República.

2/ CPI excluding 20% of the weight of items showing the greatest price volatility between January 1990 and April 1999.

3/ Total PPI does not include exports. It is calculated from the weighted sum of domestically produced and consumed goods, and imports.

Sources: Economic Studies Division (SGEE) of the Banco de la República, and the PPI and CPI lists of the National Statistics Agency (DANE).

period funds for the government (3,515 bn pesos) were more significant. These were represented by the reduction of National Treasury deposits held at the Bank by 2,132 bn pesos, net purchases of TES securities worth 552 bn pesos, and the net monetary impact, 830 bn pesos, of transferred profits (1,418 billion pesos) (Table 4).

The nominal DTF deposit rate, which remains at record lows, was 7.77% in June, slightly higher than

in December, 7.73%⁵. In real terms the DTF now stands at 0.52%, far below its historical average. Longer-term lending rates (ie, 360-day CDs) behaved much the same as the DTF (Figure 8).

In June 2003 the nominal interest rate for consumer loans averaged 26.6%, for ordinary loans 18.0%, for preferential loans 11.2%, and for treasury loans 9.5%.

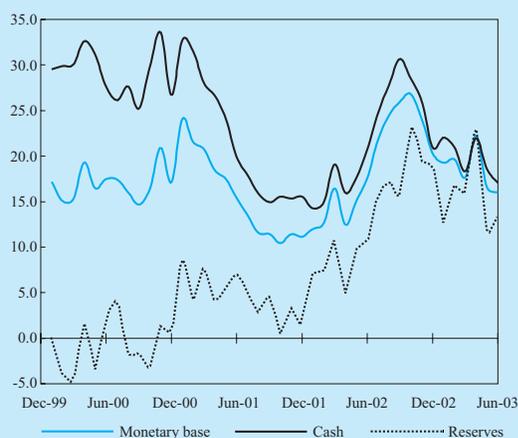
⁵ Calculated as the weighted average of 90-day fixed-term deposit rates.

TABLE 2
BANCO DE LA REPÚBLICA'S INTERVENTION RATES, 2001-2003
 (PERCENTAGE)

Period of Application		Minimum Lombard Contraction	Maximum auction Contraction	Minimum Auction expansion	Maximum Lombard expansion	Interbank rate (end of)	Real Interbank rate (end of)
From	To						
Dec.17-01	Jan.18-02	6.25	7.50	8.50	12.25	8.21	0.78
Jan.21-02	Mar.15-02	6.00	7.00	8.00	11.75	7.78	1.78
Mar.18-02	Apr.12-02	5.25	6.25	7.25	11.00	7.25	1.52
Apr.15-02	May.17-02	4.25	5.25	6.25	10.00	6.18	0.33
May.20-02	Jun.14-02	3.75	4.75	5.75	9.50	5.65	(0.56)
Jun.17-02	Jan.17-03	3.25	4.25	5.25	9.00	5.13	(2.11)
Jan.20-03	Apr.28-03	4.25	5.25	6.25	10.00	6.18	(1.55)
Apr.29-03		5.25	6.25	7.25	11.00	7.36	0.13

Source: Banco de la República.

FIGURE 7
MONETARY BASE AND ITS FORMS OF USE
 (ANNUAL % CHANGE IN MONTHLY AVERAGE)

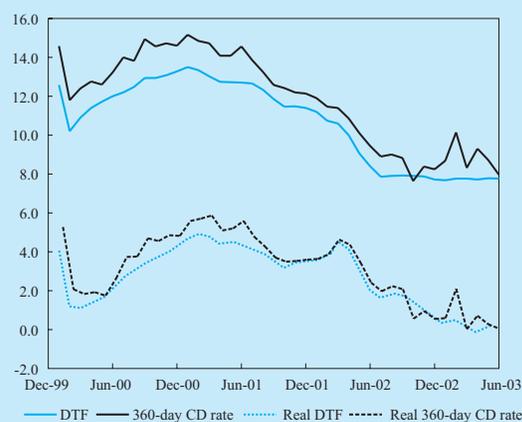


Source: Banco de la República, SGEE.

In real terms, these lending rates are close to their lowest since 2000 (Figure 9) and showed the following behavior relative to December 2002: consumer rates fell by 59 bp, ordinary rates rose by 56 bp, treasury rates rose by 30 bp, and preferential rates remained steady.

Interest rates for treasury paper (TES) trading currently stand at much the same levels as in mid-

FIGURE 8
NOMINAL AND REAL DEPOSITE RATES (*)
 (PERCENTAGE)



(*) Deflected by CPI
 Source: Banco de la República.

July 2002, before the closing of domestic and foreign markets for public-debt securities. The 10-year TES now trades at a rate of 14.7%, 250 bp lower than in April of this year, when the liquidity of the TES market decreased temporarily.

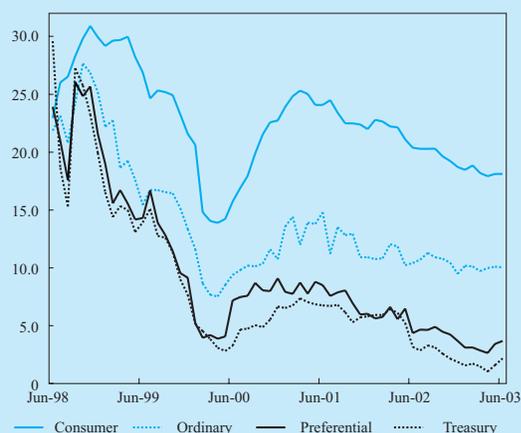
It is important also to mention the success of exchange-rate policy in helping to reduce devaluation. This obviated the likely need of future intervention-rate

TABLE 3
MONETARY AGGREGATES

		Base	Cash	Reserve	M1	Quasimoney	M2	Liabilities subject to reserves reqts	M3
Annual % nominal growth of monthly average									
2002	Jan.	12.0	14.3	7.1	10.2	6.0	7.1	8.1	8.7
	Feb.	12.6	14.9	7.5	14.6	3.6	6.3	6.6	7.4
	Mar.	16.4	19.1	10.7	15.5	3.2	6.2	6.1	7.3
	Apr.	12.4	16.0	5.0	18.0	3.6	7.1	7.7	8.5
	May.	15.1	17.6	9.7	19.7	4.3	8.0	8.3	9.1
	June.	17.6	20.7	10.9	24.7	2.5	7.8	7.8	9.1
	July.	21.8	24.7	15.6	25.5	1.5	7.3	6.8	8.6
	Aug.	24.5	27.8	17.0	29.1	1.3	7.8	5.5	7.6
	Sept.	26.0	30.7	15.8	29.7	3.6	9.7	6.4	8.8
	Oct.	26.8	28.5	23.1	29.2	5.4	11.1	5.2	7.5
	Nov.	24.0	26.0	19.5	22.6	5.7	9.9	5.4	7.4
	Dec.	20.3	20.9	18.6	18.3	4.7	8.5	5.7	7.4
2003	Jan.	19.2	22.0	12.8	22.9	5.2	10.0	6.5	8.2
	Feb.	19.7	21.0	16.7	21.1	7.1	10.8	8.9	10.2
	Mar.	17.6	18.3	16.1	20.3	9.1	12.1	10.5	11.4
	Apr.	22.2	22.0	22.8	18.2	9.2	11.6	8.9	10.3
	May.	16.6	18.6	11.9	13.4	9.3	10.4	9.6	10.6
	Jun.	16.0	17.1	13.5	13.6	10.3	11.2	10.6	11.3
Annual % real growth of monthly average									
2002	Jan.	4.3	6.4	(0.3)	2.6	(1.2)	(0.2)	0.7	1.2
	Feb.	5.5	7.7	0.8	7.4	(2.9)	(0.4)	(0.1)	0.6
	Mar.	10.0	12.5	4.5	9.1	(2.5)	0.3	0.2	1.3
	Apr.	6.4	9.8	(0.6)	11.7	(2.0)	1.3	2.0	2.7
	May.	8.7	11.1	3.7	13.1	(1.5)	2.0	2.3	3.1
	Jun.	10.6	13.6	4.4	17.4	(3.5)	1.5	1.5	2.6
	July.	14.7	17.5	8.9	18.2	(4.4)	1.1	0.6	2.3
	Aug.	17.4	20.6	10.4	21.9	(4.4)	1.8	(0.5)	1.6
	Sep.	18.9	23.3	9.3	22.4	(2.3)	3.6	0.4	2.6
	Oct.	19.3	20.8	15.7	21.5	(0.9)	4.5	(1.1)	1.0
	Nov.	15.9	17.7	11.6	14.5	(1.2)	2.7	(1.5)	0.4
	Dec.	12.4	13.0	10.9	10.6	(2.2)	1.4	(1.2)	0.3
2003	Jan.	11.0	13.6	5.0	14.4	(2,0)	2,4	(0.8)	0.8
	Feb.	11.6	12.8	8.8	12.9	(0,1)	3,3	1.6	2.8
	Mar.	9.3	9.9	7.9	11.8	1,4	4,2	2.7	3.5
	Apr.	13.3	13.1	13.9	9.6	1,2	3,5	1.0	2.3
	May.	8.2	10.1	3.9	5.3	1,4	2,5	1.8	2.6
	Jun.	8.2	9.2	5.8	6.0	2,9	3,7	3.2	3.8

Source: Banco de la República.

FIGURE 9
REAL LENDING RATES
BY TYPE OF LOAN
(PERCENTAGE)



Source: Banco de la República.

increases to check inflation expectations in an environment of higher devaluation rates, rising TES rates, larger country-risk premiums and greater macroeconomic instability. Such a situation would have damaged the climate of confidence that has allowed the recent economic upturn.

Despite lower devaluation, nominal and real exchange rates are at record highs. At the end of the first quarter, the market representative rate (TRM) stood at 2,817 pesos to the dollar, registering an annual depreciation of 17.5% (Figure 10). In the first half of this year, the peso's average annual depreciation against the dollar was 26.5%, relative to the first half of 2002.

The traditional measures of real exchange rate (ITCR-IPP and ITCR-IPC)⁶, show that the economy's competitiveness increased significantly in the first half of 2003. In March the PPI-related index was its highest point ever (140.4) with an annual variation of 26.0%,

⁶ The real exchange-rate index (ITCR: índice de tasa de cambio real) is an indicator of relative prices that measures variations in the country's competitiveness in relation to its main trading partners. It is traditionally calculated as ITCR-IPP and ITCR-IPC, using the producer-price index (IPP in Spanish) and consumer-price index (IPC in Spanish) as measures of domestic and external prices.

while the CPI-related index showed a 23.3% depreciation. Despite the dollar's recent appreciation, both the PPI-related index and the CPI-related index stood at historically high levels in June, registering real annual devaluations of 20.1% and 19.7% respectively.

The counter-cyclical policy applied by the Bank has led to a pick-up in economic activity, as described in greater detail below. This has in turn caused the broader monetary aggregates to expand. As in the case of the monetary base, in June annual growth in M1's average monthly balance (13.6%) remained higher than nominal GDP growth. The broad monetary aggregate, M3, registered an average growth of 10.3% for the first half of this year, at annual rate; its real growth was 3.3%, up from 0.8% in the first half of 2002 (Table 3). Liabilities subject to reserve requirements, the main component of M3, have shown positive real growth this year, with a rising trend that reached 3.2% in June. As mentioned earlier, this behavior is consistent with the signs of an upturn in the economy and the credit portfolio.

It is interesting to note that the impact of the anticyclical monetary policy has increased recently. Although an easy policy stance has been maintained since 2000, it is only in recent months that the pace of economic growth has picked up. This is partly

FIGURE 10
REPRESENTATIVE MARKET
EXCHANGE RATE
(PESOS TO THE DOLLAR)



Source: Banco de la República.

TABLE 4
MONETARY-BASE SOURCES, 1998 - JUNE 2003
(ANNUAL FLOW IN BILLIONS OF PESOS)

	1998	1999	2000	2001	2002	2003 1/
Government	644	2,480	832	914	1,667	3,515
Transferred profits	83	1,244	516	1,453	1,226	830
In pesos	83	1,244	516	1,453	1,226	1,481
In dollars						(651)
Net TES purchases	384	1,092	400	(623)	371	552
Treasury accounts in Banco de la República	177	143	(84)	84	70	2,132
Repos and pre-set liquidity amounts	899	1,730	(691)	(1,215)	1,128	39
Net currency purchases	(2,761)	(1,437)	692	1,445	(517)	(1,978)
Loan collection 2/			(112)	(225)	(4)	(4)
Other	(148)	44	249 3/	18	181 4/	(2)
Total	(1,365)	2,817	971	938	2,457	1,569
Base balance	6,922	9,739	10,710	11,648	14,104	12,669

Note: In terms of issuance, profit transfers are an operation of monetary contraction, similar to a sale of international reserves.

1/ Full year to June 27, 2003.

Base at July 1, 2002: 11,100.2 bn pesos.

Base at June 27, 2003: 12,669.2 bn pesos.

2/ Mainly from Granahorrar.

3/ Includes \$55 m foreign-currency purchases from multilateral agencies, increased by 126 bn pesos.

4/ Includes \$52 m foreign-currency purchases from multilateral agencies, increased by 131 bn pesos.

Source: Banco de la República.

explained by restored confidence in the country's future performance and by favorable developments in the financial system's situation, as evidenced by this year's credit figures.

Better expectations about growth and the economic situation have boosted

credit demand on the part of companies and households, whose borrowings have been reduced in recent years. Credit supply too has increased, thanks to lower perceptions of risk (greater confidence) in the economy and improvements in indicators of financial intermediaries' solvency, asset quality and profitability.

The figures show a substantial upturn in credit and in the financial system's situation. To June 2002, annual growth in the total gross nominal portfolio

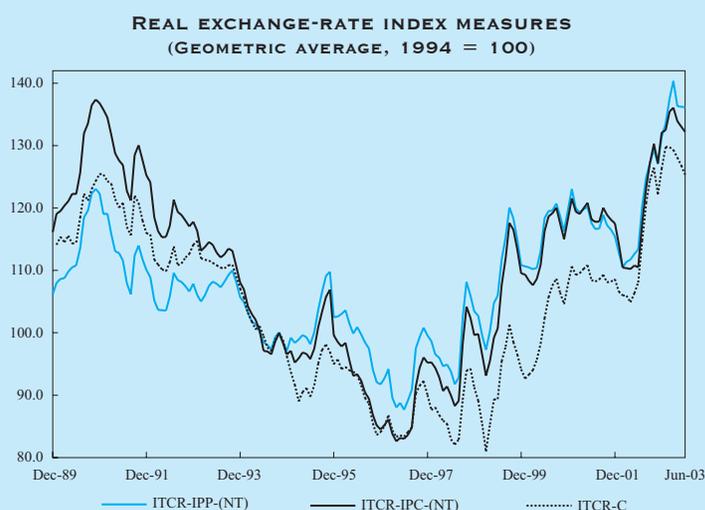
was 8.4%, with a 1.1% variation in real terms. The pick-up in the financial system's loan portfolio is evidenced by a 2.6% growth in the total gross nominal portfolio over the first half of this year, compared with a 0.3% contraction in the same period last year (Table 5).

By type of loan, average real growth at annual rate in the first half of this year compared with a year earlier was as follows: for local-currency consumer loans a 14.1% increase this year, against a 0.4% contraction last year; for local-currency commercial loans a 6.0% increase this year, against a 1.1% fall last year (Figure 11). The mortgage-loan portfolio shrank in real terms by 16.5% at annual rate over this period, affected, as it will be recalled, by a loan securitization program that removed from it mortgage loans worth 1,010.3

COMPETITIVITY INDEX IN RELATION TO OTHER COUNTRIES

Recently, to supplement the traditional competitiveness measures, the Bank has begun to calculate a real exchange-rate index (ITCR-C) to gauge the competitiveness of four Colombian exports to the United States market: coffee, bananas, flowers and textiles. This competitiveness measure is obtained by comparing in the same currency Colombia's CPI with those of countries that compete with us directly in the US market for these goods. One characteristic of this indicator is that the comparison includes countries that are not Colombia's trading partners and therefore not considered in the traditional measures.

As shown in the Figure below, the indicator reached a peak in February (129.8) with a 22.4% annual variation, having started a rising trend in early 1999. In June 2003 it stood at 125.3 with a 16.0% annual variation, and a January to June variation of -0.7%.



NT: Non-traditional trade weightings.
source: Banco de la República.

*"Competitividad de algunos productos colombianos que se exportan a Estados Unidos", Reportes del Emisor, No. 49, June 2003.

bn pesos between November 2002 and June of this year⁷.

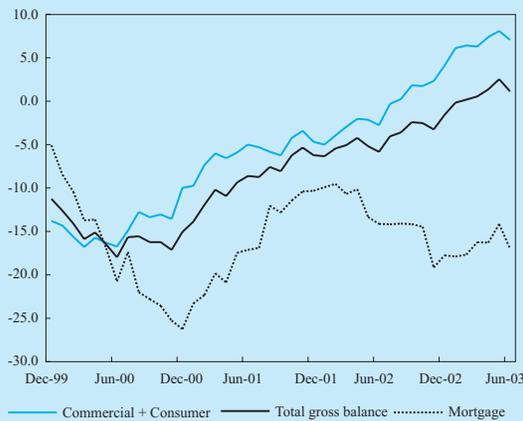
The traditional portfolio-quality indicator (overdue balance / gross balance) continued to improve over

⁷ Since April 2002, the securitization entity Titularizadora Colombia has bought and securitized mortgage loans worth 1,491,2 bn pesos, as follows: 480.9 bn pesos in April 2002, 561.9 bn pesos in the following November, and 448.4 bn pesos in June 2003.

the first five months of 2003, ending May at 8.84% (Figure 12). And the coverage indicator (provisions / overdue balance) stood at 83.3% in May (Figure 13).

The solvency indicator (technical capital / risk-weighted assets) for the entire financial system improved slightly in the first months of 2003, rising from 13.5% in December 2002 to 14.0% in May. For public-sector financial entities the indicator stood

FIGURE 11
GROSS REAL LOCAL-CURRENCY LOAN BALANCE
BY TYPE OF LOAN
(ANNUAL % CHANGE AVERAGE)



Sources: Banco de la República and Banking Superintendency.

FIGURE 12
PORTAFOLIO-QUALITY INDICATOR
(OVERDUE BALANCE / GROSSBALANCE)
(PERCENTAGES)



Sources: Banco de la República on information from the Banking Superintendency.

at 17.5% in May, and for private-sector entities at 13.4%. For commercial banks the solvency indicator rose from 12.9% in December to 13.6% in May, and for mortgage banks from 13.8% to 14.7%. Introducing market risk into the indicator, brings it to 12.8% in May 2003, above the 9.0% minimum requirement (Figure 14)⁸.

The financial system continued to show signs of recovery up to April 2003, registering profits totaling 598 bn pesos. Of this amount, specialized governmental financial entities⁹ accounted for 193 bn pesos and other governmental agencies for 73 billion pesos. Those profits, added to previous years', have allowed the system to reduce its losses accumulated since 1997, which had peaked at 5,072 bn pesos in January 2001, down to 2,448 bn pesos in April 2003 (Figure 15).

FIGURE 13
COVERAGE INDICATOR
(PROVISIONS / OVERDUE BALANCE)
(PERCENTAGES)



Sources: Banco de la República on information from the Banking Superintendency.

⁸ The indicator's strong oscillations in the third quarter of 2002 resulted from investment valuations during the crisis of TES securities.

⁹ Fogafin accounts for 147 bn pesos of these profits. It should be noted that Fogafin reports the transfers it receives from the National Treasury Office as income.

