Inflation Report

September 2003

Banco de la República

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.

✠ 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

Inflation Report

September 2003

Prepared by the
Programming and Inflation Department
of the Economic Studies Division

ECONOMIC STUDIES DIVISION
Hernando Vargas Herrera
Assistant Manager

PROGRAMMING AND INFLATION DEPARTMENT
Juan Mauricio Ramírez Cortés
Director

INFLATION SECTION (*)
Adolfo León Cobo Serna
Section Chief

Angélica María Arosemena Martán
Édgar Caicedo García
Luisa Fernanda Charry Velásquez
Alexandra Espinosa Dussán
Mario Nigrinis Ospina
Andrés Mauricio Velasco Martínez

(*) This report was prepared with the help of Franz Hamann Salcedo, Director of the Macroeconomic Models Department, Luis Fernando Melo Velandia, Rocío Clara A. Mora Quiñones, Norberto Rodríguez Niño, Jesús Antonio Bejarano R. and Paola Figueroa González.

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Recent Inflation Behaviour

A. Introduction

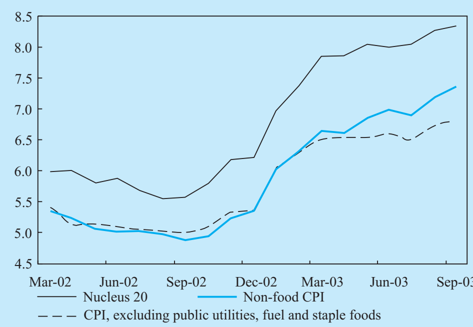
Non-food inflation and other indicators of core inflation continued to rise during the third quarter of 2003, averaging two percentage points above the target at September (Figure 1). Even so, total consumer inflation in that month was 7.1%. This is down slightly from June, was due to a major reduction in food inflation (Figure 2 and Table 1).

As in previous quarters, third-quarter inflation pressures on total and core inflation appeared to originate on two fronts: accumulated devaluation and a steady increase in the relative price of certain controlled goods and services, such as fuel, transportation and public utilities.

The pressures originating with devaluation have continued despite a stable exchange rate and explain much of the upswing in core inflation. This suggests the transfer of devaluation registered last year is still not complete. However, judging from the sizeable reduction in the producer price index (PPI) for imports in recent months, these pressures could ease in the short term. If this reduction continues, the coming months might see less pressure from costs, provided the exchange rate does not increase substantially.

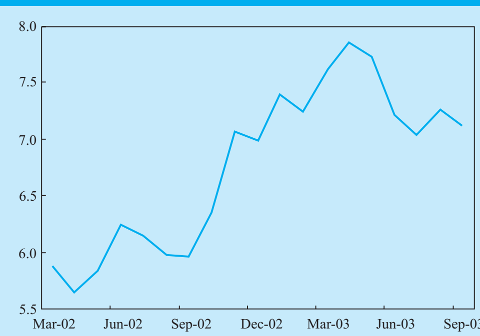
Besides the inflationary factors already mentioned, expectations of inflation also appear to have contributed to keeping core inflation at high levels. Available calculations suggest these expectations

Figure 1
Annual Core Inflation
(Percentage)



Source: DANE (State Statistical Agency)
Calculations by Banco de la República.

Figure 2
Annual Consumer Inflation
(Percentage)



Source: DANE (State Statistical Agency)
Calculations by Banco de la República.

Table 1
Inflation Indicators
(Annual variation)

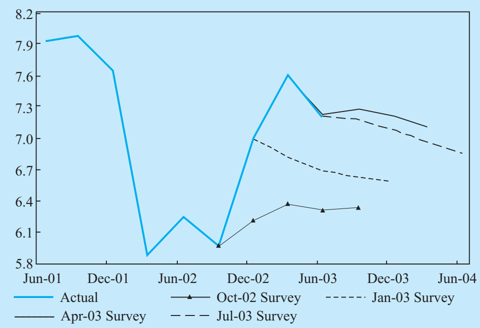
	Sep-02	Dec-02	Mar-03	Jun-03	Sep-03
I. CPI	6.0	7.0	7.6	7.2	7.1
Food	8.6	10.9	9.9	7.7	6.5
Housing	3.8	4.1	5.6	6.0	6.0
Clothing	0.9	0.7	0.9	1.4	1.1
Health Care	8.9	9.2	9.7	9.1	9.1
Education	6.4	6.5	4.9	5.0	4.9
Entertainment, Culture & Recreation	4.7	5.3	4.1	4.8	4.9
Transportation	5.1	5.9	9.5	10.7	12.9
Miscellaneous Expenses	7.7	9.0	9.0	8.1	7.4
II. Core Inflation 1/	5.1	5.6	7.0	7.2	7.5
Non-food CPI	4.9	5.4	6.6	7.0	7.4
Nucleus **2/**	5.6	6.2	7.8	8.0	8.3
CPI excl.staple foods, fuel and public utilities	5.0	5.3	6.5	6.5	6.8
III. PPI	6.8	9.3	11.5	10.9	6.9
By economic use or destination					
Intermediate Consumption	6.2	9.9	13.1	12.4	7.6
Final Consumption	6.3	7.3	7.5	8.0	5.4
Capital Goods	10.8	15.6	19.6	15.4	6.1
Building Materials	6.4	7.8	11.7	11.7	10.9
By origin					
Domestically produced and consumed	5.5	7.1	8.3	8.6	6.5
Imports	10.7	16.0	21.7	18.3	8.0
Exports **3/**	15.5	28.5	34.7	18.7	3.5
By industrial activity (ISIC)					
Farming, forestry & fishing	6.8	9.2	7.8	8.7	3.7
Mining	22.4	33.3	37.7	26.6	5.5
Manufacturing	6.3	8.6	11.6	11.1	7.7

