

PRESENTATION, SUMMARY AND CONCLUSIONS

CURRENT ECONOMIC TRENDS AND INFLATION BEHAVIOUR

✚ The different indicators of core inflation continued to rise during the third quarter of the year, averaging 7.5% at September. The increase in core inflation in recent months was primarily a response to the adjustment in prices for controlled goods and services, such as fuel, transportation and electricity. Inflation in the price of tradable goods has been high, even though the exchange rate has stabilized in the last six months.

✚ Total inflation was 7.1% at September, down from the second-quarter average (7.6%). This decline was primarily the result of less food inflation due to an increase in the supply of perishables, as predicted in earlier reports.

✚ The acceleration in core inflation up to September was accompanied by more economic growth than anticipated in earlier reports. Economic recovery has been supported by a loose monetary policy, a recovery in credit and increased confidence on the part of investors and consumers, within an environment of improved conditions for internal security.

✚ There is still no evidence that increased growth has generated inflationary pressures pushed by demand. Output remains below potential and market- basket prices that depend on pressure from demand, and have yet to be affected by devaluation or by the changes in regulated prices, grew at rates below 5%. Nevertheless, the increased growth suggests the production gap may be closing faster than anticipated.

✚ Transmission of inflation expectations caused by the various shocks to inflation since last year has been one of the primary risks to the Bank's price stabilization policy. These shocks include the increase in food prices during the second half of 2002, the rise in devaluation, and recurrent adjustments in the relative prices of certain controlled goods and services. In fact, surveys show that when inflation rose in the wake of these shocks, inflation expectations responded to the hike. In recent months, inflation expectations have remained above the 2003 goal-range, after a slight dip.

✚ To prevent expectations from getting out of hand and to lessen the impact of devaluation on inflation, the Board of Directors of Banco de la República (BDBR) raised interest rates by 200 basis points (bp) in January and April. It also announced the possibility of intervention in exchange market with up to US\$1 billion in reserve deaccumulation options. In effect, US\$345 m were deaccumulated through intervention of this type. As of May, there have been no substantial changes in monetary policy.

✚ In spite of the rise in intervention rates at the start of the year, nominal interest rates on the market, aside from the interbank rate, have yet to change. Real interest rates remained stable throughout the third quarter, and some deposit rates were near zero. At the same time, growth in monetary aggregates was relatively brisk and there was a major recovery in credit. These events supported a loose monetary policy in the third quarter.

MACROECONOMIC PROSPECTS AND THE INFLATION FORECAST

✚ There are favorable external conditions for the growth of emerging economies, particularly the Latin America economy.

✚ Capital flows to emerging markets have been encouraged by limited risk aversion in capital markets and by low interest rates in the developed economies.

✚ The North American economy is growing faster than anticipated and is expected to continue at a good pace in 2004. The European economies and the Japanese economy are also expected to perform better.

✚ The increase in growth has yet to spark inflationary pressure in the United States and Europe. Accordingly, the expectation is for low interest rates on these markets in the months ahead and for part of 2004. On the other hand, more demand for commodities has begun to have an effect on international prices, which should improve terms of trade for the developing countries.

✚ Under these conditions, the currencies of emerging countries have begun to appreciate somewhat, especially in the case of Latin America. This has helped to improve the profitability of assets denominated in local currency, thereby increasing investment possibilities.

✚ In Colombia, exports to the United States should continue to recover, backed by the Andean Trade Preference and Drug Eradication Act (ATPDEA) and by a currently competitive exchange rate. Exports to Venezuela are also expected to recover, but below levels observed prior to the crisis.

✚ On the internal front, the upturn in economic activity is expected to continue, primarily on the basis of private investment. A recovery in the price of assets is particularly important, as it reflects more confidence on the part of companies and households in future economic performance.

✚ Consumption has been the least dynamic component of internal demand during the year to date. How it performs in the near future will depend on the impact of tax measures, the recovery in employment associated with increased economic growth, and the confidence generated by the fiscal adjustment program when it comes to influencing decisions on household spending.

✚ The economy could grow by as much as 2.5% to 3% in 2003, which would exceed the forecast in the June report. The increase in growth will probably hasten closure of gap in output, which is expected to stay on the negative side for the remainder of the year. It will be 1.8% of potential gross domestic product (GDP).

✚ The forecast is for 6.2% consumer inflation at December 2003. Non-food inflation would be between 6.5% and 7.2%. Total consumer inflation would be close to 5.0% by December 2004, largely because of the drop in non-food inflation. This prediction includes transitory shocks to non-food inflation originating with readjustments in prices for public utilities, fuel and transportation. However, it does not include the effect an eventual change in the value-added tax (VAT) would have during 2004.

✚ These predictions are based on the assumption that the exchange rate will rise substantially from its current level. In effect, despite the decline in oil income, flows of external financing for the government and a gradual recovery in private capital flows would make it possible to finance a larger current account deficit.

✚ Para Colombia, se espera que continúe la recuperación de las exportaciones a los Estados Unidos, apoyada por la ley de preferencias arancelarias andinas y de erradicación de drogas (ATPDEA) y por el nivel competitivo que tiene actualmente el tipo de cambio. De otro lado, se espera una recuperación de las exportaciones a Venezuela, aunque por debajo de los niveles previos a la crisis.

THE RISKS

✦ There are important risks to inflation in the next 18 months, such as the current level of inflation expectations, the effect of a narrower gap in output, and food inflation

✦ Information on inflation expectations at September shows only a marginal decline (between 10 and 20 bp) compared with the June survey. They are still at around 6.6% for September 2004. The differential between treasury paper (TES) denominated in real value units (UVR) and fixed yield at two and three years shows a downward trend, but still at levels above the possible target for next year, and above declining inflation in 2005 and thereafter.

@ The assessment of the output gap is highly uncertain. Alternative estimates suggest it might be less than the calculation used as an assumption in this report. Analyses of sensitivity suggest that a reduction of 0.8 percentage points in this gap by the end of 2003 could raise inflation in 2004 and 2005 by 20 bp and 30 bp, respectively.

✦ Finally, the forecasts may underestimate food inflation. There have been recent increases in international prices for grains and other raw materials. If maintained, higher external prices could have an effect on domestic prices, as happened at the end of 2002, with a major impact on food inflation.

✦ In view of these considerations, the Board of Directors decided not to alter the Bank's intervention rates, which remain as follows: minimum expansion 7.25%, Lombard expansion, 11%, maximum contraction 6.25% and Lombard contraction 5.25%.

Junta Directiva Banco de la República