TABLE 5
ADJUSTED AND UNADJUSTED GROSS PORTFOLIO (*)
(ANNUAL % CHANGES)

End of:	Real growth				Nominal growth				Foreign	
	Local currency	Foreign currency	Total	Adjusted local currency	Local Currency	Foreign Currency	Total	Adjusted	local currency	
in dollars										
				(pr)				(pr)		
1999	(8.3)	(33.7)	(11.2)	(2.9)	0.1	(27.6)	(3.1)	6.1	(40.4)	
2000	(14.2)	(24.6)	(15.1)	(2.5)	(6.7)	(18.1)	(7.7)	6.0	(31.1)	
2001	(5.0)	(20.7)	(6.2)	(3.8)	2.3	(14.6)	1.0	3.5	(16.9)	
2002	Jan.	(4.7)	(26.5)	(6.3)	(3.4)	2.4	(21.1)	0.6	3.7	(21.9)
	Feb.	(4.1)	(22.7)	(5.5)	(2.8)	2.4	(17.5)	0.9	3.8	(19.4)
	Mar.	(3.1)	(29.6)	(5.0)	(2.6)	2.6	(25.4)	0.5	3.2	(23.8)
	Apr.	(2.4)	(27.4)	(4.2)	(1.6)	3.1	(23.3)	1.2	3.9	(12.3)
	May.	(4.4)	(15.7)	(5.2)	(3.6)	1.2	(10.8)	0.3	2.0	(10.7)
	Jun.	(5.2)	(13.8)	(5.8)	(3.9)	0.7	(8.5)	0.0	2.1	(12.3)
	Jul.	(4.2)	(2.3)	(4.0)	(3.2)	1.7	3.7	1.9	2.8	(9.2)
	Aug.	(4.0)	1.9	(3.6)	(3.3)	1.8	8.0	2.2	2.5	(8.1)
	Sep.	(2.6)	0.6	(2.4)	(3.0)	3.2	6.6	3.4	2.8	(12.1)
	Oct.	(2.7)	(0.4)	(2.5)	(3.1)	3.5	6.0	3.7	3.0	(11.8)
	Nov.	(3.0)	(6.7)	(3.3)	(2.6)	3.8	(0.2)	3.6	4.3	(17.2)
	Dec.	(1.6)	(0.5)	(1.6)	(1.9)	5.3	6.4	5.3	5.0	(14.9)
	Jan.	(0.7)	7.9	(0.2)	(1.2)	6.7	15.8	7.2	6.1	(10.3)
	Feb.	(0.1)	5.3	0.2	(0.9)	7.1	12.9	7.4	6.3	(11.8)
	Mar.	(0.0)	10.3	0.6	(0.6)	7.6	18.7	8.2	6.9	(9.3)
	Apr.	1.5	(0.2)	1.4	(0.7)	9.4	7.6	9.3	7.1	(15.2)
	May.	3.7	(15.2)	2.5	1.3	11.7	(8.7)	10.5	9.1	(25.7)
	Jun.	2.5	(19.4)	1.1	n.a.	9.9	(13.6)	8.4	n.a.	(26.4)
Changes:										
Dec/99-Dec/01	(18.5)	(40.2)	(20.3)	(6.3)	(4.6)	(30.0)	(6.7)	9.7	(42.8)	
Dec/01-Jun/02	(4.7)	(7.0)	(4.9)	(3.9)	(0.2)	(2.5)	(0.3)	0.2	(6.9)	
Dec/02-Jun/03	(0.7)	(24.7)	(2.3)	n.a.	4.2	(20.9)	2.6	n.a.	(19.6)	

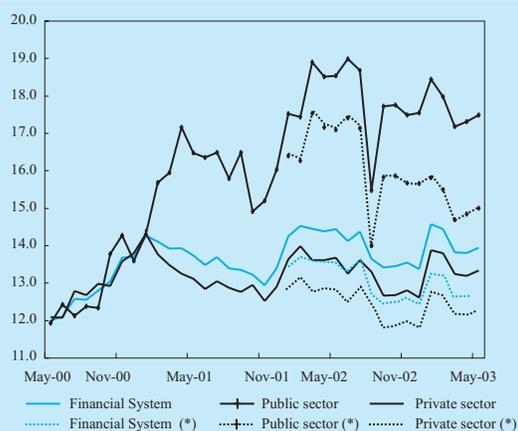
(pr) Preliminary.

n.a. Not available.

(*) Including entities under liquidation. Not including special financial entities.

Source: Banco de la República, based on financial entities' monthly balances.

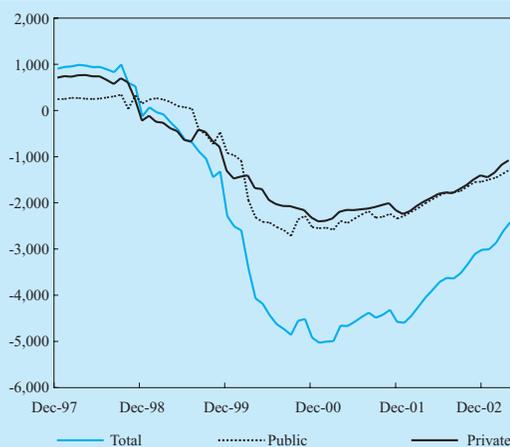
FIGURE 14
SOLVENCY OF CREDIT ENTITIES
(PERCENTAGES)



(*) Including market risk.

Sources: Banco de la República on information from the Banking Superintendency.

FIGURE 15
FINANCIAL SYSTEM'S ACCUMULATED
PROFITS DEC/97 Y APR/03
(BILLIONS OF PESOS)



Sources: Banco de la República on information from the Banking Superintendency.

OPEN MARKET OPERATIONS AND TRANSITORY LIQUIDITY SUPPORT

Under Law 31 of 1992 and Decree 2520 of 1993, the Banco de la República as the monetary authority and lender of last resort¹ is responsible for regulating monetary circulation and, in general, liquidity in the financial market. In discharging these duties the Bank intervenes in the monetary market by carrying out: 1) open market operations and 2) transitory liquidity support.

- 1) Through open market operations the Bank affects the quantity of money available in the economy transitorily or definitively. If it is intended to increase the quantity of money (expansion OMOs), the Bank either temporarily buys securities through Repo operations, or permanently purchases financial securities thereby injecting definitive liquidity. If the aim is to reduce the quantity of money held by the public (contraction OMOs), the Bank intervenes by selling securities either temporarily through reverse Repo operations, or permanently through the definitive sale of public-debt securities.

Considering the effect that these instruments have on the financial system's efficiency and stability, OMOs have been designed to operate in a streamlined, transparent and safe manner, under strict criteria developed to minimize market, credit, liquidity, systemic and operational risks.

Accordingly, since 1999 open-market operations under Decree 2520 of 1993 have been exclusively carried out with public-debt securities. These securities offer the lowest credit-risk levels in the country, for they involve sovereign risk. Moreover, the public-debt market's development in recent years has favored much greater depth and liquidity than is the case with private securities. This has facilitated implementation of homogeneous valuation methodologies, allowing one and the same fair treatment for participants in open-market operations. Furthermore, the available volumes of public-debt securities ensure access by intermediaries to the Banco de la República's resources².

¹ See Law 31 of 1992, Article 16(b), and Decree 2520 of 1993, Articles 12 and 16.

² At the end of the first half of this year, the balance of domestic public-debt held by financial entities stood at about 18 bn pesos. The pre-set Repo expansion amount averaged 1.3 bn pesos over the first half of 2003, with some 60% of it having been used; at the same time, the interbank market interest rate remained at the rate fixed by the Banco de la República for Repo operations.

Open-market operations are allocated at auction, a mechanism that ensures overall transparency and efficiency in distributing resources between the different agents making up the money market, while it minimizes credit risk through delivery-versus-payment settlement schemes. Auctions are carried out entirely by electronic means, from the agents' direct bids to the clearing and settlement of operations through the simultaneous transfer of securities and funds from the entities' deposit accounts at the Banco de la República and the Central Securities Depository where the dematerialized securities are held.

It should be noted that, for the payment system to work well, liquidity has to be injected into it towards the middle of the banking day to enable intermediaries to meet their obligations in the financial market. Hence, the mechanism for providing liquidity has to be highly efficient operationally. This can only be achieved with securities whose mobilization and transfer are highly streamlined, in a system that ensures simultaneous delivery of securities and money from accounts at the central bank. Security reasons make this system essential, given the large amounts of money involved in each operation. The characteristics of dematerialization, fungibility and mobilization through simple account annotation of public-debt securities administered by the Central Securities Depository make these securities particularly suitable as the basis for the mechanism referred to above for providing daily liquidity to the financial system as a whole.

- 2) The second form of intervention by the Banco de la República as lender of last resort is by providing transitory liquidity support to individual credit establishments experiencing other-than-solvency difficulties. To this end, the Bank makes an agreement for discounting or rediscounting public- or private-sector debt with each entity requesting support.

The Bank accepts various types of securities for these support operations, but preferably public-debt securities for the reasons explained above, and in this case it accepts a wider range of them, including loan-operation securities of credit establishments and financial investment securities. Private-sector securities must have investment-grade rating by rating agencies, and securities are also accepted from front-rank foreign-credit establishments.³ Securities must be endorsed in ownership in favor of the Banco de la República.

Many of the securities are not dematerialized and their operation involves the physical transfer, individual endorsement and relevant revision of each one, all of which reduces operational efficiency and increases both operational and credit risk, since the securities and funds cannot be transferred simultaneously. These same factors affect the discounting and rediscounting of debt securities. And, given the volumes and particular characteristics of these securities, both operational and credit risks are even greater.

The wide range of eligible securities for these operations means that entities facing temporary liquidity problems and restricted in their financial or portfolio investments have the option of resorting to central-bank resources with securities not equally acceptable among other market participants. This mechanism is intended to avoid a given entity's individual sporadic problems being transferred to other agents and triggering a systemic risk. But, given the particular nature of the eligible securities, operational mechanisms are more time-consuming and require greater risk management.

In short, the operational design of the Banco de la República's mechanisms for providing liquidity depends on the legal framework governing them and on the objective of each type of operation: whether the irrigation of resources is directed to the economy in general (OMOs) or to a particular agent (liquidity support). In either case the maximum possible standards of efficiency, security and risk management are sought, both for the Bank and for financial agents.

³ Securities issued by first-rank foreign credit establishments must meet the requirements of Article 646 of the Code of Commerce and be considered eligible by the Bank for depositing international reserves.

III

MACROECONOMIC PERFORMANCE AND OUTLOOK FOR 2003

The Colombian economy, having suffered a crisis in 1998-1999, the severest in 70 years, and registered scant growth in the past two years, is now showing signs of recovery. This has resulted partly from the increase in capital inflows to the region's countries, which has reduced the country-risk premium on sovereign debt. In addition, agents' confidence in the Colombian economy has increased with the initial successes of the government's security strategy and the progress of macroeconomic policies designed to correct the large economic imbalances generated since the first half of the 1990s. Macroeconomic policy has included notably the application of anticyclical monetary policies aimed at stimulating economic activity in a manner compatible with price stability.

Although monetary policy has been eased substantially since 2000, it has had only a moderate effect on output, because weak private spending has kept the economy on a low-growth path. Various factors accounted for this situation. On the one hand the non-financial private sector, beset by heavy debts that it found difficult to pay and apprehensive about the economy's future growth, restricted its investment and spending decisions. And the public sector's high deficits created enormous demand for both domestic and foreign funds for their financing. On the other hand the financial system, burdened by growing overdue loans, low capital levels and high vulnerability, allocated its resources mostly to the public sector to the detriment of the private sector. Consequently, private spending rose feebly, resulting in poor growth in output and employment.

Several of these factors have changed or tended to correct themselves substantially in recent months:

the financial sector has grown stronger, and low interest rates have allowed rapid recapitalization of the financial system, companies and households. In addition, the effects of the monetary-policy easings have become apparent in higher prices for such assets as real estate and equities. The financial sector's readiness and capacity to lend have thus increased, as have the private sector's desire to spend and its demand for credit. This began to be reflected in annual growth in private consumption and investment from the second quarter of last year, and in GDP growth for the first half of this year-the highest since 2000.

A. ECONOMIC ACTIVITY

Economic activity in 2003 has been unfolding in a very favorable setting. Abroad, new public-debt issues, operations to improve their profile, lower spreads, and improved rating agency perceptions point to greater confidence in Colombia's economy. At home, the findings of surveys of manufacturers, traders and households reflect higher expectations about the economy's performance this year.

Another factor that has contributed to improving economic performance has been the financial system's recovery. As noted earlier, the system's greater solvency, larger profits, and better portfolio-management indicators have allowed the gross portfolio to become more dynamic since January.

1. First quarter of 2003

The economy grew at a faster pace in the first quarter of this year. Domestic demand continued to be the

most buoyant component of spending (Table 6). The contribution of net external demand to economic growth was nil, because of lower oil exports and the fall in sales to Venezuela.

Final consumption rose by less than GDP in the first quarter. Growth in household consumption was affected by stagnation in nondurables, which has lasted for some months. Spending on durables has been boosted by low interest rates and the upturn in consumer credit, but its dynamic growth has been insufficient to offset the stagnation in nondurables.

Investment spending was the component that contributed most to domestic demand behavior. Public

works, transport equipment, and machinery and equipment were, in that order, the items that made the biggest contributions to growth in investment spending before inventories. The large build-up of inventories occurred at the same time as the strongest acceleration of industrial sales (8.6%) since the second quarter of 2000, which makes it likely that the inventory build-up was intentional.

The first quarter's unfavorable export performance is chiefly explained by lower oil production and the fall in sales to Venezuela. Nontraditional industrial exports were strongly hit by falling sales to Venezuela, despite recovery in exports to the United States—thanks to the entry into force of the Andean Trade Promotion

TABLE 6
GDP GROWTH IN TERMS OF DEMAND
(ANNUAL % CHANGE)

	2002 (p)					2003 (p)
	I	II	III	IV	Annual	I
Gross domestic product	(0.04)	2.33	2.02	2.41	1.68	3.82
Total imports	(8.11)	(1.56)	4.27	9.04	0.88	6.61
Total final supply	(1.32)	1.71	2.38	3.44	1.56	4.23
Final consumption	1.73	2.23	2.17	1.49	1.91	1.77
Households 1/	2.28	2.29	2.56	2.31	2.36	2.03
Final domestic household consumption 2/	1.90	1.89	2.42	1.96	2.04	1.94
Nondurables	0.20	0.78	1.64	1.12	0.94	1.06
Semidurables	3.15	(1.65)	4.00	1.92	1.84	(0.23)
Services	1.93	1.90	1.89	2.18	1.98	2.61
Durables	13.05	17.17	9.87	6.33	11.41	6.67
Government	0.22	2.05	1.07	(0.86)	0.62	1.04
Gross capital formation	(16.68)	4.70	16.52	26.42	7.44	33.16
Gross fixed capital formation	1.02	7.01	8.04	11.42	7.04	16.82
Farming, forestry, hunting & fishing	10.60	14.53	17.56	11.26	13.43	(0.08)
Machinery & equipment	(2.35)	(4.90)	6.21	6.40	1.47	11.63
Transport equipment	(18.76)	8.62	16.58	24.06	8.15	68.23
Building construction	29.39	33.74	24.15	33.02	30.06	7.84
Civil works	(16.00)	(3.87)	(6.80)	(5.43)	(7.86)	25.58
Subtotal: final domestic demand	(1.10)	2.61	4.32	5.12	2.74	5.85
Total exports	(2.40)	(2.89)	(7.38)	(5.17)	(4.47)	(4.11)
Total final demand	(1.32)	1.71	2.38	3.44	1.56	4.23

(p) Provisional.

1/ Includes purchases of goods made abroad by people residing in Colombia but not those made in Colombia by non-residents.

2/ Final consumption in Colombia by resident households.

Source: DANE.

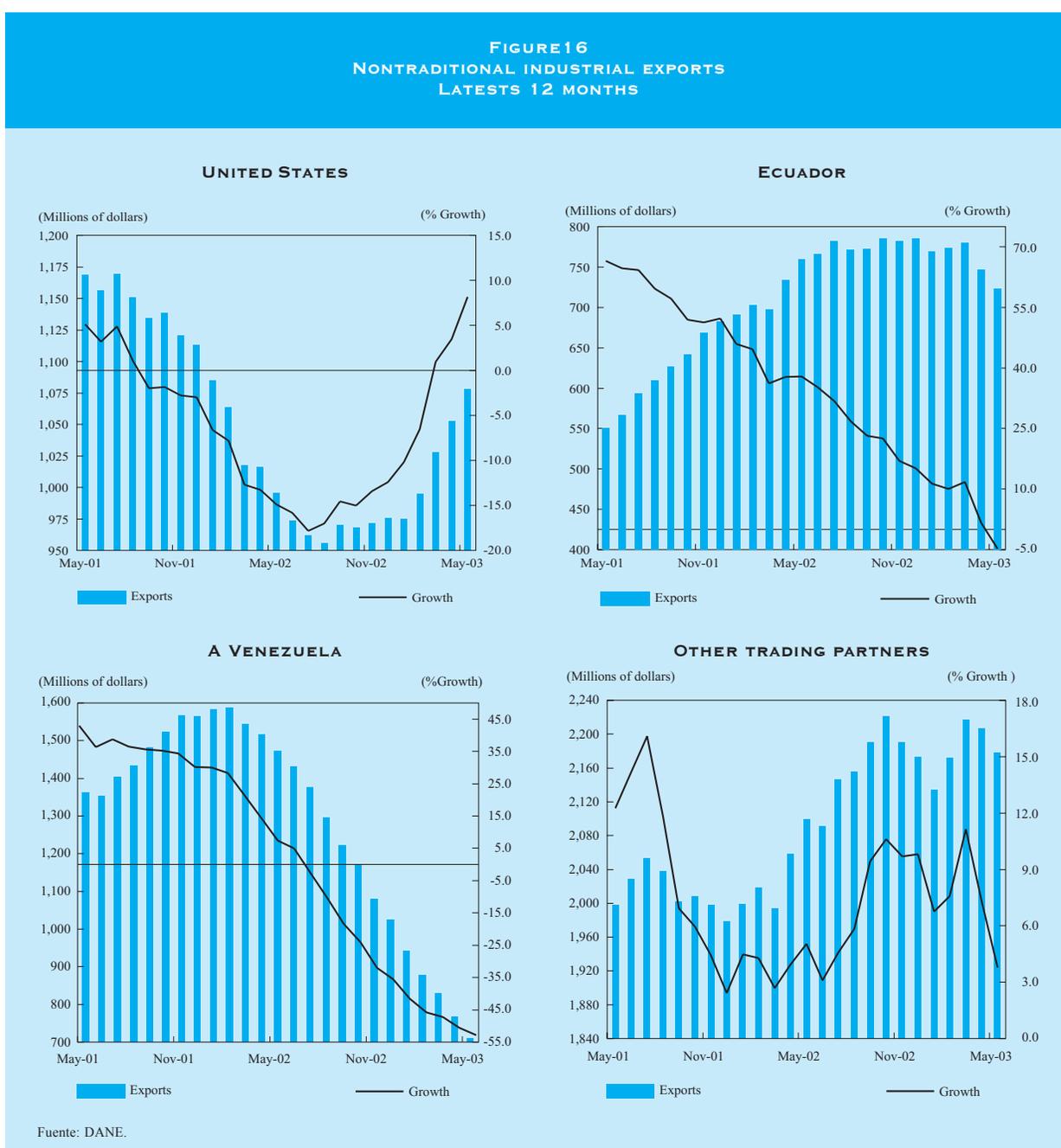
and Drugs Eradication Act, and the upturn in sales to other trading partners (ie, other than the US, Ecuador and Venezuela) (Figure 16).

Growth in private-sector activity,¹⁰ which had rebounded in the first quarter of 2002, was accelerating by 4.4% in the first quarter of this year, its fastest pace since the fourth quarter of 2002 (Figure 17)¹⁰. Private-sector activity has thus been the driving force behind the economy's upturn.

2. Outlook

Available indicators and the views of various Colombian analysts suggest that GDP growth this year may overshoot the government's 2% target. It is expected to continue to be boosted by construction, financial services, manufacturing, trade and transport.

¹⁰ This is estimated by deducting from overall GDP the items of crude oil exploitation, civil engineering works and construction, and government services.



GDP growth in the second quarter may turn out lower than in the first because of the Easter Week effect¹¹. To get a truer picture of the economy's performance so far this year, it is best therefore to compare half-year growth rates for GDP. On this basis, the economy is expected to continue the rising growth trend it has been showing since the second half of 2001 (Figure 18).

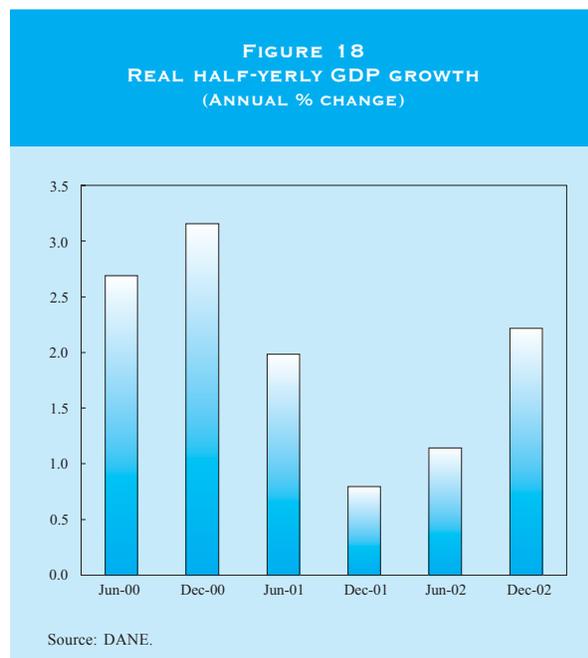
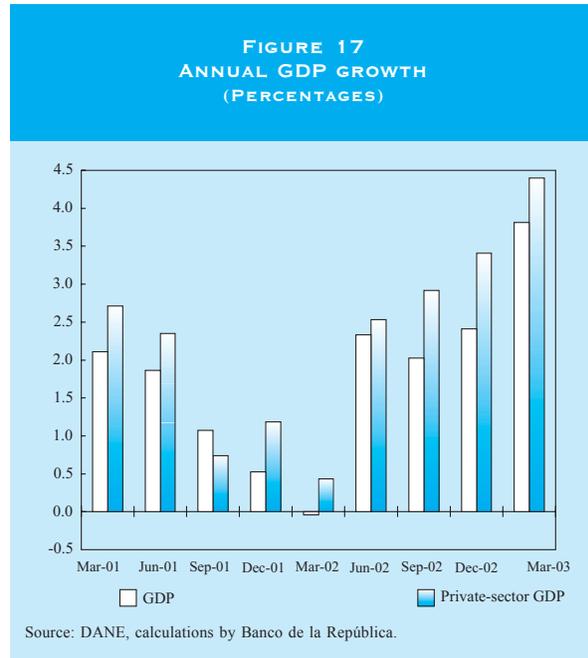
Although the National Statistics Agency's (DANE) second-quarter growth estimates are not yet available, the movements of various indicators suggest that domestic demand, particularly in the private sector, will continue to be the most dynamic spending item. The first-quarter trend in household consumption is expected to persist, judging by credit-card sales to May, buoyant consumer loans, higher hotel occupancy, and business opinion surveys. Investment spending should still be the most dynamic component of domestic demand, reflecting greater optimism among agents and the effect of the lifting of tariffs on capital-goods imports not produced in the Andean subregion. Similarly, spending on buildings construction is expected to keep up its first-quarter impetus.