1/ The average of the three core inflation indicators calculated by 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 with the weighted sum of domestically produced and consumed goods, plus imports.
Source: Economic Studies Division (SGEE), Banco de la República and the DANE PPI and CPI lists.

are likely to remain well above target inflation in the third quarter. In July 2003, a survey by Banco de la República found that inflation expectations reported by agents for the next four quarters, while down slightly, are more than one percentage point above the upper range of the inflation target for 2003 (Figure 3). Thus, credibility of the inflation target, which was 4.9%, continued to decline. This is the lowest on record.

Finally, demand pressures are still being contained. This is suggested by the stability of various subgroups in the consumer price index (CPI) that were not affected by devaluation or by the value added tax (VAT) and, therefore, would respond more to pressure from demand. Education, health care, entertainment, culture and recreation are some examples. Use of installed capacity, although still below average, supports this

Figure 3
Inflation Expectations
(Percentage)



Source: DANE and Banco de la República

claim, as do some output gap estimates that suggest use of installed capacity remains negative (that is, actual output is still below potential output).

Yet, there are signs that recent growth is closing the output gap quicker than predicted in the last report. Use of installed industrial capacity registered an important surge in August, as Fedesarrollo's indicator demonstrates, and is above historical averages. Compared with the trend in recent years, this could be mirrored in less of a downturn in price growth, particularly when companies revise price and wage agreements at the start of 2004.

High expectations, coupled with shocks from regulated prices, could aggravate these increases. The rise in certain CPI items, such as rent and dining out, and the upswing in real estate prices in cities like Bogotá and in the price of stocks could be a signal in that direction.

For next year, the main inflationary pressures might be associated with public utility rates and prices for fuel and transportation, since readjustments above the inflation target are expected due to the dismantling of certain subsidies[1] .

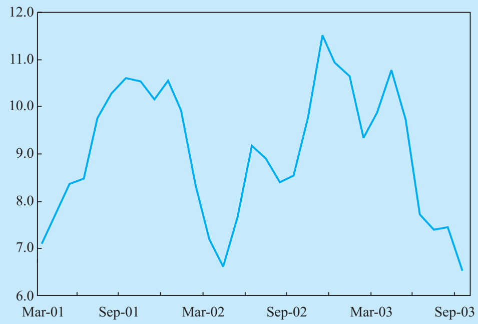
B. Transitory Inflation

There were two types of pressure on transitory inflation during the third quarter: downward pressure originating with food prices and upward pressure derived primarily from prices for fuel and transportation. Food inflation was 6.5% at December, down 1.2 percentage points from the rate last June (7.7%) (Figure 4). As expected, food inflation declined sharply, mainly because of the drop in prices for perishables, including potatoes. Good weather and high prices in late 2002 and early 2003 encouraged planting and the production of staple foods during the third quarter. This explains the decline in prices. As for the remainder of the year, agricultural supply should behave favorably, since prices for perishables are expected to remain low, and even decline, thus helping to reduce food inflation even more (Figure 5).

At 16.0%, inflation in processed foods (dining out not included) also experienced a sizeable reduction, down 3.6 percentage points from the rate in June (Figure 5). During the remainder of the year, provided the exchange rate stays at current levels and there is no surge in international prices for grain and oil seed, processed food inflation is expected to continue to decline, helping to lower food inflation.

[1] Securing «correct prices» for public utilities and their contribution to better resource allocation and fiscal rehabilitation would be favorable for mid-term and long-term inflation.

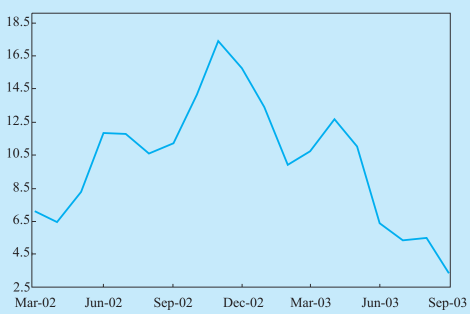
Figure 4
Annual Food Inflation
(Percentage)



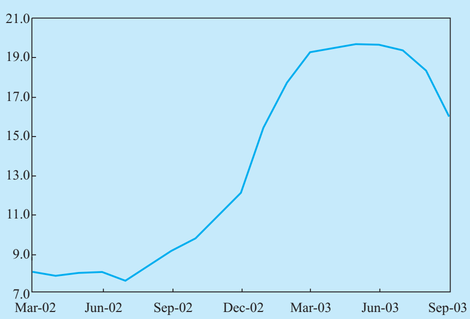
Source: DANE, calculations by Banco de la República.