In contrast, external demand is not expected to make a positive contribution to growth this year. The greater dynamism of sales to the United States and the group of "other trading partners" is unlikely to make up for the negative effect of exports to Venezuela. In addition, the pick-up in economic activity should mean higher imports of intermediate and capital goods, causing a trade deficit over the rest of the year.

B. EMPLOYMENT

Job creation has gradually picked up pace. The number of people with work in the 13 main cities¹² rose by 4.4% in May relative to the same period last

¹¹ Easter Week fell in April this year, having occurred in March last year, with the result that the second quarter of 2003 was two working days shorter than the second quarter of 2002.



year, representing 331,000 new jobs. In the year to date, urban employment has increased by 3.5%. Higher employment has resulted in a fall of 0.8 percentage points in urban unemployment (for the 13 cities) relative to a year earlier (Figure 19). For the country as a whole, the jobless rate has dropped from 16.5% in February to 13.0% in May.

¹² Bogotá, Medellín, Cali, Barranquilla, Bucaramanga, Manizales, Pasto, Pereira, Cúcuta, Ibagué, Montería, Cartagena y Villavicencio.

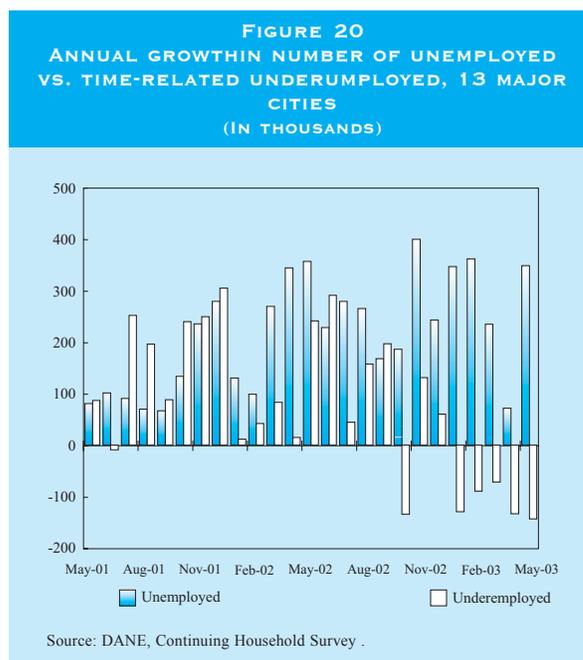
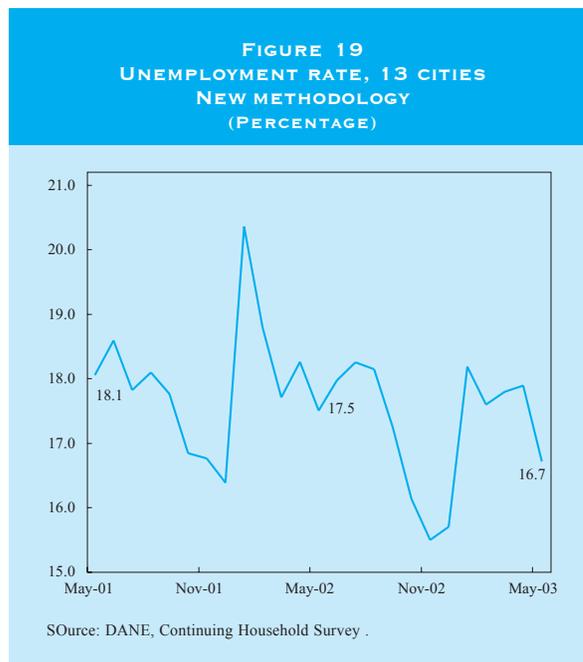
Employment has not only increased but also improved in quality: in the year to date, while the number of people in urban employment has increased on average by 260,000, the number of those claiming to be underemployed has risen by only 42,000, and those claiming to be time-related underemployed has decreased by some 110,000 relative to the same period last year (Figure 20).

The improvement in labor-force variables is closely associated with the recovery in economic activity (Figure 21). Employment growth has been boosted by the buoyancy of labor-intensive sectors such as commerce and buildings construction, both of which expanded faster than GDP in the first quarter, by annual rates of 4.0% and 8.4% respectively.

Unlike other sectors of the economy, manufacturing continues to register falling employment despite the upturn in activity; and what new jobs it does create are mostly temporary. From January to April overall manufacturing employment fell by 1.29% relative to the same period last year. At the same time temporary jobs in the sector increased by 4.13% while permanent employment decreased by 4.25%. In 2002, temporary manufacturing jobs had risen by 2.3% while permanent ones had fallen by 6.96%.

The reason for this "jobless recovery" (Figure 22) that has characterized manufacturing is that the sector's faster pace of growth has resulted from productivity gains. Labor productivity per hour has been rising since the beginning of 2002: in April this year its tendential component was 5.5% higher than 12 months earlier (Figure 23).

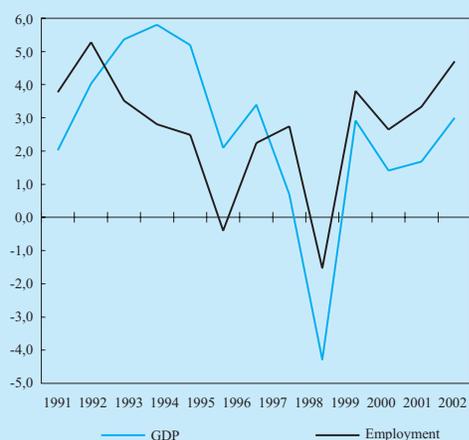
The economy is expected to continue on a path of recovery for the rest of the year, driven by the sectors of construction, commerce and services. Although it is still too early-and there is not enough information-to assess the effect of the recent labor reform on workforce variables, it is known on information from the National Apprenticeship Service (SENA) that the number of



apprentices enrolled at SENA has risen from 35,000 to 70,000¹³.

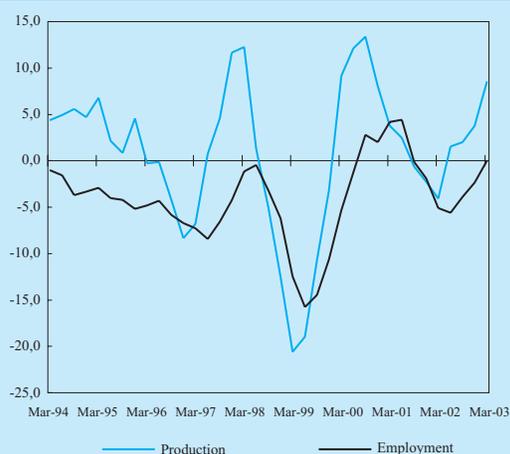
¹³ The recent labor reform should, among other things, allow labor conditions in Colombia to be made more flexible and hence improve labor indicators by making the country more competitive in relation to other nations.

FIGURE 21
GDP AND EMPLOYMENT GROWTH
SEVEN CITIES
(PERCENTAGES)



Source: Banco de la República, Jan/03 expectation survey.

FIGURE 22
INDUSTRIAL PRODUCTION AND
EMPLOYMENT GROWTH
(PERCENTAGES)



Source: DANE, Calculations by Banco de la República, SGEE.

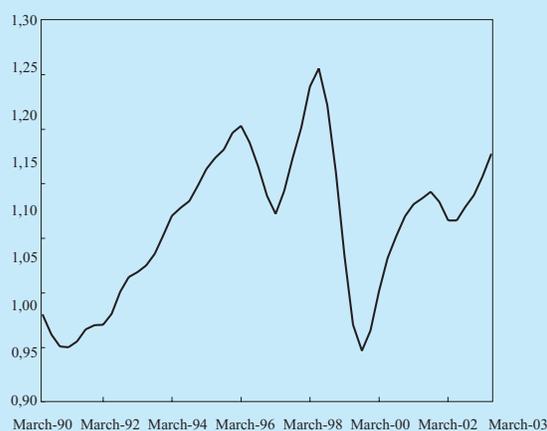
JOBLESS RECOVERY IN THE UNITED STATES

Feeble growth in industrial employment despite recovery is occurring not only in Colombia but generally in different economies. In the United States many analysts describe the recent economic upturn as "jobless recovery,"¹ similar to the situation obtaining in the early 1990s. At that time, employment growth remained weak for several months and only reached the previous peak after 31 months. Today, different indicators show persistent weakness in the US labor market. Although the recession is said to have ended in the second quarter of 2002, according to an official statement by the National Bureau of Economic Research, the rate of unemployment was 6% in December 2002, compared with 4% in the fourth quarter of 2000. There are 2.1 million fewer private-sector jobs now than at the end of 2000, and the average duration of joblessness is estimated to have increased by more than five weeks over this period. The biggest employment loss has been in manufacturing, which registered a 3.7% job decrease in the fourth quarter of 2002 relative to the same period the year before.

Different studies show that the existence of more flexible labor practices limits the costs of using labor when the strength and sustainability of an economic recovery are uncertain. Such practices include relying on temporary or part-time employment as well as on overtime. Thus firms postpone recruiting full-time and/or permanent employees until they have evidence of a sustainable upturn in the demand for their products and services..

¹ See "Number Crunches vs. Recession" in The Washington Post, July 11, 2003

FIGURE 23
HOURLY PRODUCTIVITY
(TENDENTIAL COMPONENT)



Source: DANE, calculations by Banco de la República, SGEE.

C. BALANCE OF PAYMENTS

1. Balance-of-payment movements in the first quarter of 2003

In the first quarter of this year the balance of payments showed a current-account deficit of \$725 m (4.0% of GDP), financed with net capital inflows of \$236 m (or 1.3% of GDP), deaccumulation of gross reserves (not including valuation gains) in the amount of \$271 m, and \$218 m from other flows (errors and omissions). To March, the balance of gross reserves stood at \$10,620 m (Table 7).

a. Current account

The current-account deficit rose by \$415 m in January-March 2003 relative to the same period last year, because the trade balance for goods deteriorated from a surplus position in 2002 to a first-quarter deficit of \$218 m this year. The deterioration resulted from a \$612 m increase in imports (largely of capital goods), compared with a \$144 m rise in exports. The factor-income deficit widened by \$67 m but was more than offset by a \$124 m increase in net current inflows of transfers.

Table 8 summarizes first-quarter export results by product. Hydrocarbon exports totaled \$861 m, up by \$158 m on the same period last year, thanks to higher export prices, which surged from a quarterly average of \$20.38 a barrel in 2002 to \$31.33 in 2003. Sales of gold and ferronickel also increased, though by less: \$91 m and \$29 m respectively, while coal exports fell by 14.4% because of a decrease in volume. Nontraditional exports shrank by 6.7% owing to lower sales to Venezuela and Ecuador

The first quarter saw a 23.2% expansion in imports relative to a year earlier, largely produced by a 46.2% rise in capital goods (particularly for industry and transport equipment) and to a smaller extent by a 17.9% increase in intermediate goods (Table 9).

b. Capital account

The capital and financial account showed a net inflow of \$236 m in January-March 2003, an increase of \$22 m on the same period last year.

Net foreign direct investment stood at \$241 m, some \$631 m lower than in the first quarter of 2002, mainly because investment in the communications and oil sectors declined. The mining sector received \$125 m in foreign direct investment and the manufacturing sector \$61 m.

Long-term financing flows for the public and private sectors were \$567 m and -\$329 m respectively. The first quarter saw a short-term capital outflow of \$215 m, in contrast to a net inflow of \$482 m a year earlier. Outflows in 2003 were for investments made abroad totaling \$378 m, with the public sector accounting for \$177 m and private-sector agents for \$202 m. Short-term liabilities registered a net inflow of \$164 m, representing liabilities incurred mostly by nonfinancial private sector firms, less \$231 m paid by financial and nonfinancial public-sector entities in respect of short-term loans.

c. Variations in international reserves

Between January and March 2003, movements in goods and services and capital reduced net international

TABLE 7
COLOMBIA'S BALANCE OF PAYMENTS - SUMMARIZED

	Millions of dollars			As percentage GDO			Diference 2003-2002
	2002	2003	2003	2002	2003	2003	
	Trim. I	Año	Año	Trim. I	Año	Año	
	(pr)	(e)	(proj.)	(pr)	(e)	(proj.)	
I. CURRENT ACCOUNT	(310)	(725)	(2,088)	(1.5)	(4.0)	(2.7)	(415)
Income	4,072	4,246	18,012	19.5	23.2	23.3	174
Outlays	4,382	4,972	20,100	21.0	27.2	26.0	589
A. Nonfactor goods & services	(81)	(552)	(2,016)	(0.4)	(3.0)	(2.6)	(471)
1. Goods	250	(218)	(575)	1.2	(1.2)	(0.7)	(468)
Income	2,847	2,991	12,299	13.6	16.3	15.9	144
Outlays	2,597	3,209	12,875	12.4	17.5	16.7	612
2. Nonfactor services	(330)	(334)	(1,441)	(1.6)	(1.8)	(1.9)	(4)
Outlays	454	403	1,903	2.2	2.2	2.5	(50)
Income	784	737	3,344	3.8	4.0	4.3	(47)
B. Factor income	(746)	(813)	(2,962)	(3.6)	(4.4)	(3.8)	(67)
Income	188	146	609	0.9	0.8	0.8	(43)
Outlays	934	959	3,572	4.5	5.2	4.6	25
C. Transfers	516	640	2,891	2.5	3.5	3.7	124
Income	583	706	3,200	2.8	3.9	4.1	123
Outlays	67	66	310	0.3	0.4	0.4	(0)
II. CAPITAL & FINANCIAL ACCOUNT	214	236	1,585	1.0	1.3	2.1	22
A. Financial account	214	236	1,585	1.0	1.3	2.1	22
1. Long-term financial flows	(268)	451	1,089	(1.3)	2.5	1.4	719
a. Assets	68	26	300	0.3	0.1	0.4	(42)
i. Colombian direct investment abroad	69	27	300	0.3	0.1	0.4	(42)
ii. Loans 1/	(1)	(1)	0	(0.0)	(0.0)	0.0	0
iii. Leasing	0	0	0	0.0	0.0	0.0	0
iv. Other assets	0	0	0	0.0	0.0	0.0	0
b. Liabilities	(200)	479	1,415	(1.0)	2.6	1.8	679
i. Direct foreign investment in Colombia	872	241	1,468	4.2	1.3	1.9	(631)
ii. Loans 1/	(1,016)	111	86	(4.9)	0.6	0.1	1,127
Public sector	(467)	570	803	(2.2)	3.1	1.0	1,037
Private sector	(549)	(458)	(717)	(2.6)	(2.5)	(0.9)	90
iii. Financial leasing	(56)	127	(139)	(0.3)	0.7	(0.2)	183
Public sector	(2)	(2)	11	(0.0)	(0.0)	0.0	(0)
Private sector	(54)	129	(151)	(0.3)	0.7	(0.2)	183
iv. Other liabilities	0	0	0	0.0	0.0	0.0	0
Public sector	0	0	0	0.0	0.0	0.0	0
Private sector	0	0	0	0.0	0.0	0.0	0
c. Other long-term financial movements	0	(2)	(26)	0.0	(0.0)	(0.0)	(2)
2. Short-term financial flows	482	(215)	496	2.3	(1.2)	0.6	(696)
a. Assets	(203)	378	(251)	(1.0)	2.1	(0.3)	581
i. Portafolio investment	(94)	205	(221)	(0.4)	1.1	(0.3)	298
Public sector	(663)	267	(535)	(3.2)	1.5	(0.7)	931
Private sector	570	(63)	314	2.7	(0.3)	0.4	(633)
ii. Loans 2/	(109)	174	(30)	(0.5)	1.0	(0.0)	283
Public sector	(239)	(90)	0	(1.1)	(0.5)	0.0	148
Private sector	130	264	(30)	0.6	1.4	(0.0)	134
b. Liabilities	279	164	244	1.3	0.9	0.3	(115)
i. Portafolio investment	49	(16)	0	0.2	(0.1)	0.0	(65)
Public sector	55	4	0	0.3	0.0	0.0	(51)
Private sector	(6)	(20)	0	(0.0)	(0.1)	0.0	(14)
ii. Loans 2/	230	179	244	1.1	1.0	0.3	(51)
Public sector	(164)	(231)	(218)	(0.8)	(1.3)	(0.3)	(66)
Private sector	394	410	463	1.9	2.2	0.6	15
B. Special capital flows	0	0	0	0.0	0.0	0.0	0
III. NET ERRORS AND OMISSIONS	200	218	0	1.0	1.2	0.0	19
IV. CHANGE IN GROSS INTERNATIONAL RESERVES 3/	103	(271)	(502)	0.5	(1.5)	(0.7)	(374)
V. BALANCE OF GROSS INTERNATIONAL RESERVES	10,233	10,620	10,286	12.6	13.8	13.3	388
VI. BALANCE OF NET INTERNATIONAL RESERVES	10,229	10,616	10,282	12.6	13.8	13.3	387
Months of goods imports	11.8	9.9	9.6				
Months of goods & services imports	9.1	8.1	7.6				
Nominal GDP in millions of dollars	20,881	18,294	77,180				
VII. CHANGE IN NET INTERNATIONAL RESERVES	152	(272)	(503)	0.7	(1.5)	(0.7)	(424)

(pr) Preliminary estimate.
(e) Estimate.

(proj.) Projection.

Supuestos 2003: precios de exportación: café US\$0,71 / libra (Exdock); petróleo US\$27,8 / barril; crecimiento de importaciones de bienes 6,6% (8,3% sin Plan Colombia y sin Plan Fortaleza).

1/ Includes portafolio investment, direct loans and comercial credit.

2/ Includes portafolio investment, direct loans and comercial credit.

3/ According to Balance-of- payments methodology

Source: Banco de la República.

TABLE 8
FOB EXPORTS, BY MAIN PRODUCT AND ECONOMIC SECTOR
(\$ MILLIONS)

	January -March		Variation	
	2002	2003	Absoluta	%
Total exports	2,723.4	2,877.5	154.1	5.7
Traditional exports	1,248.2	1,501.7	253.5	20.3
Coffee	174.2	190.6	16.4	9.4
Coal	285.3	244.2	(41.1)	(14.4)
Ferroníquel	57.6	86.4	28.8	50.1
Petroleum and derivative	702.5	860.9	158.4	22.6
Gold	8.1	99.2	91.1	1,119.2
Emerald	20.5	20.4	(0.1)	(0.5)
Non-traditional exports (*)	1,475.2	1,375.8	(99.4)	(6.7)
Land sector	350.4	358.5	8.0	2.3
Industrial sector	1,111.0	1,002.4	(108.6)	(9.8)
Mining sector	13.7	14.9	1.2	8.5

(pr) Preliminary..

(*) Not including temporary exports, re-exports and others. Including balance-of-payment adjustments.

n.a. Not applicable.

Sources: DANE and Banco de la República.

TABLE 9
FOB IMPORTS, BY USE OR ECONOMIC DESTINATION (PR)
(\$ MILLIONS)

	January-March		Variation	
	2002	2003	Statement	%
Total imports	2,552.3	3,144.8	592.5	23.2
Consumption goods	552.3	549.6	(2.7)	(0.5)
Durables	225.3	248.2	22.9	10.2
Non-durables	327.0	301.4	(25.6)	(7.8)
Intermediate goods	1,158.0	1,365.6	207.6	17.9
Fuel and lubricants (*)	25.4	64.8	39.4	155.2
For agriculture	99.9	120.4	20.5	20.6
For industry	1,032.7	1,180.3	147.6	14.3
Capital goods	839.5	1,227.6	388.1	46.2
Construction materials	41.9	38.2	(3.6)	(8.7)
Para la agricultura	11.8	10.2	(1.6)	(13.2)
For industry	513.8	630.0	116.2	22.6
Transport equipment	272.0	549.1	277.1	101.9
Non-classified goods	2.5	2.0	(0.5)	(18.8)

(pr) Preliminary.

(*) Including petroleum and coal derivatives.

Sources: DANE and the Tax and Customs Administration (DIAN).

reserves-not including valuation gains-by \$272 m, to \$10,616 m. This balance represents 9.9 months of imports of goods, 8.1 months of imports of goods and services, and 1.1 times the value of public- and private-debt amortizations in a year.

2. Balance-of-payments outlook for 2003

The latest balance-of-payments projections (Table 7) show the current-account deficit for 2003 running at \$2,088 m (2.7% of GDP). The deficit would be financed from expected capital receipts amounting to \$1,585 m (2.1% of GDP), made up of net long-term and short-term capital inflows of \$1,089 m and \$496 m respectively.

In the current account, exports are projected to edge down this year by 0.03%¹⁴. In particular, external sales in dollars are expected to decrease for coffee (by 4.67%), coal (by 3.06%), and nontraditional products (by 1.91%), but increase for oil (by 5.17%) and ferronickel (by 10.28%). Imports are projected to expand by 6.60%.

The capital and financial account projection incorporates long-term inflows of \$1,089 m and short-term ones of \$496 m. Net foreign direct investment is expected to amount to \$1,468 m and the public sector's net long-term external borrowing to \$814 m. In contrast, the projection contemplates net private-sector long-term debt payments of \$868 m. As regards short-term flows, the public sector is

¹⁴ Including special trade operations.

expected to account for a good part of their behavior by liquidating investments abroad worth about \$535 m, essentially by the government and the Petroleum Savings and Stabilization Fund (FAEP).

D. IMF AGREEMENT

On January 15, 2003 the executive board of the IMF ratified a Stand-By Arrangement with the government of Colombia for the period 2003-2004 intended to support the strengthening of macroeconomic and structural policies and improve the dynamics of the public debt.

The Arrangement is for a total sum of 1.5 billion Special Drawing Rights (about \$2.1 billion). Signing of the Arrangement confers the right to a first disbursement of SDR 193 m (about \$264 m), the remainder to be disbursed on a quarterly basis when set targets have been achieved, subject to periodic review by the IMF of the program's fulfillment.

Key components of the program include tax, pension and labor reforms, already approved by Congress. Table 10 shows that the targets for the first quarter of 2003 were met. Although inflation in March (7.6%) was higher than the 6.1% target set for the month with the IMF, the Arrangement allows for a band of about two percentage points around the point target (ie, arrange of 4.1% to 8.1%) within which the target is considered attained.

TABLE 10
INTERNATIONAL MONETARY FUND PROGRAM

	March-03			IMF Target	
	IMF Target (a)	Actual (b)	Difference (b) - (a)	Jun-03 1/	Sep-03 1/
NIR floor (\$m) 2/	10,360	10,316	(44)	10,420	10,480
Inflation target	6.10	7.60	1.50	6.30	6.10
Consolidated global public-sector deficit ceiling, since January 1, 2003 (bn. pesos)	1,590	1,121	(469)	3,240	3,315
Net accumulated medium- & long-term public-sector external- debt disbursements ceiling since January 1, 2003 (\$m) 3/	650	563	(87)	1,250	1,850
Net accumulated short-term public-sector external- debt disbursements ceiling since January 1, 2003 (US\$m)	300	(226)	(526)	200	200

1/ An indicative target, not a compliance criterion.

2/ The IMF accord's technical memorandum adjusted the NIR ceiling up to \$2 bn to accommodate the Banco de la República's exchange interventions. For this reason, the NIR performance criterion is considered fulfilled although the actual level was \$44 m below the March floor.

3/ Preliminary information to March 2003.

Sources: Banco de la República, DANE, and Ministry of Finance and Public Credit.

IV

THE BANCO DE LA REPUBLIC AND PAYMENT SYSTEMS

A. INTRODUCTION

1. Institutional arrangement for financial stability

A sound, well-regulated financial system is essential to an economy's macroeconomic and financial stability. In Colombia, under general provisions of the Constitution and the Financial System Organic Statute, it is the responsibility of the government to exercise oversight over financial entities engaged in managing, making use of and auditing funds raised from the public. The oversight duties are basically performed by the Ministry of Finance and Public Credit, the Banking Superintendency, Securities Superintendency, Solidarity Economy Superintendency and the State Financial Institutions Guarantee Fund (Fogafin)

The Ministry of Finance is responsible for issuing regulations on financial, stockmarket, insurance and cooperative activities, directly or through the Securities Board, the Banking Superintendency or the Solidarity Economy Superintendency. The Ministry is also responsible for the supervision and inspection of entities engaged in said activities and performs these functions through the Banking, Securities and Solidarity Economy Superintendencies. Fogafin for its part helps to maintain confidence among the depositors and creditors of financial institutions by taking measures to rehabilitate and recover the capital of such institutions and by

operating the deposit insurance system. Lastly, the Banco de la República, by virtue of its constitutional authority, is responsible for ensuring monetary stability and acting as lender of last resort and the bank's bank.

2. The Banco de la República and its function in payment systems

The accelerated development that has characterized financial markets worldwide in the past decade has made payment systems key instruments for ensuring the soundness and stability of financial systems.

In Colombia, the Banco de la República has played an essential role in modernizing the clearing and settlement systems for payments and securities. The following section points out the importance of this function, which is explicitly contemplated by the Bank's legal framework as the country's central bank, to the efficiency and security of interbank and commercial payments, the effectiveness of monetary policy, and the soundness of the financial system.

Section B also discusses the following topics: i) the major basic concepts of a proper payment system as regards financial stability, transmission of monetary policy and economic efficiency; and the system's methods of payment and risks; ii) the role of central banks in payment systems and, in Colombia's case, the Banco de la República's role in regulating and providing infrastructure services for the system; and lastly iii) risk management in the Bank's payment systems, and other operational aspects.

B. PAYMENT SYSTEM

1. Major basic concepts regarding financial stability, monetary policy transmission and economic efficiency

A payment system comprises the entire range of instruments, means, standards and procedures employed by economic agents for transferring funds and making payments, from those associated with low-value transactions of goods and services to high-value interbank operations. The payment system is a basic element of the "infrastructure" of financial and capital markets, and its central function is to ensure that money circulates safely and efficiently, both domestically and internationally.

The system's proper design and operation contribute to economic efficiency, interbank liquidity, monetary-policy effectiveness, and the financial system's soundness and stability. Economic agents settle their obligations arising from financial transactions through the payment system, and the system's efficiency is a decisive factor in ensuring timely, secure payments and reducing transaction costs across the economy.

The payment system is also an indispensable mechanism for the operation of a money market where commercial banks can obtain liquidity, and where the central bank can carry out its open-market operations assured of an effective channel for sending clear monetary-policy signals. Design defects in the payment system can create liquidity and segmentation problems in the money market, placing the central bank under pressure to perform its role of lender of last resort

Furthermore, the payment system is a key element for integrating and deepening financial markets and avoiding systemic risk. The problems of troubled financial entities surface initially in the payment system. This is explained by the fact that a participant's failure to meet his obligations within a

payment system may lead to a chain of defaults with his counterparts that could, in an extreme case, trigger systemic effects.

Accordingly, measures regarding payment systems have become financial-policy priorities for central banks and public authorities all over the world. Their significance has been reiterated with the publication in 2001 of "Core Principles for Systemically Important Payment Systems" by the Committee on Payment and Settlement Systems (CPSS)¹⁵ of the Bank for International Settlements. These Principles constitute "universal guidelines to encourage the design and operation of safer and more efficient systemically important payment systems worldwide" and are the equivalent in this matter of those widely known as "Core Principles for Effective Banking Supervision", also drawn up by the BIS. The following paragraphs show how our country has reached a high degree of compliance with those principles and has one of the soundest payment systems in Latin America.

2. Payment system risks

The risks to which participants in a payment system are exposed may be classified as: credit, liquidity and market, legal, operational and systemic risks.

- *Credit risk*: Defined as the risk that a counterpart may fail to meet his obligations either at the present or any future time. This concept involves both the risk to the principal and the risk of its replacement cost.
- *Liquidity risk*: This is the risk that a counterpart may fail to pay his obligation in full at the time previously agreed on, but since it does not imply

¹⁵ The Committee on Payment and Settlement Systems, which has its secretariat at the Bank for International Settlements, is a forum for central banks (originally of the G-10 countries, later expanded to admit increasingly more countries, including from Latin America) interested mainly in monitoring and analyzing developments in domestic and cross-border systems for clearing and settling payments and securities.

that the participant is insolvent he will do so at a later, undetermined time. This situation may result in the counterpart's having to incur additional costs to obtain the missing assets, especially in respect of adverse price changes in securities or currencies (market risk).

- *Legal risk:* The integrity, soundness and consistency of the legal framework constitute a basic element for the proper functioning of payment systems. Ambiguities or vagueness in regulations on the rights and obligations of the parties involved; a weak regulatory framework and institutions, deficient and incompletely defined contracts and procedures; and lack of clarity in identifying obligations and responsibilities where loss has occurred impair confidence in the payment system and undermine legal certainty.
- *Operational risk:* System outages that disrupt payment procedures, security and control problems or design and maintenance problems of systems, fraudulent use of services, personation of clients, and legal authentication problems pose threats to the soundness and operation of payment systems.
- *Systemic risk:* The risk that either a participant's inability to meet his obligations in a payment system when due or a disruption of the system may result in other participants in the system becoming unable in turn to meet their own obligations when due.

3. The role of central banks in payment systems

Rapid technological progress has led to vertiginous growth in the volumes and values of both domestic and international transactions and payments in increasingly more integrated financial markets. For this reason, the efficiency, stability and security of payment systems have become strategic objectives for central banks the world over. And the central banks' involvement in this area as regulators,

overseers of payment systems' functioning or service providers to the financial system has become increasingly important, particularly since the decade of the 1990s.

As a common factor, practically all central banks in the world offer at least a payment system that allows the exchange of funds held in it by financial intermediaries, for purposes of fund transfers between them and for the execution of monetary policy.[sic] And, although many central banks also take part in various kinds of low-value payment systems (checks, electronic payment, etc.), their experience in this respect is highly varied.

Furthermore, the supervision of payment systems has become one of the key functions of many central banks. In several European countries of British heritage and in Brazil, Mexico and other countries, this function is envisaged in laws expressly promulgated for the purpose. Failing an express legal framework, central banks have tended to resort to persuasion and a search for informal mechanisms of cooperation and leadership.

4. The Banco de la República and payment systems

In Colombia, the Banco de la República had made a significant contribution to modernizing the payment system's legal, operational and institutional aspects.

a. The Banco de la República's role in regulating the payment systems

Under Law 31 of 1992, the Banco de la República has legal authority to "regulate monetary circulation and, in general, financial-market liquidity and the normal operation of the economy's domestic and external payments."

More recently another important legislative step has been the promulgation of Law 795 of 2003, whose Article 6(j) amends Article 48 of the Financial System Organic Statute regarding the government's oversight

authority. The government is assigned authority "To regulate payment systems and the activities connected with this service that are the responsibility of the Banco de la República. This authority shall be exercised subject to the prior opinion of the Bank's Board of Directors, in order that this body may have its say regarding the effect of regulatory action on the policies it is responsible for." Moreover, Article 70 of said law has conferred authority on the Banking Superintendency to subject "to inspection, supervision and control...all such entities as administer credit-or debit-card systems, and also those that administer payment and settlement systems..."

It follows from the above, in the first place, that the regulation of high-value payment systems is recognized to be the responsibility of the Bank's Board of Directors, as it has been since 1992, and in the second place that the government is charged with developing a new regulatory area connected with low-value payments systems (including various types of retail electronic payment, credit and debit cards, etc.) and their oversight, subject to the prior opinion of the Board regarding its field of responsibility.

By virtue of its powers the Board has issued regulations on the payment services operated by the Bank itself. The regulations have been complemented by detailed regulatory circulars and operating manuals that explicitly define conditions of access to the systems, the authorized entities, the rights and obligations of participants and of the Bank itself in its capacity as service operator and provider, the penalty system for default, operating procedures and technical conditions, instructions for contingency management, and the grounds for and consequences of an intermediary's voluntary or forced departure from the system

b. The Banco de la República's role as provider of infrastructure services for the payment system

Regarding operational aspects, from the early 1990s the Bank set on foot a thoroughgoing reform of the payment system's infrastructure to improve the

safety and efficiency of transactions made by financial intermediaries and capital markets. In the first half of the decade the aim was to replace physical documents (checks, the predominant form of payment for both high- and low-level interbank operations) and public-debt securities by new payment instruments and electronic means of channeling orders and instructions.

Thus, in 1992 the Bank put into operation the Central Securities Depository (DCV) for the dematerialized handling of securities issued or administered by the Bank, and of government securities constituting mandatory or substitutive investments of entities regulated by the Banking Superintendency. The Depository has streamlined operations in the securities market, simplified capital and interest payments, and eliminated the risks of theft and forgery associated with transporting and handling securities. Moreover, with the Depository automatically connected to the deposit-account system, the principle of delivery against payment can be applied in the settlement of tradings in securities administered by the Depository, thus eliminating counterpart credit risk. The Depository also allows open-market operations to be carried out in an efficient, timely and safe manner, which is of critical importance in the modern management of monetary policy.

In 1993 the local-currency deposit-account service (CUD) was set up as a high-value payment mechanism. The service is basically provided to financial and stockmarket intermediaries. The accounts have a national coverage, with online balance control. The system is used for settlement of monetary-policy operations, National Treasury Office payments, interbank money-market operations, trading operations in securities deposited in the DCV or other depositories, operations on automatic teller machine networks, and balances of clearing and trading systems connected thereto.

To ensure fast, safe and information-protected ("encrypted") telecommunication contact with the Bank, an access portal called Banco de la República

Electronic System (SERBA) was developed at the same time as the central depository (DCV) and the deposit-account service.(CUD) thereby eliminating the need for paper instructions. Besides being connected to the DCV and CUD, SERBA later provided access to the bank's open-market operations and different information services.

Subsequently, in July 1998, the payment system's mode of operation was greatly reformed. From then on, all CUD operations have to conform to the principle of real-time gross settlement (RTGS)¹⁶, which means that if the entity generating a transaction does not have sufficient funds in its account at the time of sending the payment order, the order will be rejected. the RTGS system ensures the operation's immediate finality, offers participants great security and precludes credit risk and the spread of systemic risk.

Although RTGS mechanisms definitely help to reduce risks, they are highly demanding in terms of management and availability of intraday liquidity in the system. To improve their functioning, the Bank made major adjustments to its payment-system policies, notably by introducing the intraday Repo mechanism in late 1998 and by revising the sequence of its intraday operations. These modifications helped to increase the availability of liquidity in the system. They also improved the cash position of financial and capital-market intermediaries at the start of the day, and strengthened the interrelation of the high-value payment system with other clearing and settlement systems.

¹⁶ There are different ways of clearing and settling payments. It is possible to opt for clearing mutual obligations between a pair of participants (bilateral netting) or a group of them (multilateral netting), at a given point in time. This is known as Deferred Net Settlement (DNS). Alternatively, it is possible to opt for settling (paying definitely) operation by operation (gross) immediately and continuously (in real time). This is known as Real-Time Gross Settlement (RTGS). In systems using DNS (as in the case of checks) payments are usually settled at the end of the day, hence this type of system involves an implicit extension of intraday credit by the party receiving resources from the paying entity. In this

In the second half of the 1990s, the Bank began a second phase of payment-system modernizing. The priorities now centered on deepening the public-debt market and making it more transparent, modernizing check clearance, and setting up electronic systems for low-value payments and international exchange operations. Thus, in 1998-1999 four new electronic systems managed by the Bank were put into operation:

- 1) *The electronic trading system (SEN)*, a trading system for the secondary purchase and sale of public-debt securities, interconnected with the Bank's central securities depository and deposit-account system, to carry out operations on the principle of delivery against payment.
- 2) *The electronic check clearing system (CEDEC)*, an automated center for the electronic transmission of clearing information that continues to offset under a deferred net multilateral scheme and to settle automatically against deposits accounts held by banks at the Banco de la República, on the value date of presentation of the documents for cashing;
- 3) *The national interbank electronic clearing system (ACH-CENIT)*, an automated clearing center that offsets debit and credit electronic transfers by multilateral netting and settles them automatically against the current accounts held by authorized entities at the Bank;
- 4) *The international operations system (SOI)*, is used for processing operations under international agreements (Latin American Integration

type of scheme, failure by a participant to pay may generate chain effects on others, who in turn will be unable to cover their obligations. In an extreme case, this situation could put pressure on the central bank to finance the defaulters' shortfalls, which would produce undesired monetary and moral-hazard effects. In RTGS systems, payments are settled as soon as they are accepted by the system, and thus have immediate finality. This type of system eliminates the credit risks inherent in DNS systems but is more demanding in terms of intraday liquidity management, as explained in the text.

Association), incoming and outgoing wire transfers, and transactions with international organizations. More recently the Bank has been working together with exchange-market intermediaries on designing a mechanism for settling currency operations on the principle of delivery against payment, for the greater security of all agents.

The series of reforms and actions by the Bank have had a considerable impact on fund transfers and the Colombian capital market.

The principal balance of securities deposited in the Central Depository (which include TES and other government securities, paper issued by the Farm Financing Agency-Finagro-, and Fogafin bonds) surged from 1.3 billion pesos in 1994, to 9.1 bn in 1996, 38.1 billion in 2000, 56.7 billion in 2002, and 61.0 billion up to June 2003. The number of Central Depository operations has increased from 43,129 in 1996, to 535,552 in 2000, and 693,444 in 2002. The average monthly value of public-debt securities traded through the electronic system SEN has risen exponentially: from 1.2 billion pesos in 2000, to 12.9 billion in 2002, and 16.2 billion in the first half of 2003.

As regards high-value payments, the platform offered by the Bank has permanently changed the way transfers are made between banks, revealing the importance of safe, timely payment as provided by electronic means, with the result that checks have been essentially relegated to low-value operations. But even in low-value operations checks have lost relative share to various forms of electronic payment (debit and credit cards, audio-answering systems, ACH, etc.). Thus the number of operations channeled through the Bank's electronic system SEBRA, in fund transfers and transaction payments in the central depository DCV, jumped from 157,000 in 1996 to 545,000 in 2000 and to 1.12 million in 2002. Their value climbed from 291 bn pesos in 1996, to 1,361 bn pesos in 2000, and 2,620 bn pesos in 2002. It should be pointed out that since April 2001 all low-value payment systems operating in Colombia have been settling their final clearing result in deposit

accounts at the Bank. And since October 2001 a settling system of delivery against payment has been in service for private-debt securities deposited with the firm of Deceval¹⁷.

Low-value electronic payments channeled through (privately-owned) ACH Colombia and (Bank-owned) CENIT systems have also expanded sharply, from 6.4 bn pesos in 1999, to 35.5 bn pesos in 2000, and 70.6 bn pesos in 2002. By contrast, the use of checks has declined considerably as electronic payment systems have spread. Thus, in 1996 the Bank's interbank clearing center processed 212 million checks worth 532 bn pesos, but by 2002 the number of checks exchanged between banks had declined to 77 million amounting to some 309 bn pesos. Another factor decisively responsible for this decline was the introduction of the financial-transactions levy (now at three per thousand) at the end of 1998, which boosted the demand for bills¹⁸.

Lastly, it should be noted that the established policy of the Bank's Administration Council regarding the provision of all the above services is that costs should be recovered through charges to be paid by service users and issuers of securities, such costs to include the estimated opportunity cost of the resources invested.

c. Risk management and other operational aspects of the Bank's payment systems

As mentioned earlier, risk management is a fundamental concern in designing safe payment systems. The Bank has been introducing different mechanisms to ensure normal operation of the systems it runs.

¹⁷ Deceval (Depósito Centralizado de Valores) is a corporation created with capital provided by the country's financial and stockmarket sectors. It manages private-sector securities registered in the National Register of Securities and Intermediaries.

¹⁸ Detailed information on this is to be found in the quarterly statistical bulletins on the Bank's website. These bulletins are by way of a contribution to public analysis and discussion and transparency on the Bank's running.

This issue is of particular importance in the case of the high-value system, CUD, which is considered 'systemically important', as defined by the Bank for International Settlements. That is to say, a failure in its operation could set off a chain effect that would have an impact on the entire financial system. Up until 1998, the CUD operated through a multiple netting scheme with settlement deferred to the end of the day, which entailed a potential credit risk. To reduce the finality for this type of operation, a real-time gross settlement scheme with online balance control was introduced in the CUD system in 1998.

Similarly, to lessen liquidity risk the Bank's Board of Directors set up an intraday Repo mechanism in 1998. By this means the Bank provides financial entities with intraday liquidity to streamline electronic payments made through their deposit accounts. In this order of ideas and for the same purpose an overnight Repo clearing mechanism was put in place in February 2001.

This mechanism supplies funds to financial entities participating in the interbank clearing of checks and other physical payment instruments, to cover any shortfalls in the first exchange session, or to increase the deposit-account balance so as to avoid potential shortfalls at the end of the first exchange session, or cover any deposit-account shortfalls at the end of the second session resulting from clearing reprocessing upon exclusion of a participating entity.

With regard to technological-risk management, the Bank has adopted a series of preventive measures to reduce the likelihood of outage in its systems: redundancy in computing and communications environments, computing center at a practically "hot" alternate site for recovering systems activity, constant monitoring and alarm implementation for space, memory and process events, continuous technical support by internal area and software provider. In addition, contingency procedures have been established for communications systems and for hardware and software; they range from transmission through alternate channels with appropriate security measures, to equipment duplication and reprocessing by using other applications or manual processes.

To prevent operational risks arising from human error, procedures have been established for double checking and verifying operational activities, periodic review of logs, continual personnel training, and verification of processes and procedures by the internal control and audit areas.