Figure 5
Annual Food Inflation by Origin
(Percentage)

Staple Foods



Processed Foods



Source: Source: DANE and Banco de la República.

As to upward shocks, annual fuel inflation remained high compared with the inflation target for 2003. This was due to the policy for dismantling subsidies, the effects of which were aggravated by significant accumulated devaluation and high international prices. In September, annual inflation for this item was 22.3%; that is, 4.7 percentage points above the figure in June.

Major readjustments in the price of fuel are anticipated during the remainder of the year and in 2004, because of the program to dismantle subsidies, particularly considering that accumulated devaluation will remain high in the coming months and international prices are expected to stay near current levels, even in the year ahead. Moreover, the increase in fuel prices led to a sharp hike in prices for transportation, especially public transportation in Bogotá. Transportation inflation is now 11.9%, up 2.0 percentage points compared with the figure at June.

Inflation in public utilities declined compared with the three previous quarters. A, Although, it is still well above total inflation. The rest of the year and 2004 are expected to see monthly increases similar to those observed throughout 2003, meaning annual inflation for this item will remain high in relation to the inflation target.

C. Core Inflation

All core inflation indicators analyzed by Banco de la República continued to rise during the third quarter of 2003. Accordingly, core inflation, measured as the average of the non-food CPI, the inflation nucleus[2] and the CPI excluding staple foods, fuel and public utilities, was 7.5%, up by 0.3 percentage points on June 2003. On this occasion, the non-food CPI was the indicator that increased the most, having gone from 7.0% in June to 7.4% in September (Table 1 and Figure 1).

The rise in these indicators is largely due to increased inflation in the transportation and communications group. When excluding this subgroup, we see that inflation for the remaining basket items, which include 74.3% of the CPI, has been stable at 6.2% since March 2003. This indicator of core inflation rose from 4.9% in October 2002 to 6.2% in the first two months of 2003, because of increased devaluation and changes in the value-added tax (VAT). Higher inflation expectations were probably a factor as well (Figure 6).

At September, accumulated devaluation continued to have an impact on core and total inflation. Inflation in CPI tradables went from 8.7% at June to 9.7% at September. Yet, the reclassification of tradables between durables (with slow inventory turnover) and perishables (with high inventory turnover) again shows the increase in tradables inflation is mostly the result of higher prices for fuel and transportation. Inflation in other tradable goods (both consumer durables and non-durables) was stable, but high compared with the second quarter, suggesting the transfer of devaluation to inflation could be near completion (Figure 7). This is corroborated by PPI inflation for imports, down 10.3 percentage points between June and September, which could ease pressure on costs in the coming months, provided the exchange rate remains stable (Figure 8).

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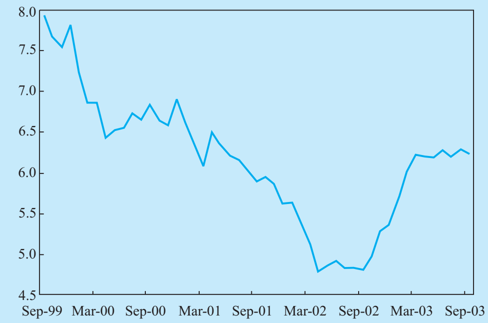
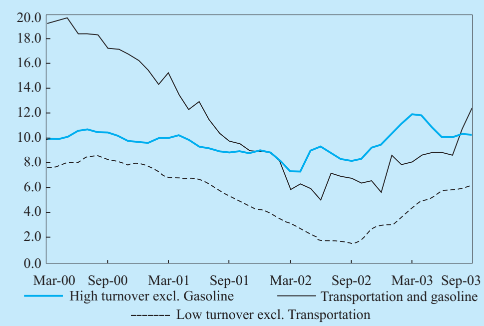
2 The inflation nucleus is the CPI excluding 20% of the basket items showing the most price volatility between January 1990 and April 1999.

FIGURE 6
ANNUAL CPI INFLATION EXCLUDING STAPLE FOODS, FUEL, PUBLIC UTILITIES AND TRANSPORTATION
(PERCENTAGE)



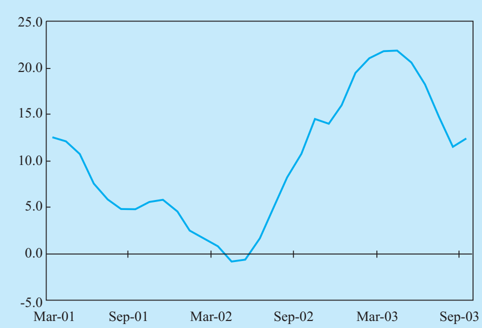
Source: DANE, calculations by Banco de la República.