To reduce security risks and ensure the confidentiality, authentication, non-repudiation, availability and auditability of the Bank's payment systems, encrypted communications systems have been put in place in which access is controlled by means of authentication using Smart Card with security codes, and synchronous token, implementation of authentication Gateway and Praxis in the Bank's electronic system SEBRA, software encryption for file transmission, asymmetrical keys and user profiles for each application.

Moreover, continuous monitoring procedures have been established for each one of the systems managed by the Bank, for the purpose of evaluating them and making any necessary corrections. Based on such monitoring, the situation and use of the services are diagnosed by statistical analysis to determine the behavior of major actors in the market, types of operation, critical times and other variables.

Lastly, coordination with the users of payment system plays a very important part in taking measures connected with the systems' objectives and governing policies. For this reason, the Bank has set up committees of users for each of the systems it runs. The committees serve as forums for analysis and discussion, making it easier not only to evaluate the services provided by the Bank but also to disseminate information about the aims and central policies the Bank adopts for payment systems. For the same reasons, the Bank also takes an active part in technical committees organized by the Banking Association, the Stock Exchange of Colombia, Deceval and others, and keeps channels permanently open for bilateral dialogue with individual participants or professional associations of the sector.

C. CONCLUSIONES

The Banco de la República has been highly instrumental in developing and modernizing Colombia's payment system. Progress on this front has improved the execution of monetary policy, reduced instability in demand for means of payment, increased the soundness

of the financial system, and raised public confidence in money. It has also helped to make the financial sector more efficient and productive and strengthened the promotion of new financial services offered by intermediaries to their users and the public in general. All these factors should go to increase the sector's competitiveness and reduce the margins of financial intermediation, while serving decisively to avert risks that may affect the financial system's stability.

COLOMBIA'S INTERNATIONAL RESERVES AND THEIR RECENT MANAGEMENT

A. INTERNATIONAL RESERVES AND MACROECONOMIC MANAGEMENT

International reserves are defined as assets held abroad under the control of the monetary authorities, which may be used to correct balance-of-payments imbalances through the Bank's intervention in the exchange market. The level of reserves is an indicator of the country's solvency. International financial markets are characterized by efficient information management, changing risk perceptions and great volatility. International reserves serve as assurance that the Nation is in a position to honor its obligations. The higher the level of reserves, the greater the access to markets and the lower the cost. But if reserves fall below a level considered "adequate" by international lenders, markets get closed, the risk premium rises, and rating agencies reduce their perception of the country's likelihood of meeting payments.

The economic authorities' decision regarding the right amount of international reserves must take into account the costs and benefits of maintaining a given level. Hence the reserves-management policy must not only compare the opportunity costs of the different alternatives for investing reserves (consumption, investment, debt payment), it must also consider the cost to the economy of being left without that adequate level of reserves. Taking the reserves to levels that offer no safeguard against external shocks has a great economic and social cost and may lead to difficult situations that would call into question the country's very economic and political viability.

B. RECENT MANAGEMENT OF INTERNATIONAL RESERVES

1. The Banco de la República's strategy for management of international reserves

The Banco de la República's management of the international reserves should be understood as part of a more general macroeconomic strategy developed in coordination with the Ministry of Finance around three central elements: applying an inflation-targeting monetary policy, permanently maintaining a floating exchange-rate regime, and administering the international reserves to the best possible effect. These components are intended to ensure stability in the economy as an essential requirement for economic growth and social development. The main justification for selecting this strategy is the existence of suitable instruments for dealing with external shocks and domestic fluctuations. A set of instruments have been defined for executing the strategy that are used for accumulating and deaccumulating international reserves and controlling exchange-rate volatility (see Chapter II). Similarly, a number of criteria have been laid down for administering the country's reserve, as explained in the following section.

2. Current level of international reserves and criteria for their administration

Net international reserves¹⁹ amounted to \$10,499.8 m in June 2003, some \$340.7 m less than in December

¹⁹ They are equal to total international reserves, or gross reserves, less short-term external liabilities of the Bank. These liabilities consist of foreign-currency sight obligations to non-resident agents.

2002. The biggest component is the investment portfolio, representing 89.9% of the total, or \$9.443.8 m in June 2003. The remaining balance is made up of: i) the reserve position at the IMF and contributions to the Latin American Reserve Fund, \$704.2 m; ii) Special Drawing Rights, \$160.2 m; iii) gold, Andean pesos and positive balances under international agreements, \$133.1 m; and iv) demand deposits and cash on hand, \$63.6 m. Short-term external liabilities stood at \$5.0m in June 2003 Table 11).

The criteria for administrating the international reserves are, in order of importance, safety, liquidity and profitability. Accordingly, reserves are invested only in securities given the highest credit ratings by the different rating agencies having longer international track records²⁰. Since the safety criterion limits potential return on investments, the Bank conducts studies to devise a liquidity policy that, taking into account its short-term reserves needs, efficiently improves its investment returns and hence its performance. On the basis of these studies, the reserves are divided into three quantifiable tranches, the amount of each depending on its likelihood of being used in different periods of time, with a high degree of reliability. The tranches are: i) working capital, covering immediate liquidity needs; ii) an indexed tranche, defined as providing intermediate liquidity, in an amount limited by the gross reserves' historical deaccumulation during one-year periods, with a 99% degree of reliability; and iii) a non-indexed tranche, comprising funds with less than 1% probability of being used within a year.

To facilitate the country's payments abroad, the currency composition of the reserves' investment portfolio is maintained in proportions similar to the Nation's balance-of-payment outlays, currently as follows: 86% in US dollars, 11% in euros and 3% in Japanese yen. The Bank does not speculate with this structure, for exchange rates are highly volatile, unpredictable asset prices. To do so would mean taking

excessive risks, increasing the probability of making losses in a year, and being less able to protect the economy against external shocks (in contradiction to the management criteria stated above). Colombia's way of defining the currency composition of international reserves is common to most countries. This trend has become stronger in recent years: according to the IMF's latest report the overall currency composition of international reserves in the world is as shown in Table 12²¹.

To comply with the investment criteria for reserves, a risk parameter has been adopted to the effect that returns on reserves investments shall not be negative in any one year, with about 95% reliability. For implementation of this policy, benchmark indices are built for each of the liquidity tranches. They are made up of optimum portfolios that maximize returns, subject to the risk parameters, the defined currency composition and liquidity needs. A number of investment guidelines are also established for improving on the benchmark-index yield by purchasing assets other than those making up the index.

The Bank directly administers the first two tranches and uses specialized international firms for the third tranche, taking advantage of their ample experience, geographic strengths and management techniques.²² The third tranche in turn is divided into two types of mandate: a global one focused on strategies based on economic fundamentals in different countries, and a mandate for asset rotation in the United States to take advantage of the benefits of the different investment assets offered in the US market.

The Bank currently uses the services of four specialized firms: Barclays Global Investors, J.P.

²⁰ The minimum rating acceptable to the Bank is A- given by Standard and Poor's and Fitch Ratings, and A3 by Moody's Investors Service.

²¹ International Monetary Fund (2002): the Executive Directors' Annual Report for the fiscal year ending on April 30, which therefore contains information available only up to 2001.

²² It is important to point out that several central banks, including those of Brazil and Chile, employ similar schemes for delegating the management of part of their external assets to front-rank entities in order to benefit from the high degree of specialization they offer.

TABLE 11
INTERNATIONAL RESERVES, BY MAIN COMPONENT
(MILLIONS OF DOLLARS)

Components	June 2002	share %	December 2002	Share %	June 2003	Share %
Cash	35.9	0.3	38.8	0.4	63.6	0.6
Cash in hand	35.3	0.3	36.4	0.3	63.0	0.6
Demand deposits	0.6	0.0	2.4	0.0	0.6	0.0
Investments	9,841.5	91.0	9,825.7	90.6	9,443.8	89.9
Directly managed	6,621.8	61.2	4,806.3	44.3	4,297.7	40.9
Delegated management	3,219.7	29.8	5,019.5	46.3	5,146.1	49.0
Gold	104.4	1.0	112.1	1.0	112.8	1.1
In hand	0.0	0.0	0.0	0.0	0.0	0.0
Custody	104.4	1.0	112.1	1.0	112.8	1.1
International monetary fund	528.9	4.9	542.0	5.0	560.6	5.3
Special Drawing Rights	148.6	1.4	154.8	1.4	160.2	1.5
Reserve position	380.3	3.5	387.1	3.6	400.4	3.8
Latin American reserve Fund	309.1	2.9	323.8	3.0	323.8	3.1
Contributions	289.1	2.7	303.8	2.8	303.8	2.9
Andean pesos	20.0	0.2	20.0	0.2	20.0	0.2
International agreements	1.0	0.0	1.7	0.0	0.3	0.0
Total gross reserves	10,820.8	100.0	10,844.1	100.0	10,504.8	100.0
Short-term liabilities	3.8	0.0	3.6	0.0	5.0	0.0
International agencies	0.0	0.0	0.0	0.0	0.0	0.0
Foreign Banks	0.0	0.0	0.0	0.0	0.0	0.0
Fondo Latinoamericano de Reservas FLAR	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding payment orders	0.0	0.0	0.0	0.0	0.0	0.0
Current acct. deposits in other entities	3.8	0.0	3.6	0.0	5.0	0.0
Total net reserves	10,817.0	100.0	10,840.5	100.0	10,499.8	100.0

Source: Banco de la República.

Morgan Investment Management Inc., Goldman Sachs Asset Management and Morgan Stanley Investments L.P. The first two administer global mandates and are located in England, while the other two administer asset-rotation mandates and are located in the United States. These firms were chosen through a rigorous selection process²³.

The selection process started with preselection of prospective management firms among market leaders, based on certain general criteria such as high credit

rating, experience in fund-management services, credit exposure to Colombia, membership of stock exchange brokers in the United States, and status as subsidiary of market makers authorized by the Federal Reserve of New York. Preselected firms are invited

²³ Each of these factors is weighted and rated according to pre-established criteria. Financial offers are also taken into account and rated. Each candidate firm's final rating, which determines selection of the external manager, is the weighted total rating of the factors evaluated, based on the invitation to offer, visits to the firm and ratings for financial offers.

TABLE 12
EXCHANGE COMPOSITION OF WORLDWIDE INTERNATIONAL RESERVES
(PERCENTAGE OF TOTAL)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
US dollar	55.3	56.7	56.6	57.0	60.3	62.4	65.9	68.4	68.1	68.3
Japanese yen	7.6	7.7	7.9	6.8	6.0	5.2	5.4	5.5	5.2	4.9
Sterling	3.1	3.0	3.3	3.2	3.4	3.7	3.9	4.0	3.9	4.0
Swiss franc	1.0	1.1	0.9	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Euro (*)	26.4	24.9	24.8	23.2	21.2	19.7	14.8	12.7	13.0	13.0
Other	6.5	6.6	6.4	8.9	8.3	8.4	9.3	8.8	9.1	9.0

(*) The currencies now making up the euro are aggregated for years up to 1999.

Source: IMF

to answer an invitation to offer that evaluates such factors as company structure (assets, clients, experience related to central banks, legal situation), their organization (organizational structure, staff, internal technology processes and information flow), investment process (investment philosophy, decision-making process, investment alternatives used), reconciliation reporting and methods, offers of additional services in training and transfer of technology, and analysis of returns on portfolios comparable to those of the reserves.

According to recently published surveys, the firms currently providing services to the Bank are among the market leaders²⁴.

The selected firms are constantly evaluated by using indicators measuring such variables as excess returns generated, use of risk, and operational capacity. The aim of this evaluation is to ensure management quality within originally defined parameters for the external management program, which may be summed up as outperforming the benchmark index consistently and, timewise, efficiently.

At the end of June 2003, of the total investment portfolio, the Bank was directly managing \$4,283.7 m (or 45.43% of the total investment tranche), including working capital of \$691.6 m, while external administrators managed the remaining 54.57%, or \$5,146.1 m²⁵.

In June 2003, the benchmark index for evaluating management of the global mandate showed a 3.41% return for the year to date, compared with a 4.36% return on the portion administered by Barclays Global Investors, and a 3.22% return obtained by J.P. Morgan Investment Management Inc. Over the same period, the benchmark index for the asset-rotation mandate yielded 1.34%, compared with a 1.67% return on the portfolio administered by Goldman Sachs Asset Management and 0.76% on the one managed by Morgan Stanley Investment L.P. The portion of the portfolio directly managed by the Bank, excluding working capital, yielded 2.11% to June 2003, similar to the yield on the benchmark index for evaluating this portion. The return on working capital was 0.59%.²⁶

²⁴ For example, according to the specialized firm of Institutional Investor, Goldman Sachs Management ranks third among the world's major asset managers; Morgan Stanley Investment Management fourth, J.P. Morgan Fleming Asset Management sixth, and Barclays Global Investors tenth.

²⁵ At May 31, 2003 the approximate amount managed by each firm was: \$1,241 m by Morgan Stanley Investments L.P., \$1,260 m by Goldman Sachs Asset Management, \$1,318 m by J.P. Morgan Investment Management, and \$1,332 m by Barclays Global Investors.

²⁶ Figures may not add up, because of rounding. Rates are those prevailing at the time and are not annualized.

Credit risk for the total investment portfolio is mainly concentrated in the sovereign sector, both short-term and long-term, representing 63.97% of the portfolio; the rest is distributed among the other sectors as follows: 19.97% in the banking sector, 8.38% in the corporate sector, 4.07% in the supranational sector, and 3.61% in BIS²⁷. In June 2003, the breakdown of this risk according to the specialized agencies' ratings was as follows: 44.25% rated "P-1", 46.09% rated "AAA", 5.17% rated "AA", 0.34% rated "A" and 3.61% in BIS²⁸. This credit-risk distribution reflects the safety criterion applied in managing the country's international reserves.

In the year to June, the net return obtained by the Bank and the delegated administrators on the investment portfolio of international reserves totaled \$209.2 m, of which \$98.5 m was earned income and \$110.7 m represented valuation gains in the reserves' market price²⁹. Valuation gains resulted both from movements in the euro and yen against the

dollar, \$106.7, and from the value increase in bond investments caused by lower interest rates, \$4.0 m.

3. Evolución reciente e indicadores de las reservas internacionales

Net international reserves including valuation gains declined by \$304.7 m in the year to June 30, 2003, mainly as a result of the following movements: a \$225.3 m increase in net returns on the assets making up the reserves, a \$344.5 m decrease from sales of foreign currency through the exercise of reserves-reducing options, and a \$220 m decrease from the transfer of profits to the central government.

As discussed in detail in the March 2003 Report to Congress, one way of evaluating a country's international standing is by building liquidity indicators on internationally accepted criteria³⁰. The most commonly used indicators are international reserves and the reserves-related indicators of external-debt repayment and imports. It may be observed from Table 13 that for Colombia these indicators currently stand at levels considered adequate by international standards.

²⁷ Bank for International Settlements

²⁸ *Standard & Poor's, Moody's and Fitch Ratings*. P-1 is part of Moody's Prime Rating System used to grade issuers' ability to meet their short-term obligations (with an original maturity of less than a year). In particular, the P-1 designation is applied to issuers with the highest repayment probability.

²⁹ This figure refers to the reserves portfolio and does not therefore include valuation gains in SDRs, gold, contributions to the Latin American Reserves Fund or international agreements.

³⁰ See *Informe de la Junta Directiva al Congreso de la República, March 2003*, pp. 56-59.

TABLE 13
PAYMENT CAPACITY INDICATORS, JUNE 2003

Indicator	Brazil 1/	Chile	Colombia	México 2/	Perú
NR / Months of imports	4.23	11.03	9.82	4.05	14.73
NR / External debt	0.07	0.38	0.28	0.36	0.36
GR / Debt amortizations 3/	0.87	1.91	1.03	1.02	1.99

NR: Net reserves.

GR: Gross reserves.

1/ Net reserves to April 2003.

2/ Net and gross reserves to May 2003.

3/ Public- and private-sector debt amortizations in the next 12 months. Calculations Goldman Sachs and J.P. Morgan.

Source: Central Banks.

VI

USE OF THE BANCO DE LA REPÚBLICA'S RESOURCES, AND ITS FINANCIAL STATEMENTS

The National Constituent Assembly of 1991 introduced major changes to the functions thitherto exercised by the Banco de la República. The new Constitution not only provided that the Bank was to be organized as an entity with legal capacity, governed by public law and enjoying management, financial and technical autonomy, it also limited some of the Bank's functions.

Under the new Constitution, the Bank's activities are focused on performing the basic functions of regulating the currency, international exchanges and credit, issuing legal tender, managing the international reserves, acting as lender of last resort and banker to banks, and serving as the government's fiscal agent. In particular, the prohibition to establish credit allocations or extend guarantees in favor of private parties, except where intermediation of external credit lines is involved, have enabled the Bank to discharge its task of ensuring greater monetary and exchange-rate stability. Moreover, a series of specialized state financial institutions have been created by law to provide credit, including Finagro (farming), Bancoldex (foreign trade), Findeter (development) and FEN (energy), which have replaced the Bank in these activities. Furthermore, Law 9 of 1991 has established a new exchange regime and dismantled exchange-rate control, which was essentially supervised by the Exchange Office, managed by the Banco de la República.

A. THE BANK'S ACTIVITY, FUNCTIONS, PROFITS AND COSTS

The functions assigned to the Bank may be divided into four perfectly identifiable activities: central bank,

banking services, industrial activity and metals, and cultural activity. These activities are complemented and supported by an infrastructure of security services, information-technology management, and a network of branches.

Figure 24 summarizes from the statement of results for 2002 each activity group's percentage share of the Bank's overall expenses.

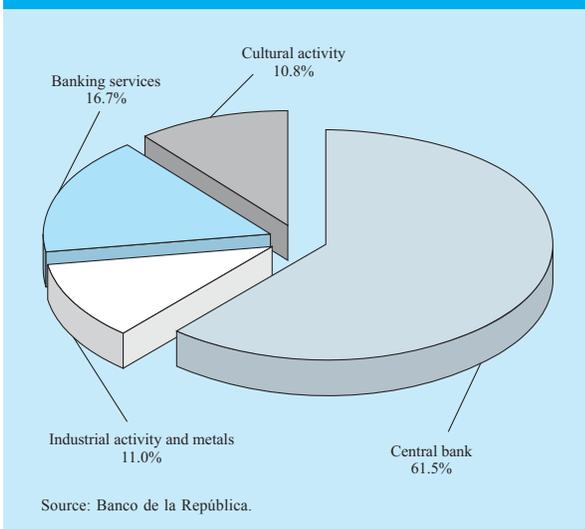
1. Central bank

The Bank's Technical Management Office, a functional structure staffed with highly qualified professionals, performs the Bank's functions of providing technical support to the Board of Directors for their decisions on monetary, exchange and credit policy, and administering the international reserves. In executing the Board's decisions, the Technical Management Office carries out intervention operations in exchange and monetary markets and administers the international reserves, in accordance with the strict criteria of security, liquidity and profitability.

El mandato legal de estabilidad de precios y los cambios en los mercados internacionales de capitales ha hecho necesario un análisis profundo del funcionamiento de la economía colombiana y ha requerido la modernización del manejo de las reservas internacionales como principal activo de la institución y uno de los determinantes principales del acceso del país a recursos externos.

The legal mandate of maintaining price levels and stabilizing exchange rates in international

FIGURE 24
BANCO DE LA REPÚBLICA EXPENSES, 2002
PERCENTAGE SHARE BY ACTIVITY



capital markets has made it necessary to undertake a thorough analysis of how the Colombian economy functions. It has also entailed modernizing the management of the international reserves as the institution's principal asset and a major determinant of the country's access to external resources.

In the past five years, central-bank activity has generated between 89% and 95% of the Bank's income. The major income items are interest and returns on international reserves, higher value of Treasury paper in monetary-expansion operations and expansion Repos. In 2002, this activity accounted for 61.5% of the Bank's overall expenses, with typical central-banking expenses and administration costs. The main items of central-banking expenses were interest and returns paid on the deposit accounts of commercial banks and the National Treasury Office and, to a lesser extent, contraction Repos. Other significant expenses were those arising from exchange-rate differentials in the Bank's foreign-currency obligations, under still-existing

external-credit lines (in which the Bank is guarantor to the Nation), the deposit accounts of the financial system and the national government, and contributions to international organizations. As a result of the strategy for adjusting and reducing administration costs, the past five years have seen a 14.5% real decrease in administration costs (including personnel costs and overhead).

2. The Bank as a banking-services enterprise

The Banco de la República's activities connected with the financial sector arise from its responsibilities as banker and lender of last resort to credit establishments, fiscal agent to the government, and promoter of the payment system's efficient and safe operation. Under Law 31 of 1992, the Bank is also responsible for (a) managing the securities depository, including receiving in deposit and administering securities issued, guaranteed or administered by the Bank and also securities constituting mandatory or substitutive investments of entities subject to inspection and supervision by the Banking Superintendency; (b) opening and managing deposit accounts required for the payment system's operation; (c) providing interbank clearing services; (d) administering reciprocal payment and credit agreements made with other countries; and (e) monitoring and registering activities involving international exchange operations.

To perform these duties, the Bank has used technology of the highest international standards to devise several electronic-transaction systems that have helped to make its banking services more efficient, transparent, timely and safe, thereby furthering the development of the country's payment system.