FIGURE 7
ANNUAL INFLATION IN CONSUMER TRADABLES
(PERCENTAGE)



Source: CPI, DANE and Banco de la República.

FIGURE 8
ANNUAL VARIATION IN THE IMPORTED COMPONENT OF THE CPI
(PERCENTAGE)



Source: Economic Studies Division (SGEE), Banco de la República.

Generalized inflationary pressures pushed by demand were not evident in the first half of 2003. This is consistent with a negative output gap and use of installed capacity during the period. The indicators directly associated with demand inflation, and not affected by transitory shocks (VAT) or devaluation, exhibited low rates of inflation compared with average annual inflation. These include inflation in items such as entertainment, culture and recreation, clothing and non-regulated utilities.

However, as of July, general use of installed industrial capacity rose substantially. Even sectors such as chemicals, paper, beverages and tobacco registered levels in August above their historic average. In some sectors, this could represent a break in the trend. Although not expected to produce strong inflationary pressures in the short term, it could indicate future price increases, especially at the start of 2004, taking advantage of contract revisions.

II

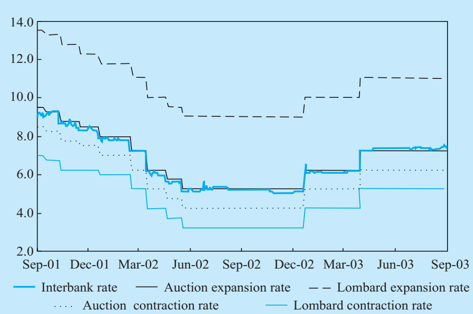
Determinants of Inflation

A. Summary of Monetary Policy and Monetary and Financial Variables

The last six months have seen no major change in monetary policy. The Board of Directors of Banco de la República (BDBR) kept intervention rates stable. Since April, they have been at the following levels: minimum expansion rate, 7.25%; Lombard expansion rate, 11.0%; maximum contraction rate, 6.25% and Lombard contraction rate, 5.25% (Figure 9). The interbank rate was 7.3% in September as opposed to 7.4% in June and 5.0% in December 2002.

During the course of the year, the BRBR took various steps to restore confidence in the exchange market and to adjust inflation expectations.

Figure 9
Banco de la República Interbank and Intervention Rates
(Percentage)



Source : Banco de la República.

The BRBR changed its position on interest rates on two occasions during the first half of the year, increasing all its intervention rates by 100 basis points (bp) as of January 20 and others by 100 bp as of April 29. It also adopted a number of exchange measures during the same six months. For example, at the end of February, the BRBR announced its intention to intervene in the exchange market through auctions of up to US$1 billion in call options[3], US$344.5 m of which have been sold. The measure succeeded in stabilizing the dollar and reduced the effect of devaluation on inflation[4].

As to interest rates, perhaps the most significant event during the year to date has been the decline and stability in rates on treasury paper (TES). As of May, and coinciding with the second increase in the Bank's intervention rates, there has been a decline in the long end of the TES yield curve. This suggests the country's monetary policy may have gained more credibility with the markets. Increased fiscal uncertainty in October and September had only a transitory impact on these rates.

[3] Pursuant to current regulations, call options are auctioned to deaccumulate reserves when the representative market rate (TRM) is 4.0% above its 20-day moving average.

[4] On July 2, Banco de la República auctioned US$6.2 m in put options to accumulate reserves. Put options may be exercised only with the TRM is 4.0% below its 20-day moving average

As to other market rates, by September and early October, the average deposit rate in the financial system (DTF) had yet to respond to increases in the intervention rates and was close to 7.8%, quite similar to what it had been since the start of the second quarter. In real terms, this continues to imply record low interest rates on deposits, which are close to zero. Also, there have been no important changes in lending rates since June.

The demand for liquidity in the first nine months of the year was met with one-day expansion repos. As to the last four months of 2003, Banco de la República announced the schedule for supplying year-end liquidity on August 29. First of all, permanent liquidity will be made available between September and December 2003 through the purchase of approximately Col$1 trillion (t) in TES B. Secondly, semi-permanent liquidity for the same period will be granted through Col$1.5 t in repos with three and four month maturities.

Generally speaking, there was considerable liquidity available to the market in the third quarter. Both the monetary base and M3 continued to grow at annual rates above 10.0%. This situation, coupled with stable interest rates, has helped to reinforce the profits and soundness of the financial system and to restore the demand for credit.

1. Monetary and Credit Aggregates

a. Monetary Base

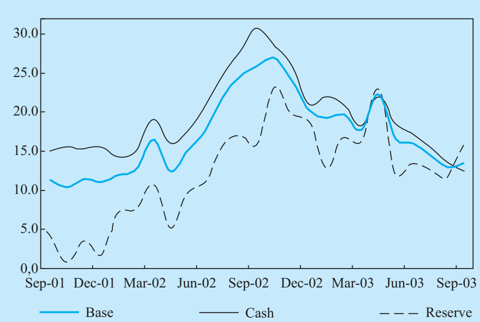
Growth of the monetary base continued to slow during the third quarter, as has been the case since the final quarter of 2002. Growth in the monetary base declined from 16.0% to 13.5% between June and September. Cash growth was similar, falling from 17.1% to 12.5%, while the increase in reserves has gone from 13.5% to 16.1% (Figure 10).

b. M3

Annual growth in the broader measure of liquidity (M3) accelerated (12.1%) in relation to June 2003 (11.3%). This growth in financial savings continues to be compatible with nominal GDP expected for 2003.

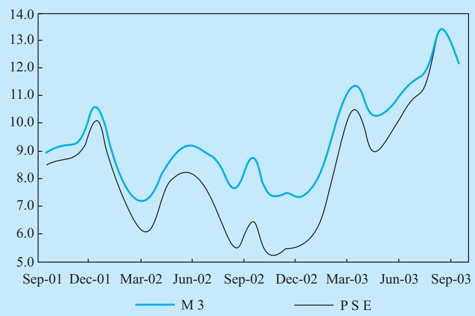
At the close of the third quarter, liabilities subject to reserve requirements (LSRR) showed an annual increase (12.1%) above the one three months earlier (10.6%) (Figure 11). According to the type of liability, there was considerable recovery in term CD balances, with annual growth up from negative rates at the start of the year to 3.6% at June and 8.2% at September. As with term CDs, the last three months saw a recovery in checking account growth (up from 10.7% in June to 13.4% in September), bonds (up from –0.7% to 2.5%) and repos with the productive sector (up from 27.11% to 119.4%). In contrast, savings account growth lost some of its momentum between June (17.7%) and September (11.9%) (Figure 12).

FIGURE 10
MONETARY BASE AND ITS FORMS OF USE
(ANNUAL % CHANGE IN THE MONTHLY AVERAGE)



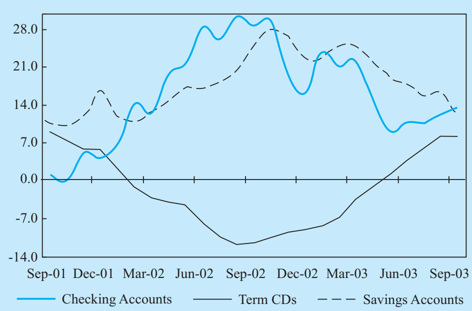
Source: Economic Studies Division (SGEE), Banco de la República.

FIGURE 11
M3 AND LIABILITIES SUBJECT TO RESERVE REQUIREMENTS (LSRR) ANNUAL % CHANGE
(MONTHLY AVERAGE)



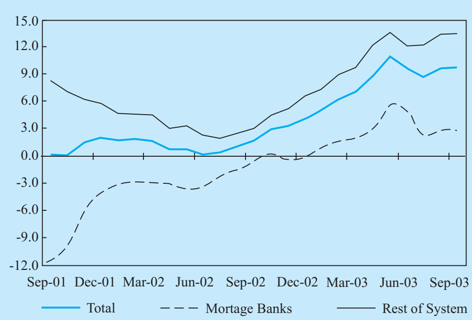
Source: Economic Studies Division (SGEE), Banco de la República.

FIGURE 12
COMPONENTS OF LIABILITIES SUBJECT TO RESERVE REQUIREMENTS ANNUAL % CHANGE
(MONTHLY AVERAGE)



Source: Economic Studies Division (SGEE), Banco de la República.

FIGURE 13
GROSS NOMINAL LOCAL-CURRENCY LOAN BALANCE OF THE FINANCIAL SYSTEM, EXCLUDING FEN
(ANNUAL % CHANGE, MONTHLY AVERAGE)



Source: Banco de la República and the Banking Superintendency.

The growth in financial savings (M3) throughout 2003 has been consistent with the recovery in credit as of mid-2002. The gross portfolio has continued to grow at an annual rate of around 10.0% since May 2003 (Figure 13).

Annual growth in non-mortgage banking was up from 12.1% at June to 13.5% at September. In contrast, mortgage portfolio growth slowed in the third quarter, from 5.1% in June to 2.9% in September, following a gradual revival during the first half of the year.

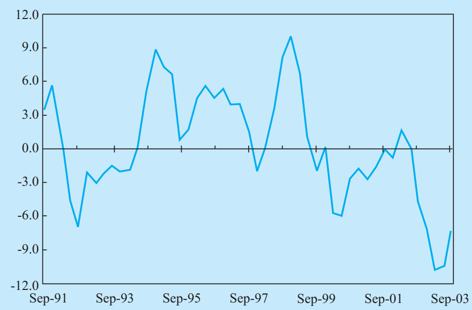
The recovery in credit is a reflection of the better macroeconomic conditions during the course of 2003 to date, compared with the previous year. This improvement was influenced by a variety of factors, such as low interest rates, the new opportunities created by the Andean Trade Preference and Drug Eradication Act (ATPDEA), and increased investor confidence and expectations for the country's economic future.