In the past five years, income from banking services has risen by more than 38% in real terms, increasing this activity's share of the Bank's total income from

2.8% to 4%. The items largely accountable for the rise are trust fees for management and custody of public-debt securities issued in the Central Securities Depository (DCV), charges for money transfers between holders of deposit accounts in the Bank, for transactions made through the Electronic Trading System (SEN), for providing the financial sector with cash, and for clearing checks between banks, and commissions on foreign-currency deposits made by exchange-market intermediaries.

The volume of deposit-account operations carried out through the Deposit Account System (CUD) has doubled in the past four years, the number of transfers averaging 76,606 a month in 2002, with an average monthly value of 185,867 bn pesos. At the same time, the number of staff connected with these operations has decreased by 33%, thanks to greater

systematization and operating efficiency. At the end of 2002, there were 637 local- and foreign-currency accounts being managed in this System.

Regarding the provision of interbank check-clearing service, action by the Bank has been of decisive help in reducing costs to the commercial banks and in automating processes through the electronic exchange of information. In 2002, some 76.6 million checks worth 308.9 bn pesos were cleared. Clearing is done in two daily sessions (one of them at night), during which the physical exchange of documents also takes place.

With regard to international banking services, it should be noted first of all that they are among the riskiest operations the Bank performs, involving a high operating load on account of the control mechanisms

BANKING SERVICES ACTIVITY

In the past four years the Central Securities Depository has tripled the number of transactions and almost doubled the balance of deposited securities. Included among the transactions are Repo operations or final purchase and sale of public-debt or portfolio securities, carried out in execution of the monetary policy specified by the Board of Directors, with volumes showing a significant increase. In contrast, the number of staff employed in this service decreased by 20% between 1999 and 2002. The electronic trading system (SEN) has also registered exponential growth in recent years both in the number of transactions and in the value of securities traded: from 5,000 transactions amounting to over 5 bn pesos 1999, to 87,000 transactions worth more than 155 bn pesos in 2002, without any increase in the number of staff manning this service.

Year	Central Depository operations		Electronic system operations		Banco de la República monetary operations	
	Number of operations	Securities balance (bn pesos)	Number of transactions	Value traded (bn pesos)	Number of operations	Value executed (bn pesos)
1999	236,467	31,576	5,247	5,739	10,506	83,534
2000	271,412	38,000	12,076	14,607	7,724	117,533
2001	535,552	46,708	53,877	84,411	11,837	187,700
2002	693,444	56,715	87,040	155,492	18,786	233,829

Source: Banco de la República.

they require. Some of these operations pertain to the administration and management of international reserves, which entailed 2,332 operations worth \$69,116 m in 2001, and 2319 operations worth \$72,414 m in 2002. Others arise from instructions for overseas transfers given by financial entities or the government, or are payments by the Bank itself including intervention operations in the exchange market. In the past four years, the Bank has sent 18,777 overseas transfers worth \$35,179 m.

Another, very different set of exchange-related activities includes registering public and private external debt, foreign capital investments in Colombia and Colombian capital investments overseas, [administering?] the clearing accounts through which individuals and entities are obliged to channel their international exchange operations, and receiving and processing information required for drawing up the exchange balance. This set of services is among the most modernized ones in the Bank, having progressed in a few years from the reception of physical documents and manual drafting, to magnetic devices, and then to extensive use of the Internet, with automated processing. Since the internet access was setup in September 2001, some 4.7 million exchange operations have been processed through the network.

Despite the significant volume of overseas transfers and registration of exchange operations, the number of staff engaged in this work has been reduced by 20%.

The Bank also coordinates and plans on a national scale the necessary measures for meeting national demand for cash adequately and determining the economy's future needs of coins and bills. In this connection, it dispatches cash to all parts of the country, with distribution costs amounting to 3,422 m pesos in 2002. Likewise, the Bank performs the function of making and receiving payments to and from banks in pesos and foreign currency.

To meet the needs of users and the public in general satisfactorily, many of the services referred to above have an operational and administrative infrastructure

with staff working extended hours to provide night-time service nationwide and/or a two-shift internal operating day. Despite this, efforts to make the relevant processes more efficient has gradually reduced the banking services' share of the Bank's total expenses from 19.6% in 1998 to 16.7% in 2002.

3. The Bank as an industrial and precious metals enterprise

Under Law 31 of 1992, the Bank is responsible for producing or importing the bills and coins constituting Colombian legal tender to supply the country's needs. The Banco de la República began to print some bills in 1958, and since 1989 it has been producing all the bills in circulation in the country. The Mint, which has been in operation in the city of Ibagué since 1982, also produces and mints the coins needed to meet domestic demand, employing for the purpose plants equipped with the infrastructure, machinery and technology required for this type of activity. The designs and characteristics of Colombian bills and coins are achieved by means of sophisticated technological processes to ensure their quality and security. Both the Printing House and the Mint make their own production tools (plates, moulds, punches and dies).

Income from this activity is limited to the face value of the coins put into circulation, while the cost of producing both bills and coins, including their replacement cost, is recorded as expenses. Consequently, the statement of results for the Bank's industrial activity tends to show a deficit, as generally occurs in other central banks. Nonetheless, the Bank has been selling coins for other countries of the region and takes part in international biddings to provide bills and coins to other countries, to generate further income from this activity.

Attention is drawn to the fact that in 2000 a major adjustment was made to the mint's workforce, reducing it from 164 to 40 employees, through a restructuring plan that called for modernizing production processes. The new system of work has

made production more efficient and reduced the cost of making each coin by 44.21% in 2000-2002.

In 2002, industrial-activity expenses represented 11% of the Bank's overall expenses. Operating costs, made up of the cost of issuing bills and the face value of destroyed coinage, accounted for 70% of the industry total and administration costs for 17%.³¹

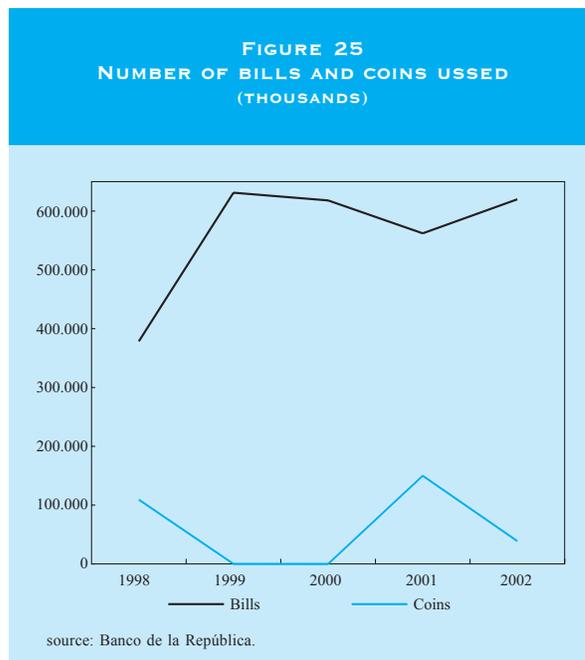
In 2002, some 620 million bills of different denominations were produced at a cost of 35,894.5 m pesos, and 38,8 million coins minted at a cost of 6,396 million pesos (Figure 25). In addition, the Bank, through its directly administered gold-purchasing agencies (in remote places such as Condoto and Guapi) buys gold, silver or platinum produced in Colombia and offered to it on sale. Purchases are made according to standards of precision, accuracy and safety, and the metals are refined and subsequently sold in domestic or international markets. Although purchases have decreased in value in recent years, the Bank's function is very important in that it establishes a reference price for the miners.

4. The Bank as a cultural-services enterprise

As provided by Article 25 of Law 31 of 1992 and Article 26 of the Statutes, the Bank continues to perform the cultural activities it was engaged in before the law was adopted. It does so through the Gold Museum and the Luis-Ángel Arango Library (BLAA) with its music and plastic-arts extensions, cultural areas and regional libraries at branch offices, and its art, coinage and philatelic collections.

The aim of the Bank's cultural activity is to collaborate in salvaging, conserving, analyzing, studying and disseminating the Nation's cultural heritage so as to safeguard the cultural identity of the country's people. Through the years of its

³¹ Including personnel costs and overhead other than production expenses.



existence the Banco de la República has compiled collections of books, plastic art, pre-Columbian pieces, coins and stamps, which have received national and international acclaim and are available to the community at large.

The art collection contains both paintings and sculptures, including a representative selection of the best Colombian and Latin American art. Much of the collection is on display in the ten exhibition halls located in Bogotá's Candelaria sector and is visited by more than 586,000 people a year. Exhibitions are often arranged to show the work of artists of national and world repute, providing the community with the opportunity of appreciating great works of art.

Most of the Bank's cultural areas (16 out of 27) are open to the public until late in the evening and also at weekends, usually until 1:00 p.m. The Library itself remains open on Sundays until 6:00 p.m. (Figures 26, 27 and 28).

The Bank has a very good average occupancy rate of 4.2 users a day per seat, and a high book rotation of 4.9 take-outs a year. Moreover, the Bank's website allows the public to use the services of the Library

and Gold Museum without having to visit their premises.

Within the framework of its cultural function the Banco de la República has provided financial, operational and logistic support to the government's National Libraries Plan and Bogotá's network of libraries. Under cooperation agreements, the Bank helps to improve the local libraries' reference

services, cataloguing, and acquisition of collections, aiming to lessen duplication of efforts, reduce operating costs and streamline their internal procedures. As a result, local communities receive better service and the Luis-Ángel Arango Library reduces the pressure it has been under from the growing number of users (Table 14).

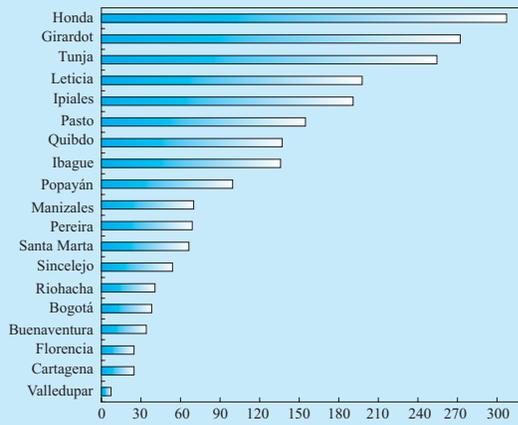
In 2002 cultural activities generated income of 3,700m pesos, less than 1% of the Bank's overall income, while accounting for 10.7% of its overall expenses. Personnel costs represented 35.4% of cultural expenses, which is explained by the fact that such activities essentially involve attending to the public, though this share has been decreasing in recent years. In 2001-2002 cultural spending rose in real terms by 21.8%, mostly because 11 of the Bank's branches were turned into cultural centers.

5. Support services

a. Security

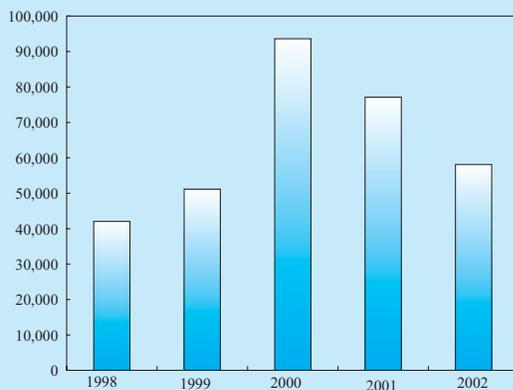
The Banco de la República has its own security system, organized for the main purpose of providing

FIGURE 26
BANCO DE LA REPÚBLICA LIBRARY NETWORK;
NUMBER OF USERS PER
100 INHABITANTS - 2002



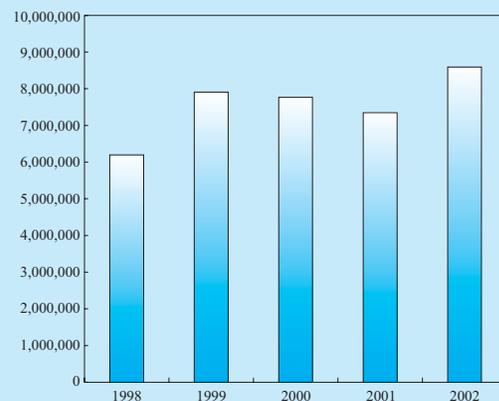
Source: Banco de la República.

FIGURE 27
INCREASE IN SIZE OF BOOK COLLECTION (*)



(*) Comprises collections in Bogotá and branches, as well as books on exchange and donated collections. A large increase occurred in 2000 with the purchase of books by six branches that started operations that year (Valledupar, Sincelejo, Santa Marta, Florencia, Tunja and Popayán).
Source: Banco de la República.

FIGURE 28
NUMBER OF PRESENTIAL
LIBRARY USERS (*)



(*) The nationwide number of presential users includes also visitors to the Luis-Angel Arango Library, the Gold Museum, the Plastic Arts Hall and the Music Room.
Source: Banco de la República.

integral protection to its facilities and valuables³² and safe transportation for valuables. Security activities also include conducting special investigations, in some cases in coordination with international organizations for preventing and combating money forging. In line with international standards, the security system is organized as a Division within the bank's

administrative structure, with a special workforce, and equipped with armored cars, security devices and communications systems of its own³³. This Division permanently guards and controls, nationwide, access to the Bank's 100 safety vaults and 59 buildings with their surroundings and operates 31 satellite alarm centers. In 2002 it carried out 1,238 valuables transport operations, 312 of them by air.

TABLE 14
2002 CULTURAL ACTIVITY STATISTICS

The Bank's cultural activity benefits a quarter of the country's population, as follows:

Visitors

Libraries	8,500,000
Gold Museum	939,000
Plastic arts	586,000
Music	257,000
Independent programs	94,000

Book collection

Volumes	1,120,000
Yearly Internet consultations	1,665,000
Regional libraries	19
Documentation centers	5

Gold Museum collection (*)

Goldwork	34,000
Ceramics	13,500 Aprox.
Stonework	3,396
Shellwork	1,127
Bonework	324
Textile artifacts	116

(*) Created by the Bank in 1939 for the purpose of recovering and preserving the country's pre-Hispanic heritage.

Much of the collection is on display at the Gold Museum in Bogotá and in the regional museums located at the branches in Armenia, Cali, Cartagena, Manizales, Pasto and Santa Marta.

- Collections are visited by about 912,000 people a year, plus a further 27,000 virtual visitors to the collection through the Internet.
- The Gold Museum collection is unique in the world. Its artifacts are periodically requested on loan for display at international exhibitions. Our pre-Columbian cultural heritage is thus disseminated throughout the world.

In addition, educational services are provided through:

- The loan of didactic material.
- Videos and printed matter.
- Organization of workshops for teachers and students.

Source: Banco de la República.

The security system's expenses in 2002 totaled 22,923m pesos, representing 39.9% of the Bank's overhead and 5.8% of its corporate expenses. The major spending items were personnel costs 12,078 m pesos (56.2%); hiring of private guard service: 5,318 m pesos (24.7%); operating costs 3,595 m pesos (16.7%); equipment depreciation 453 m pesos (2.1%); and non-operating costs 44 m pesos (0.2%).

The country's public-order situation has obliged the Bank to reinforce safety measures for protecting the securities it holds in custody and its facilities. Yet, outlays connected with the security system increased by only 1.0% in real terms in 1999-2002.

b. Information technology

Since the second half of the 1990s the Bank has made considerable investment in technology to modernize and optimize its banking services, particularly the payment system. *Hardware and software* updating in 1996-2002 cost 68 bn pesos³⁴.

The modernization strategy was underpinned by the outsourcing of services on four fronts, namely: development of information systems, support service, data telecommunications service, and information-systems maintenance. Outsourcing made it possible to modernize several services at the same time and undertake highly specialized, sporadic tasks swiftly and at less cost. By providing access to high-quality services performed by specialized personnel using updated technology, it

³³ Decree 2520 of 1993, Article 78.

³⁴ At current prices.

also allowed the Bank to offer solutions to all areas of the organization without increasing the workforce.

Despite large investments in information technology, the personnel costs and overhead connected with the use and maintenance of such technology remained steady in 1999-2002 at an average 7.2% of the Bank's total corporate expenses, peaking at 8.1% in 2001 owing to the information systems' higher amortization value.

Equipment maintenance and depreciation and software amortization made up a major component of information-technology expenses: 38% in 2002 and over 50% in 2000 and 2001. Personnel costs for the Bank's IT areas accounted for more than half of total IT expenses in 2002.

6. Training

The Bank lays particular emphasis on its training policy and therefore allocates the necessary resources for it to be implemented efficiently. This is reflected by an 8% rise in real terms in training expenses over the past five years. Management regards this as sound policy, for it has provided the Bank with highly qualified, suitable staff, an essential requirement for discharging the important duties entrusted to it

The Bank's training programs provide scholarships for postgraduate studies or shorter courses in Colombia or abroad, which are authorized according to the needs of the Bank's areas or specific projects. As in other training schemes, employees granted scholarships to study in Colombia or abroad become indebted to the Bank for the amount of the scholarship, which is repaid by working for a period of time depending on the length of the course of study. This type of program has represented about 44%, on average, of the Bank's training costs in the past five years. Staff also study for degrees in the country (an average 14% of training costs), or attend seminars and courses sponsored by the Bank or other entities (Table 15).

The Bank also offers scholarships to non-employees under programs called doctorate in economics, doctorate in economic law, and young talents. The aim is to have trained professionals who can apply their knowledge for the benefit not only of the Bank but also of the country. Non-employee scholarships have accounted for some 23%, on average, of the Bank's training costs in the past five years.

A major effort has also been made in retraining staff in new operating processes, because of the adjustment process and the movement of personnel it has led to.

TABLE 15
BANCO DE LA REPÚBLICA'S SCHOLARSHIP WINNERS SINCE 1980

Years	Employees		Non-employees		Total
	Study in Colombia	Study abroad	Economics scholarships	Young talent	
1980-1999	361	158	69	7	595
2000	36	15	6	0	57
2001	26	13	6	0	45
2002	31	8	5	2	46
Total	454	194	86	9	743

Source: Banco de la República.

The benefits of the training programs described above are by way of a contribution by the Bank to the country, for a considerable number of scholarship winners have worked or are now working in different management positions in the Bank itself or in government, research institutes, business associations or academia.

B. A DECADE OF ADJUSTMENT AT THE BANCO DE LA REPÚBLICA, 1991-2002

In 1992 the Bank began to implement a re-engineering strategy prompted by the changes made to its functions under the new Constitution of 1991. The guiding principle has been to improve the efficiency and quality of the Bank's operation and also to enhance the analytical capability of the whole organization. The strategy was designed around four chief elements: modifying the Bank's structure, constantly revising processes to make them more efficient and less costly, reducing the workforce, and outsourcing services.

1. Modifying the Bank's structure

The Bank's structure has been modified both in Bogotá and in the branch offices, and also at the Mint, by reducing hierarchical levels, grouping functions, and integrating operating units. In 1993, the four units reporting directly to the President's Office were reduced to two, which integrate all activity at the Bank's Headquarters, resulting in a reduction of functional areas. Similarly, at the branches several levels reporting to the Manager's Office were eliminated, as is explained in the section on re-engineering of the branch network. The composition of the Bank's workforce has been modified to include even more professional posts, with these now representing 40.06% of the workforce, compared with 32.86% in 1998.

2. Constant revision of processes

In 1991 the Bank began to revise its internal processes, not only because of the new legal mandates of that year and the consequent modification of the Bank's structure, but also as an ongoing task to streamline its processes and make them more transparent, less costly and hence much more efficient.

This has been done by: eliminating unnecessary and inefficient controls and insisting on the need for the processes themselves to be self-controlling; doing away with superfluous procedures, the jobs associated with them, and redundant information; and making intensive use of information technology in running the Bank itself and also the services provided to external users.

The areas of banking services, the Mint and bill printing provide useful examples of process redesigning. In the case of bill printing, the cost per bill was cut by 5.49% in real terms in 2000-2002 and printing defects were reduced by 7.5%, raising the Bank's printing operation to international standards of excellence.

3. Reducción de la planta de personal

In December 1990 the Bank had 5,212 employees. By December 2002 the number had been reduced by 51.48% to 2,529 (Figure 29), mainly through:

- *An early retirement plan implemented in 1993, which resulted in 560 employees retiring. The plan is estimated to have produced benefits in terms of net present value in 10 years time, of the order of 14,000 m in pesos of 1993.*
- *A retirement-cum-bonus program that led to the retirement of a further 580 workers, or 14% of the workforce at the time. The Bank recovered the amount of the bonuses paid under this program in less than two years. Moreover, 94% of the employees were induced by a bonus offer to be*

governed by the provisions of Law 50. Retroactive severance pay was thus eliminated; the resulting cost reduction led to the bonus cost being recovered within three years and, from 1998 on, signified increasingly greater savings for the Bank.

- *Leaving vacant posts unfilled*, unless it was considered essential to fill them.