According to the Bank's latest expectation survey, which was conducted in July 2003, the markets continued to perceive credit availability as high. Since July 2001, the proportion of those surveyed who expressed this opinion increased by 44.4 percentage points to 76.5% in July, up from 73.7% in April.

The Indicator of Monetary Conditions (IMC)[5] for the third quarter of 2003 remained low, relative to the reference period (1998:01=100), but was above the level calculated for June (Figure 14).

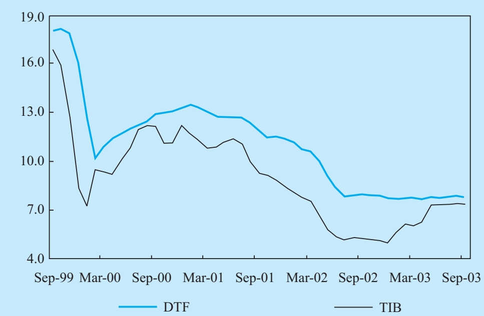
[5] The IMC shows the extent to which provision of liquidity is more restrictive (if the indicator is positive) or more expansive (if the indicator is negative), relative to the liquidity in the economy during a reference period (1998:01). This indicator is the weighted sum of changes in the short-term interest rate and the exchange rate, relative to a base year. The weightings reflect the relative effects of changes in the interest rate and the exchange rate on aggregate demand and inflation, helping to characterize the current state of monetary policy.

Figure 14
Indicator of Monetary Conditions (IMC)
(Percentage)



Source: Economic Studies Division (SGEE), Banco de la República.

Figure 15
DTF and TIB Interest Rates, Monthly Average
(Percentage)



Source, Economic Studies Division (SGEE), Banco de la República.

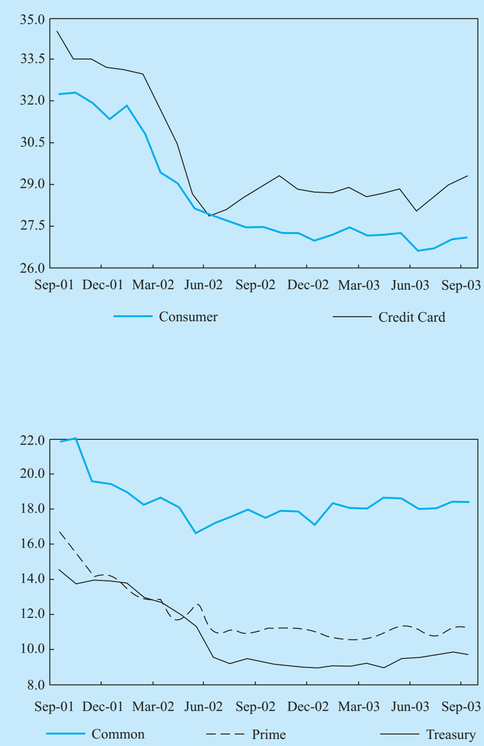
The slowdown in devaluation and a minimal rise in interest rates explain the position of the indicator. The relative effects of the interest and exchange rates, grouped in the IMC, suggest a loose monetary policy in relation to aggregate demand.

2. Interest Rates

The first half of 2003 saw mixed behavior, following an almost constant drop in interest rates during 2002 on both deposits and lending. The DTF remained stable at around 7.8%, showing no reaction to the two increases in the Bank's reference rate: one in January and another in April. The result has been a gradual closure in the gap between the DTF and the interbank rate (TIB) throughout 2003 (Figure 15).

By type of loan, all rates, expect the prime, registered an increase in September compared with June. The rate on consumer loans went from 26.6% at June to 27.1% at September. During the same period, the credit card rate went from 28.2% to 29.4%. The rate on common loans rose from 18.0% to 18.4%, while the treasury loan rate went from 9.5% to 9.7%. The prime rate remained stable at 11.2%. Aggregate interest rates rose slightly in relation to June. The total

Figure 16
Nominal Interest Rates, by Type of Loan
(Percentage)



Source: Banco de la República

rate, including bank treasury loans, went from 12.5% in June to 12.7% in September. The same rate, excluding treasury loans, rose from 16.3% to 16.7%, while Banco de la República's lending rate went from 14.9% in June to 15.2% in September (Figure 16).

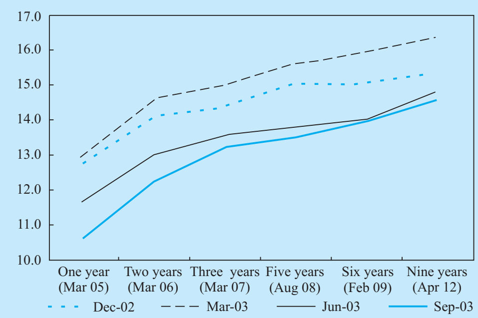
The increase in the Bank's intervention rates has yet to be passed forcefully to the market rates. This is partly because of the high degree of liquidity in the financial system. As mentioned in the last report, other explanations are less credit risk in the financial system, which tends to reduce interest rates, and the substitution between treasury paper (TES) and term CDs. In addition, exchange stability during the year to date may have favored interest rate stability. The fact that market rates have yet to react may be only temporary, since there is normally a period of several months between movement in the Bank's rates and those of the market.

Real interest rates are still at record lows and the movements that have been registered are a reflection of inflation dynamics. The real DTF in September (0.64%) was slightly less than in December 2002 (0.69%) and somewhat above the rate observed in June 2003 (0.52%). All ex post real lending rates rose in relation to June. Credit card loans saw the largest rate increase (1.3 percentage points). The lowest increase was in the prime rate (0.1 percentage points).

The Bank's latest expectation survey, for July, shows lower expectations for interest rates than in April 2003. Those interviewed for the July survey indicated the DTF would end the year at 8.1%, down 0.2 percentage points from the estimate three months earlier

As of the second quarter, the rate of return on public-debt securities (TES) on the secondary

FIGURE 17
TES YIELD CURVE (*)
(PERCENTAGE)



(*) Data from the Electronic Transaction System (SEN).
Source: Banco de la República.

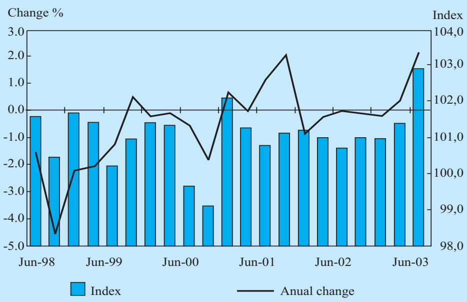
market declined for the different maturities. The downward correction in the last three months was less pronounced for securities near maturity, lifting the curve slightly (Figure 17).

According to a number of analysts, the decline in TES yields compared with June is explained by fewer expectations of inflation in the third quarter compared with the beginning of 2002. The revival in TES prices also appears to have benefited from currently low interest rates in the European Union and the United States, which enhanced the attractiveness of investing the debt markets of emerging countries. Increased optimism among local and foreign investors about economic recovery, the growth in exports during the first eight months of the year (8.7%) and the gradual decline in unemployment throughout 2003 were also contributing factors. Yet, all of this was not enough to avoid several rate increases in September and early October, associated with news on the fiscal front.

3. Housing Prices and the Colombian Stock Exchange General Index

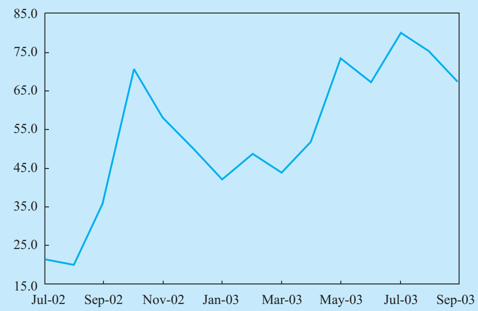
The price of housing rose during the first half of the year, up from an annual variation of -0.2% in the

Figure 18
Trend in New Housing Prices



Source: DANE.

Figure 19
Profitability of the Colombian Stock Exchange General Index in Pesos
(Percentage)



Source: Colombian Stock Exchange. Calculations by Banco de la República.

fourth quarter of 2002 to 0.4% in the first quarter of 2003 and 2.2% in the second quarter of 2003 (Figure 18). By type of housing, revival of the sector during the six months in question was due to apartment prices, which went from -1.2% growth (fourth quarter of 2002) to -0.2% (first quarter of 2003) and then to 2.8% (second quarter of 2003). On the other hand, the annual increase in home prices (0.7%) was lower than in the last quarter of 2002 (1.8%).

The Colombian Stock Exchange General Index stabilized during the third quarter, having increased up to June, before sliding back in August and September. Yet, at the close of the third quarter, the CSEGI showed yields similar to those registered three months earlier. Annual yield was 67.5% in September as opposed to 67.6% last June (Figure 19).

Investment in the stock market continued to offer high profitability, the best the market. According to a number of analysts, this is largely because interest rates are low and assets denominated in US dollars are less attractive due to the minimum amount devaluation accumulated during the year. Furthermore, less inflation and positive expectations about foreign trade and economic growth have favored stock market yields.