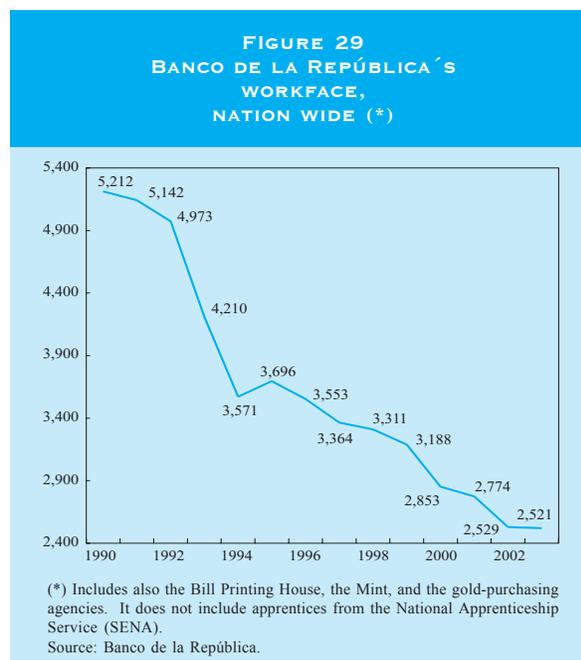
4. Outsourcing of services

As part of the Bank's re-engineering process, many activities once performed internally were eliminated if outsourcing was estimated to be a more efficient way of having them carried out. A case in point was the Bank's publishing of its own publications. This area had become obsolete and was costing more than having the printing done by specialized firms.

The entire process reduced the Bank's overall corporate expenses by 21.9% in real terms between 1998 and 2002, at the same time as multiplying its banking services and making them more efficient through the use of cutting-edge technology. It is noteworthy that personnel costs have fallen by 5.4% in real terms in the past five years. Table 16 presents expense figures for the five years.

5. Management of international reserves

In 1997 the International Reserves Department initiated a strategic project for optimizing reserves



management, which has resulted in an investment policy that is more efficient and consistent with international-market practices. Implementation of this new policy has also involved making major changes to reserves management in other respects, notably:

- Organizational structure: The organization structure has been adapted to the financial industry's standards of segregation of functions.
- Personnel: An integral personnel policy has been designed. It starts with a rigorous selection process,

TABLE 16
CORPORATE EXPENSES IN REAL TERMS
(MILLIONS OF 1998 PESOS)

	1998	1999	2000	2001	2002	% Change 1998-2002
Personnel costs	124,511	130,436	126,795	119,530	117,835	(5.4)
Pensioner costs	150,514 1/	51,754	50,798	49,778	66,994	(55.5)
Overhead	38,884	37,871	35,884	35,601	32,054	(17.6)
Cultural expenses	3,836	4,059	5,070	4,424	4,630	20.7
Depreciation, amort. provisions	15,898	20,964	22,028	31,062	38,997 2/	145.3
Total egresos corporativos	333,643	245,084	240,575	240,394	260,511	(21.9)

1/ In 1998 a provision was made for 100% of actuarial liabilities.

2/ Support for Bogotá's library network accounted for 10,000 m pesos of this figure.

Source: Banco de la República.

The Banco de la República has constantly been regarded as an example for its appropriate reserves management and has taken an active part in seminars and training programs with the IMF and the World Bank. The Banco de la República has been a pioneer in developing with the IMF appropriate reserves management standards and information dissemination standards. The relevant document is available to the public in English at the following link: <http://www.imf.org/external/np/mae/ferm/2003/eng/index.htm>

involving assessment of the candidates' technical knowledge, command of English and personal characteristics. This is followed by a training scheme focused on the particular area, lasting six and a half years, on average, and requiring a long-term commitment between the professional and the Bank. Lastly, the pay policy is designed to minimize staff turnover by offering competitive salaries in relation to the industry average.

c. Technological platform: Considerable changes have been made in this respect by systematizing the critical process of reserves management. As a result, operating times, costs and errors have been reduced significantly, and operational and analytical capacity of the areas for managing market risk and measuring and attributing performance has been increased³⁵.

d. Operational risk management: With greater emphasis laid on operational-risk management, the probability of errors and fraud has been reduced to a minimum and business continuity has become more reliable. This result has been achieved by segregating functions, maintaining manuals of procedures, establishing strict security standards for access to systems and drawing up a sound contingency plan.

6. Medical service

The medical service for the Bank's employees was started in 1946, before creation of the state Social Security Institute (ISS), and was extended under an arbitration award in 1965 to pensioners and family members.

Since the creation of the ISS, the Bank has paid both health and pension contributions to the general social security system and, under Law 100 of 1993, also contributions for occupational hazard.

At March 31, 2003, the number of people covered by the medical service was 17,195, grouped as follows: 2,516 employees, 3,711 pensioners, 4,912 employees' family members, and 6,056 pensioners' family members. The cost of providing health care to this population increased by 2.2% in real terms in 2000-2002, accounting for 7.2% of the Bank's corporate expenses in 2002. Pursuant to Article 53 of Law 812 of 2003, embodying the National Development Plan, the Bank is in a process of transition regarding the direct provision of medical services.

7. Re-engineering of the Bank's network of branches

In 1992, the Bank was operating a network of 28 branches with 2,175 employees for covering all services required in different cities of the country. The Bank's new constitutional mandate and the elimination of special functions led to the branches' activity being simplified and so made it necessary to review and modernize their organizational structure.

Treasury operations have thus been gradually reduced based on the assessment of cash circulation and by modernizing accounting processes, updating hardware and software technology in all areas, and using new outsourcing schemes. As a result of the ongoing adjustment process, the branches' overall workforce has been reduced by two thirds over the decade, to a figure even lower than planned, and their administrative expenses (personnel costs, overhead and cultural expenses) have fallen by about 18% in real terms in 1999-2002 (Figure 30).

³⁵ The methodology used by these systems is in line with the AIMR and GIPS investment performance standards applied worldwide.

BANCO DE LA REPÚBLICA, SERVICES PROVIDED AT BRANCHES

The Bank's regional network consists of 28 branches and two gold purchasing agencies, manned by 819 employees, or 32% of the Bank's total staff.

The Banco de la República performs three different types of activity in the regions: providing cash and banking services, carrying out economic analysis, and engaging in cultural activity. Depending on the region, some branches discharge all three functions, while others are more specialized and lay greater emphasis on cultural work and/or economic analysis (as detailed in the Table below).

The Bank's contribution to the regions stands out in two very important respects: regional economic analysis and cultural activity. The first involves the active valuable task of compiling essential data for decision-making by the Board of Directors and for research into regional economies. Thus local authorities and business communities are also provided with the latest information through the regional economic studies centers.

Cultural activity has included a very great effort to strengthen the Bank's regional libraries, furnishing them with up-to-date collections, to serve as support for the government's library program.

City	Banking & public services	Economic studies 2/	Museum	Library	Regional documentation center	Multiactivity hall	Musical activity 6/
Armenia	Integral banking services 1/	In association with Manizales	Gold artifacts Quimbaya Culture		Specializing in Quimbaya Amerindian culture	Diversified programs 3/	Four music concerts
Barranquilla	Integral banking services 1/	In association with Cartagena				Diversified program 5/	Amira de la Rosa Theater: Bank sponsored concerts. Rented out for cultural events. Park Band stand: open-air musical activity for schools
Bucaramanga	Integral banking services 1/	Regional				Diversified program 5/	In association with the region's cultural entities organizes three musical festivals.
Buenaventura				Inaugurated March 2002 3/		Diversified program 5/	One music concert.
Cali	Integral banking services 1/	Regional	Gold artifacts Calima and Malagana cultures 3/		Specializing in the subject of the Cauca Valley 5/	Diversified program 5/	Three classical music concerts, and four didactic concerts in the city's neighborhoods and rural area 5/
Cartagena	Integral banking services 1/	Regional	Gold artifacts Sinú culture since 1986 4/	Bartolomé Calvo Library. Started in 1981 3/		Diversified program 3/	Two music concerts 3/
Cúcuta	Integral banking services 1/	In association with Bucaramanga			Specializing in Greater Santander and the border economy 5/	Diversified program 5/	Three classical music concerts, by national and international groups .5/
Florencia		In association with Ibagué		Started in september 2002 3/			Two music concerts.
Girardot		In association with Ibagué		Started in 1981 3/		Diversified program 3/	Three music concerts by national and international groups.
Honda				Inició en 1998 5/			One music concert.
Ibagué	Servicios bancarios integrales 1/	Regional		Biblioteca Darío Echandía. Inició en 1984 3/		Programación diversificada 3/	Two music concerts. In association with Tolima University and the Conservatory organizes young talent recitals and national singing duet festivals 3/

Ciudad	Servicios bancarios y al público	Estudios económicos 2/	Museo	Biblioteca	Centro de documentación regional	Sala múltiple	Actividad musical 6/
Ipiales				Started in 1984 3/		Diversified program 3/	Three classical music concerts. Supports library development in Obando Province.
Leticia	Integral banking services 1/	In association with Villavicencio	Ethnography amazone culture since 1986.	Started in 1986 3/		Diversified programs 3/	Two music concerts. Cultural events organized by the Ban and the region's cultural entities.
Manizales	Integral banking services 1/	Regional	Gold artifacts Quimbaya culture since 1981	Started in 1981 3/		Diversified program 3/	Four classical music concerts, two of them at regional level. 3/
Medellín	Integral banking services 1/	Regional			Specializing in economic subjects 5/	Diversified program 3/	Philatelic collection.
Montería	Integral banking services 1/	In asociacion with Cartagena			Specializing en temas regionales 5/	Diversified program 5/	One music concert.
Neiva	Integral banking services 1/	In association with Ibagué					
Pasto	Integral banking services 1/	In association with Cali	Gold artifacts Nariño culture since 1984	Sterted in 1984 3/		Diversified program 3/	Leopoldo López Álvarez. Cultural center. Three classical music concerts by national and international groups. 3/
Pereira	Check exchange	In association with Manizales		Started in 1983 3/			Four classical music concerts, two of them at regional level. 3/
Popayán		In association with Cali		Started in february 2002 3/		Diversified Program 3/	Two classical music cconcerts and participation in the religious music festival.
Quibdó	Integral banking services 1/			Started in 1987 5/		Diversified program 5/	Two classical music concerts and five regional concerts.
Riohacha	Integral banking services 1/	In association with Cartagena		Started in 1981 5/		Diversified programs 5/	Two music concerts
San Andrés Isla	Integral banking services 1/	In association with Cartagena			Specializing in caribbean subjects 5/	Diversified programs 5/	Two music concerts
Santa Marta			Gold artifacts Tairona culture. since 1980	Started in october 2001 3/		Diversified programs 3/	Two music concerts 3/
Sincelejo		In association with Cartagena		Started in february 2002 3/			Two music concerts
Tunja		In association with Bucaramanga		Alfonso Patiño Rosselli Library started in 1988 3/		Diversified program 3/	Three music concerts, one of them at regional and another at international level.
Valledupar		In association with Cartagena		Consuelo Araújo Noguera Library started in may 2002 3/		Diversified program 3/	Two music concerts
Villavicencio	Integral banking services 1/	Regional				Diversified program 5/	Three music concerts, one of them at international level.

1/ Including: payments, exchange, local- and foreign-currency deposits, clearing, classification and counting, destruction and remittances.

2/ Associated branches are responsible for gathering, analyzing and sending economic and statistical information required by regional branches, which in turn perform the respective analyses for the regions.

3/ Open from Monday to Saturday.

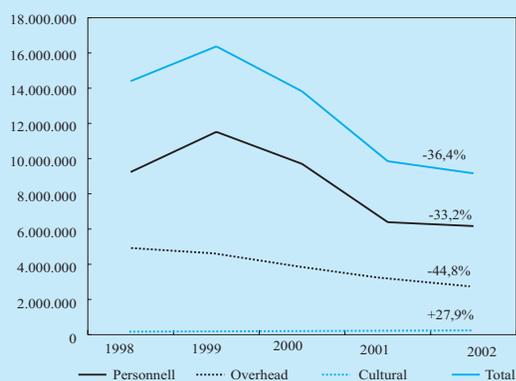
4/ Open from Tuesday to Saturday.

5/ Open from Monday to Friday.

6/ Scheduled for 2003.

Source: Banco de la República.

FIGURE 30
CULTURAL BRANCHES' OPERATING
AND CULTURAL EXPENSES, 1998-2002(*)



(*) With the closing of treasury areas in 11 branches between April 1997 and November 2002, expenses fell by 34.6% in the now so-called cultural branches, which carry out cultural activities; some of them are engaged also in economic activity.

Source: Banco de la República.

C. PAY POLICY AND PENSION SYSTEM

1. Política salarial

Pay policy is a determining factor of the Bank's personnel strategy. It is predicated on keeping the pay scale competitive in relation to different reference markets and maintaining internal fairness, to be able to recruit and retain highly qualified, suitable people who uphold the ethics imposed by the nature of the Bank's activities.

To this end the Bank periodically reviews the question of pay by conducting surveys in relation to different reference markets to ascertain pay levels for individual job groups. The 2002 study shows the Bank to be competitive at administrative, secretarial, professional and middle-management levels but below reference markets for top management. Internal fairness is maintained by conducting technical assessments of jobs and allocating applicable pay levels to them on that basis.

a. Collective bargaining agreement

Another determining factor of the Bank's pay regime is the collective bargaining agreement. The last time

an agreement was negotiated was in 1997. That agreement has been automatically extended every six months since 1999 despite management's systematic demand since then that it be terminated and updated. But, as the union has refused to terminate the agreement, a new negotiating stage has not been initiated.

The law and jurisprudence hold that "If termination is desired by management only, the collective agreement shall remain in force, through legal extensions, for management lacks the right to present claims and therefore has not the power to initiate a collective dispute that may culminate in another collective agreement or an award by a court of mandatory arbitration"³⁶.

b. Non-agreement regime

In 1998 the Bank decided to make an official distinction regarding the extralegal benefits of workers not covered by the collective agreement by establishing a regime for them that may be amended unilaterally when the Administration Council sees fit. The regime covers 164 employees, of whom 143 receive an integral salary (no extra bonuses). It differs from the collective agreement in the following respects:

- The annual salary increase is determined by the Administration Council. From 1998 to 2002 it has been 6.84% in real terms, half the pay rises under the collective agreement.
- There is no 15% increase on being promoted.
- From February 2003 retirement ages are as provided by the general retirement law, except for employees with more than 15 years of service on that date.
- The salary base for calculating pensions is the average earned in the last five years, annually adjusted for CPI inflation, except for the transition cases referred to in the previous point.

³⁶ The Supreme Court of Justice, November 22, 1984; No. 11,672 Supreme Court of Justice, February 12, 1999; C-1050/01 Constitutional Court, October 4, 2001.

- Pension conditions under the non-agreement regime apply to employees recruited after February 7, 2003.
- Employees pay 10% of the cost of medicines

The non-agreement employees' share of personnel costs³⁷ is 15.84% in 2003, with 69.1% of this percentage represented by integral salaries. It should be noted that non-agreement employees have received no pay rise in 2003.

c. Salaries of the members of the Board of Directors

According to law, Board members' integral salaries are raised by the same amount as is decreed for cabinet ministers. In the past ten years, increases have generally been lower than inflation, resulting in a 15.17% decrease in real terms.

2. Pension system

The Bank's employees have been covered by the Social Security Institute since 1968, so pensions are shared with the Institute and the Bank pays only the difference, if any, between the pension payable by it and the amount covered by a Private Fund Manager (private pension funds or the ISS).

The pension system established in the collective bargaining agreement provides for payment of pensions after 20 years' service at the age of 50 for women and 55 for men. It also provides that women with 25 years of service and men with 30 years are eligible for receiving pensions regardless of age. The amount of the pension varies between 75% and 100% of salary, without exceeding 25 times the minimum legal wage in force. This pension system has been one of the main reasons for the Bank's desire to terminate the collective agreement. If the Referendum is approved, such special pension systems will be eliminated starting from 2007.

³⁷ Including salaries, social benefits, contributions to ISS, parafiscal costs, bonuses and education allowance.

The pension system for members of the Board of Directors is as provided by Law 100 of 1993.

The pension regime for non-agreement employees has been described above, in Section 1.b; it should be noted that new employees are subject to the relevant law.

a. The Bank's pensioners

Throughout the years of its existence the Banco de la República has administered various entities on behalf of the government, including among others the Muzo and Coscuez Emerald Mines, the Salt Concession, the Exchange Control Office, Proexpo (export promotion), the Mint, and the Gold Purchasing Agencies. During the period of administration, the Bank paid pensions on behalf of the government and, was finally left responsible for them upon termination of the respective agreements, which is why not all of the Bank's pensioners worked for it directly. As shown in Table 17, some 15% of the Bank's pensioners were employed in activities no longer carried out by the Bank.

b. Pensioner expenses and pension liabilities

The Banking Superintendency, by Circular 063 of 1990, required all financial entities regulated by it to

TABLE 17
NUMBER OF PENSIONERS BY COST CENTER
(DATA TO JUNE 30, 2003)

Cost center	Number	% Chare
Mint	188	4.40
Bank	3,648	85.39
Proexpo	244	5.71
Exchange office	156	3.65
Stabilization Fund	15	0.35
Gold purchasing agencies	21	0.49
Total	4,272	100.00

Source: Banco de la República.

make provisions for 100% of their pension liabilities and to do so by December 2000. The Banco de la República complied with this regulation, completing the process by December 1998.

In 1995 the Bank decided to have its pension-liabilities resources managed by various specialized trust entities and created a fund of 126,576.6 m pesos to have the yield go toward meeting pension-related costs. In 1998-2002, income from portfolio yield and housing interest covered, on average, 60% of pensioner costs, with a 7.7% average real return.

Within the Bank's expense structure, pension costs represented 12.1% of the Bank's total expenses in 2002; their breakdown is shown in Figure 31 and Table 18.

D. THE BANK'S FINANCIAL STATEMENTS

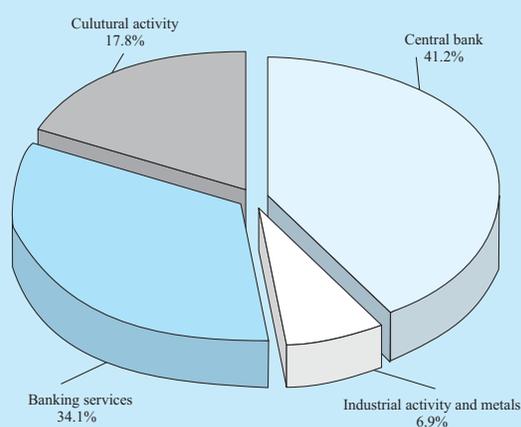
1. Results to June 2003

At the end of the first half of 2003, the Bank's assets amounted to 39,464.2 bn pesos, some 1,221.3 bn pesos less than in December 2002 (Table 19). The main causes of the decline were: (a) a decrease of 865.4 bn pesos in demand for Repos and transitory

liquidity support on the part of the financial system, and (b) a fall of 824.4 bn pesos in the value of international reserves, because of the reduction of reserves by \$339.2 m³⁸. Contributions in international organizations rose by 551.9 bn pesos, a purely accounting adjustment to maintain the peso value of contributions to the IMF, reflecting the

³⁸ Part of this decline is explained by the fact that in February this year profits amounting to \$220 m were transferred to the government. In addition, during the first half of the year the Banco de la República sold \$345 m of reserves, through the exercise of deaccumulation options.

FIGURE 31
PENSIONER EXPENSES, 2002
PERCENTAGE SHARE BY ACTIVITY



Source: Banco de la República.

TABLE 18
MOVEMENTS IN BANCO DE LA REPÚBLICA'S PENSION LIABILITIES
(THOUSANDS OF PESOS)

	1998	1999	2000	2001	2002
Sources - Pension liabilities	696.977.377	839.603.519	919.199.935	1.007.424.682	1.109.272.437
Uses - Investment and loans	687.603.461	802.449.559	916.912.845	1.006.390.012	1.109.845.485
Yield and interest income	149.318.443	177.465.872	133.869.406	146.629.335	141.618.226
Expenses 1/	289.451.187	234.890.550	190.462.443	211.983.989	235.823.933
Surplus or deficit	(140.132.743)	(57.424.678)	(56.593.037)	(65.354.654)	(94.205.707)
% of income toward covering expense	51.6	75.6	70.3	69,2	60,1
Real return	5.5	13.9	6.1	7,2	5,9

1/ Comprises: provision for liabilities, monthly pension payments, fees to fund managers, medical service and pension contributions.
Source: Banco de la República.

TABLE 19
BANCO DE LA REPÚBLICA BALANCE SHEET - 2001-2003 RESULTS
(BILLIONS OF PESOS PESOS)

	December, 2001		December, 2002		June, 2003 1/	
	Balance	Share %	Balance	Share %	Balance	Share %
Assets	31,874.5	100.0	40,685.4	100.0	39,464.2	100.0
Gross international reserves	23,634.5	74.1	30,525.0	75.0	29,696.7	75.2
Contributions in internat'l agencies	2,482.3	7.8	2,680.5	6.6	3,232.4	8.2
Investments	2,056.0	6.5	2,371.9	5.8	2,277.1	5.8
Consolidated public-sector debt	240.3	0.8	162.6	0.4	78.0	0.2
Public-sector monetary regulation	1,730.2	5.4	2,154.6	5.3	2,138.1	5.4
Private sector	85.4	0.3	54.7	0.1	61.0	0.2
Loan portafolio	141.7	0.4	130.2	0.3	95.1	0.2
Public-sector national government	3.4	0.0	3.1	0.0	3.0	0.0
Comercial banks	3.5	0.0	1.8	0.0	1.1	0.0
Finance corporations	132.9	0.4	127.6	0.3	93.1	0.2
Other loans 2/	14.5	0.0	0.9	0.0	0.8	0.0
Minus: provisions	(12.6)	(0.0)	(3.2)	(0.0)	(2.8)	(0.0)
Repurchase agreements - Bridging liquidity support	1,111.4	3.5	2,212.0	5.4	1,346.7	3.4
Account receivable	94.3	0.3	110.0	0.3	100.9	0.3
Other net assets	2,354.3	7.4	2,655.8	6.5	2,715.4	6.9
Liabilities and net worth	31,874.5	100.0	40,685.4	100.0	39,464.2	100.0
Liabilities	15,288.6	48.0	17,701.5	43.5	17,047.7	43.2
Foreign currency liabilities affecting int'l. reserves	4.3	0.0	10.2	0.0	14.3	0.0
Monetary base	11,647.9	36.5	14,104.6	34.7	12,669.2	32.1
Notes in circulation	9,990.8	31.3	12,013.0	29.5	11,012.0	27.9
Treasury money	357.7	1.1	349.7	0.9	346.0	0.9
Banks' reserve requirement deposits	1,118.5	3.5	1,622.3	4.0	1,182.6	3.0
Current acct. deposits rest of financial sector	180.9	0.6	119.6	0.3	128.6	0.3
Other deposits	244.5	0.8	179.6	0.4	79.7	0.2
Treasury	97.9	0.3	39.8	0.1	44.0	0.1
International agency obligations	1,980.2	6.2	2,060.9	5.1	2,610.9	6.6
External credit liabilities	183.9	0.6	203.1	0.5	194.7	0.5
Monetary and exchange regulating securities	162.7	0.5	134.6	0.3	397.4	1.0
Reverse REPOs & central-bank paper	161.8	0.5	134.0	0.3	396.9	1.0
Foreign-currency funding certs & Board Res. 5/97 Dep.	0.8	0.0	0.5	0.0	0.4	0.0
Others	0.1	0.0	0.1	0.0	0.0	0.0
Appreciation	40.9	0.1	37.1	0.1	35.1	0.1
Results	926.3	2.9	931.5	2.3	1,002.4	2.5
Total Net Worth	16,585.9	52.0	22,984.0	56.5	22,416.5	56.8
Capital	12.7	0.0	12.7	0.0	12.7	0.0
Reserves	321.2	1.0	311.6	0.8	893.2	2.3
Patrimonial Superávit	14,172.1	44.5	19,593.3	48.2	19,753.4	50.1
CEC Liquidation	453.5	1.4	453.5	1.1	453.5	1.1
Foreign exchange adjustmant since 1993 and superavit	13,689.3	42.9	19,103.2	47.0	19,254.9	48.8
Others	29.3	0.1	36.7	0.1	45.0	0.1
Appreciations	856.1	2.7	995.0	2.4	995.0	2.5
Results	1,223.8	3.8	2,071.3	5.1	762.2	1.9
Previous profit or loss	0.0	0.0	0.0	0.0	0.0	0.0
Profit or loss for fiscal year	1,223.8	3.8	2,071.3	5.1	762.2	1.9

1/ Figures subject to revision.

2/ Includes the portfolio corresponding to the seizure of charged assets for default on liquidity quota credit.

Source: Banco de la República.

appreciation of SDRs against the dollar; the corresponding liabilities entry is that of obligations to the international organizations.

On the other side of the balance sheet, liabilities fell by 653.8 bn pesos to 17,047.7 bn pesos and net worth by 567.5 bn pesos to 22,416.5 bn pesos. The major movements in liabilities were: (a) a decrease of 1,435.4 bn pesos in the monetary base, and (b) an increase of 550 bn pesos in obligations to international organizations, plus an increase of 262.9 bn pesos in monetary-contraction Repos. The fall in net worth resulted from a 1,309.1 bn peso decline in this year's profits relative to those obtained in 2002, a 581.6 bn peso increase in net-worth reserves, and a peso-dollar exchange adjustment of 151.8 bn pesos in international reserves³⁹.

As detailed in Table 20, the Bank's statement of results for the first half of 2003, showed profits of 762.1 bn pesos, from income of 999.9 bn pesos and expenses of 237.8 bn pesos. Compared with figures for the same period last year, income decreased by 203.7 bn pesos or 17.0%, and expenses by 48.5 bn pesos or 16.9%. An important income item was return on international reserves, which amounted to 667.0 bn pesos (\$225.3 m), including revaluation gains of \$123.0 m from appreciation of the euro and the yen against the dollar and lower international interest rates. Other representative income items were valuation gains of 117.5 bn pesos on money-regulating TES B securities, 56.2 bn pesos received in commissions (mostly for banking services), and transitory purchase of securities worth 31.1 bn pesos.

The main expense items were: personnel costs, 79.0 bn pesos; interest and yields paid, 72.3 bn pesos; exchange difference on foreign-currency liabilities,

³⁹ Resulting from the creation of currency-fluctuation reserves amounting to 588.1 bn pesos and the use of 6.5 bn pesos from the asset-protection reserves.

22.6 bn pesos; overhead, 19.5 bn pesos; the cost of issuing money, 14.7 bn pesos; and provisions, depreciation and amortizations, 13.8 bn pesos⁴⁰.

2. Projected income and expenses for 2003

Profits for the year are projected at 708.1 bn pesos, an increase of 358.8bn pesos on the March Report's projection of 349.3 bn pesos.

This increase in projected profits is based on higher income of 440.7 bn pesos and higher expenses of 81.9 bn pesos. Higher income is largely explained by \$125 m in revaluation gains of international reserves over the first half of the year, and 56.4 bn pesos from re-estimation of the TES portfolio's valuation gains resulting from these securities' lower trading interest rate. Higher expenses arise from the increase in pensions provisions required by Law 797 of 2003.

The budget for administrative and operating costs remains unchanged from March. In particular, overhead and personnel costs continue to show real negative growth.

However, given that projected profits for 2003 include actual valuation gains in the reserves portfolio over the first half of the year, the Bank's statutes require that provision be made for currency fluctuations. The valuation gains in January-June amounted to 295 bn pesos and are projected to remain at this level for the year as a whole, because no further valuation gains or losses are assumed to occur for the rest of the year. Hence, profits available for distribution between cultural investment, other provisions⁴¹ and the government should amount to some 413 bn pesos⁴¹.

⁴⁰ This overhead includes: utilities, cleaning service, guard service, maintenance and repairs, transport of cash, stationery, public information, etc.

⁴¹ Other reserves are: monetary and exchange-rate stabilization reserves, intended to provide resources whenever losses are expected for the following two years; exchange-rate movement reserves, to cover losses from the purchase and sale of dollars; and asset-protection reserves. The distribution of profits to the government also depends on the amount earmarked for cultural investment.

TABLE 20
BANCO DE LA REPÚBLICA, PROFIT AND LOSS STATEMENT, 2001-2002
(BILLIONS OF PESOS)

	Execution (*)			
	Jan-June, 2002		Jan-June, 2003	
	Flujos	Part. %	Flujos	Part. %
I. Total income	1,203.4	100.0	999.9	100.0
1. Operating income	1,198.6	99.6	994.9	99.5
Interest and yields	1,102.5	91.6	891.3	89.1
Net international reserves	911.2	75.7	667.0	66.7
External credit lines	4.1	0.3	2.7	0.3
«A» TES market price appreciation	13.7	1.1	4.3	0.4
TES apprecn. form monetary expansn. operations	142.4	11.8	177.5	17.8
TES Ley 546	4.1	0.3	5.5	0.6
Bridging purchase of securities & alloens	20.7	1.7	31.1	3.1
Other	6.3	0.5	3.2	0.3
Commissions	56.0	4.7	56.2	5.6
Banking services	46.2	3.8	41.7	4.2
Currency purchase & sale	6.5	0.5	11.8	1.2
Other	3.3	0.3	2.7	0.3
Exchange differences	36.4	3.0	29.1	2.9
Money emissions & precious metals	1.2	0.1	0.0	0.0
Other	2.5	0.2	18.3	1.8
2. Non-operating income	4.8	0.4	5.0	0.5
II. Total outlays	286.3	100.0	237.8	100.0
1. Operating outlays	283.2	98.9	235.6	99.1
Interest and yields	91.5	32.0	72.3	30.4
Central bank paper	65.5	22.9	47.3	19.9
Deposit accts. reserve requirement	11.8	4.1	6.0	2.5
External lines & exchangeable securities	4.7	1.6	5.0	2.1
Deposit accts. reserve requirement	9.5	3.3	14.0	5.9
Comissions and fees	1.1	0.4	1.7	0.7
Exchange diferences	27.7	9.7	22.6	9.5
International agencies	5.8	2.0	7.5	3.2
External lines	9.6	3.4	12.0	5.0
Other	12.3	4.3	3.1	1.3
Bill & coins emission cost	23.6	8.2	14.7	6.2
Personel costs	80.3	28.0	79.0	33.2
Pensions	17.4	6.1	0.6	0.3
General expenses	21.3	7.4	19.5	8.2
Taxes	1.5	0.5	2.2	0.9
Insurances	3.0	1.0	5.1	2.1
Contributions	1.8	0.6	1.3	0.5
Cultural expenses	1.8	0.6	2.8	1.2
Provisions, depreciaciones y amortizaciones	12.2	4.3	13.8	5.8
2. Non-operating outlays *	3.1	1.1	2.2	0.9
III. Fiscal year profit or loss including depreciation	917.1	320.3	762.1	320.5

(*) Figures subject to revision

Sources: Banco de la República

Variación		Ejecución		Proyección		Variación	
Ene-Jun		Ene-Dic, 2002		Ene-Dic, 2003		Ene-Dic	
2003-2002		Flujos	Part.	Flujos	Part.	2003-2002	
Abs.	%		%		%	Abs.	%
(203,5)	(16,9)	2.827,2	100,0	1.484,8	100,0	(1.342,4)	(47,5)
(203,7)	(17,0)	2.809,5	99,4	1.479,2	99,6	(1.330,3)	(47,3)
(211,2)	(19,2)	2.412,0	85,3	1.258,1	84,7	(1.153,9)	(47,8)
(244,2)	(26,8)	2.044,2	72,3	832,8	56,1	(1.211,4)	(59,3)
(1,4)	(34,1)	7,5	0,3	6,7	0,5	(0,8)	(10,5)
(9,4)	(68,6)	20,3	0,7	7,6	0,5	(12,7)	(62,6)
35,1	24,6	274,8	9,7	308,5	20,8	33,7	12,2
1,4	34,1	6,6	0,2	5,2	0,4	(1,4)	(21,2)
10,4	50,2	48,1	1,7	89,4	6,0	41,3	85,8
(3,1)	(49,2)	10,5	0,4	7,9	0,5	(2,6)	(24,8)
0,2	0,4	117,7	4,2	125,4	8,4	7,7	6,6
(4,5)	(9,7)	97,7	3,5	105,3	7,1	7,6	7,8
5,3	81,5	13,5	0,5	20,1	1,4	6,6	49,0
(0,6)	(18,2)	6,4	0,2	0,0	0,0	(6,4)	(100,0)
(7,3)	(20,1)	259,9	9,2	49,6	3,3	(210,3)	(80,9)
(1,2)	(100,0)	1,5	0,1	24,0	1,6	22,5	1.466,6
15,8	632,0	18,4	0,6	22,1	1,5	3,7	20,3
0,2	4,2	17,7	0,6	5,6	0,4	(12,1)	(68,4)
(48,5)	(16,9)	755,8	100,0	776,7	100,0	20,9	2,8
(47,6)	(16,8)	755,8	100,0	761,9	98,1	6,1	0,8
(19,2)	(21,0)	179,1	23,7	161,3	20,8	(17,8)	(9,9)
(18,2)	(27,8)	123,9	16,4	113,7	14,6	(10,2)	(8,2)
(5,8)	(49,2)	19,3	2,6	8,3	1,1	(11,0)	(57,1)
0,3	6,4	9,6	1,3	9,4	1,2	(0,2)	(2,4)
4,5	47,4	26,2	3,5	29,9	3,8	3,7	13,9
0,6	54,5	2,7	0,4	2,6	0,3	(0,1)	(2,4)
(5,1)	(18,4)	139,3	18,4	23,5	3,0	(115,8)	(83,1)
1,7	29,3	26,6	3,5	5,3	0,7	(21,3)	(80,1)
2,4	25,0	52,8	7,0	7,7	1,0	(45,1)	(85,4)
(9,2)	(74,8)	60,0	7,9	10,5	1,4	(49,5)	(82,5)
(8,9)	(37,7)	58,7	7,8	122,7	15,8	64,0	109,1
(1,3)	(1,6)	161,2	21,3	170,2	21,9	9,0	5,6
(16,8)	(96,6)	91,7	12,1	172,4	22,2	80,7	88,1
(1,8)	(8,5)	43,9	5,8	46,3	6,0	2,4	5,5
0,7	46,7	3,2	0,4	3,8	0,5	0,6	17,3
2,1	70,0	7,9	1,0	11,6	1,5	3,7	46,9
(0,5)	(27,8)	3,3	0,4	3,9	0,5	0,6	17,5
1,0	55,6	6,3	0,8	7,0	0,9	0,7	11,2
1,6	13,1	38,6	5,1	36,6	4,7	(2,0)	(5,2)
(0,9)	(29,0)	20,0	2,6	14,8	1,9	(5,2)	(26,0)
(155,0)	(16,9)	2.071,3	274,0	708,1	91,2	(1.363,2)	(65,8)

Nonetheless, this figure (413 bn pesos) could get to be higher in the following events:

a) If expenses are reduced by 142 bn pesos, as a result of the Banking Superintendency assenting to the Bank's request to defer the impact of Law 797 of 2003 on its pension liabilities.

b) If income is increased by 85 bn pesos, which would be the effect that approval of the Referendum would have on the Bank's pension liabilities.

c) If the provision for currency fluctuations is not raised by 295 bn pesos. This is the amount of profits from the net increase in foreign-currency assets and liabilities caused by exchange-rate variations between the US dollar and other currencies. The reserve for such variations now stands at 688.3 bn pesos, which is considered a reasonable amount for covering possible risks from rate changes between the dollar and other currencies, essentially the euro. In order not to increase this reserve, the Bank shall request the government to amend Decree 2520 of 1993, which requires the Bank to increase the reserve amount by the total profits generated in this way. This figure could be lower if the dollar appreciates against other currencies.

d) If use is made of the reserve for exchange-rate fluctuations, now of the order of 62.5 bn pesos. This is because under current regulations on exchange-market intervention, there is not risk of loss in the purchase or sale of foreign currency, for the operations are carried out at the market representative rate (TRM).

3. Main accounting policies and practices

The Banco de la República's accounting is in accordance with Decree 1520 of 1993, the Bank's statutes, Banking Superintendency regulations, and Decree 2649 of 1993, as applicable⁴². The accounting

period is one year, and the accrual or accumulation method of accounting is used to record economic facts.

The portfolio of international reserves is valued on a daily basis at market prices. Investments in TES treasury paper are also valued at market prices, in accordance with Banking Superintendency instructions.

Some foreign-currency assets and liabilities affect international reserves, and others simply affect the Bank's balance sheet. Similarly, there are factors that affect the accounting record through profit and loss and/or net worth surplus: (i) fluctuations of other currencies against the dollar; (ii) variations in the market prices of foreign-currency investments; and (iii) variations in the peso against the dollar. The first two are reflected in the statement of results and the third in net worth surplus.

Thus, in our case, fluctuations in the prices of different currencies against the US dollar, the unit of reference, are called exchange differential and affect the Bank's operating results: revaluation of the euro and yen relative to the dollar generates profits for the Bank. The opposite occurs if they depreciate against the dollar.

Variations in the market prices of the different securities or paper in the portfolio of international reserves produce valuation gains or losses, which also affect the statement of results. Valuation of the portfolio at market prices means that a decrease in interest rates in the United States or European Union will generate profits for the Bank, as has in fact occurred in the past two years. If this trend reverses, the increase in international interest rates would cause valuation losses in the Bank's assets and operating losses. To hedge against this risk, the Bank has reduced the "duration" of its portfolio, as explained in Chapter V.

The peso's variation against the US dollar are referred to as exchange-rate adjustment in the Bank's financial statements and reported in net worth surplus. The

⁴² Accounting principles or standards generally accepted in Colombia

exchange-rate adjustment caused by foreign-currency assets and liabilities not constituting international reserves are reported in the period's results.

Regarding the exchange-rate differential, it should be noted that the Bank's statutes require the creation of a reserve for currency fluctuations. The reserve is created with the part of each fiscal year's profits that comes from an increase in the net value of the Bank's foreign-currency assets and liabilities resulting from variations between the dollar and the currencies they are denominated in, provided that profits have been produced in the respective fiscal year. If at the end of the year currency fluctuations have produced a negative net result, this is applied against this reserve, which covers losses in the purchase and sale of dollars.

The rest of the annual profits, once appropriations to reserves have been made, is exclusively for the Nation. If the fiscal year produces losses, these are first charged to the monetary and exchange stabilization reserve created for this specific purpose. Any shortfall in the reserve must be covered by the Nation's general budget. The net result of the Bank's operation is projected every year and incorporated into the annual budget law. To this end, the profits projected to be received from the Banco de la República are incorporated into the revenue budget; likewise, if the Bank is expected to show a deficit, the necessary appropriations are made up to the amount of the deficit and accumulated losses from previous years. Payment of profits to the Nation or of losses, as the case may be, is made in cash within the first three months of each year, as provided by Law 31 of 1992.

4. Inspection, supervision and control

As authorized by law, the President of Colombia has delegated performance of the function of inspection and supervision to the Banking Superintendency and the function of control to the Auditing Office. The Auditor is appointed by the President of Colombia and is responsible among other matters for certifying the Bank's financial statements, discharging all other duties laid down

SUPERVISION AND CONTROL BODIES

- Congress
- Council of State
- President of Colombia
- Banking Superintendency
- Office of the government Auditor to the Bank
- External international auditors
- Attorney General's Office
- Comptrollership General
- Public Prosecutor's Office
- The Judiciary
- The Bank's Internal Control Department
- The Bank's Internal Disciplinary Control

in the Code of Commerce for the Statutory Auditor, and exercising control of the management and results of the entity. The findings of the Auditing Office's activities are set out in periodic reports submitted to the President of Colombia, and the Bank's Board of Directors and management.

Moreover, starting in 2002 the Bank has engaged a firm of internationally-oriented external auditors having experience with central banks to render an independent opinion on the Bank's financial statements. Both the Auditor to the Bank and the external auditors (the firm of Deloitte & Touches) have issued an opinion without reservations, that is, they have stated that the financial statements reasonably present the financial situation of the Banco de la República and the results of its operations⁴³.

E. THE CASH CENTER

Four reasons have led the Bank to undertake the Cash Center project: 1) To resolve space constraints at the present Bill Printing House, which preclude the use

⁴³ The opinion was rendered on the financial statements for 2002.

of either machinery of greater production capacity or larger storage areas for raw materials, making it difficult to meet the growing demand for banknotes; 2) The need for facilities that meet the highest security standards for this type of activity; 3) The constant movement of banknotes-with the security problems their displacement entails-, because of the separate operation of the Printing House and the Treasury; and 4) The fragility of the present premises for ensuring the continuity of critical operations in any emergency.

The project has therefore been designed to integrate in one single center control of the activities of production, movement and management of valuables, optimize their processes of production, storage and distribution, and thus substantially improve the way this service is provided. The Bank of England acted as consultants during the project's feasibility stage and expressed the opinion that the project would help to resolve existing problems.

The project is currently under way at a site measuring 62,417 m², located in Bogotá at Avenida Eldorado

and Avenida 68, which was purchased by the Bank in 1984. The constructed area will be 34,387 m² and will have different levels of both physical and electronic security, involving the use of materials with special technical specifications (reinforced concrete walls, aerial vaults, metal sealings in highly resistant steel, etc.) and appropriate technological equipment to ensure the conditions required by the Bank's industrial production activities.

The Cash Center is also designed to run two lines of production. The first line will be installed with new machinery comprising equipment with larger printing format and higher speed, to replace machinery that has reached the limit of its useful life with over 30 years' service. The second line of production consists of equipment currently in service.

Over a hundred firms have been invited to present offers according to the Bank's different systems of awarding contracts, and 57 works contracts have been signed to date for 62,391 m pesos. The total investment projected for the Center is shown in Table 22.

TABLE 22
CASH CENTER INVESTMENT, 1999-2005
(MILLIONS OF PESOS)

Description	Overall amount	Amount Paid	Amount Comitted	Amount for further contracts
Civil works	102.886	47.864	14.706	40.316
Machinery	112.627	70.803	15.371	26.453
Treasury equipment	9.984	0	0	9.984
Protection equipment	5.728	0	0	5.728
Total	231.225	118.667	30.077	82.481

Source: Banco de la República.

This Report has been prepared
by the Banco de la República's
Economic Studies Division.
Editing and diagramming by the Publications Section,
Department of Institutional Communication.
Printed by Litoperla Impresores Ltda.
July 2003
Translated by Fereshteh Ebrahimzadeh