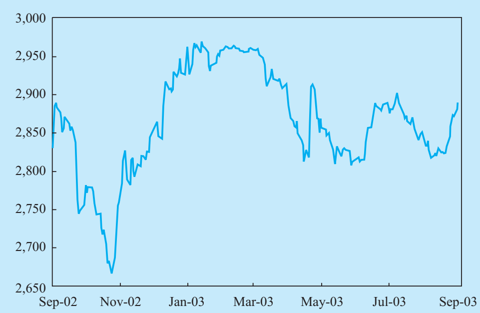
4. Exchange Rate

The significant decline in devaluation during the third quarter was partly due to the reduction in the exchange rate during the same period in 2002. The rate of nominal exchange was Col$2,889.4 per dollar by the end of the third quarter, with 2.2% annual variation and 0.9% devaluation during the year to date (Figure 20). In general terms, behavior of the exchange rate continues to bear some relation to the country-risk premium on Colombia's external debt and to the other Latin American currencies.

Although the real exchange rate declined slightly between July and September, it remains at a record high. In effect, the ITCR1[6] index, calculated by Banco de la República, was 136.1 at September (Figure 21). Compared with the value of the same index a year earlier, real devaluation was 3.6%.

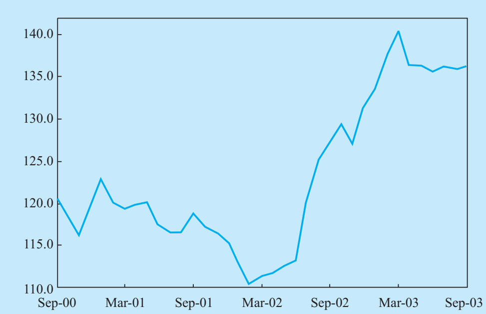
[6] The ITCR1 is based on the consumer price indexes for Colombia and its 20 trading partners.

Figure 20
Nominal Exchange Rate
(TRM, pesos per dollar)



Source: Banco de la República.

Figure 21
Real Exchange Rate
ITCR1 (1994 = 100)



Source: Banco de la República.

B. Supply and Demand

1. Overview

Economic performance during the first half of the year was better than predicted in earlier reports. Annual economic growth, at 3.1% in the period, was up from 2002. The faster growth rate can be explained by the recovery in domestic demand. This was due essentially to investment behavior, since household consumption rose by only 1.0% during the first six months of 2003. On the other hand, although external demand improved in relation to the year before, its contribution to growth remains negative.

The upswing in the economy during the first half of the year helped to narrow the output gap faster than expected. Several indicators of use of installed industrial capacity have recovered considerably in recent months. The increase in growth has also been reflected in the increase in the price of assets (stocks and real estate).

The economy is expected to maintain its rate of growth during the second half of the year. Favorable news concerning the agreement to facilitate payment for exports to Venezuela leads us to expect a slight recovery in sales of this type during the remainder of the year. Accordingly, everything seems to suggest GDP growth this year will be higher than what the government predicts (2.0%) and could be between 2.5% and 3.0%.

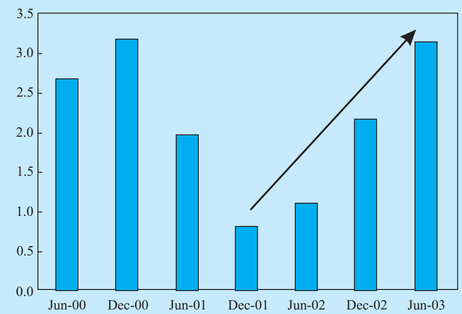
2. First Half of 2003

The rate of economic growth continued to pick up during the first six months of the year (Figure 22). This positive outcome was influenced by factors such as increased confidence among internal and external agents, more remittances from workers, and the revival in credit and the financial system.

a. Private Spending

Growth in private spending picked up as a result of investment in transportation equipment, followed by spending on machinery and equipment, and building construction (Table 2). As mentioned in the last report, the increase in spending on investment in transportation equipment was due,

GRÁFICO 22
ANNUAL GROWTH IN REAL GDP, PER SEMESTER
(PERCENTAGES)



Source: DANE.

in part, to the decision by several airlines to modernize their fleets in order to take advantage of new route assignments.

Spending on machinery and equipment has grown, thanks to the momentum of industrial production in the first half of the year (4.6% annually), the application of ATPDEA, better economic and socio-political conditions for investment, and tax exemptions on imports of capital goods.

Building construction continued to rise at significant rates. The upswing in real estate prices (especially

TABLE 2
ANNUAL REAL GDP GROWTH IN TERMS OF DEMAND
(% CHANGE)

	2002 (p)					2003 (p)		
	I	II	III	IV	Annual	I	II	Semester
Gross domestic product	(0.05)	2.30	1.99	2.34	1.65	4.09	2.20	3.13
Total imports	(8.48)	(1.07)	4.07	7.47	0.55	16.69	1.35	8.62
Total final supply	(1.36)	1.77	2.32	3.15	1.48	5.91	2.07	3.96
Final consumption	1.69	2.12	2.10	1.39	1.82	1.22	0.93	1.07
Households **1/**	2.16	2.20	2.45	2.19	2.25	1.21	0.75	0.98
Final domestic household consumption **2/**	1.79	1.85	2.37	1.85	1.96	1.44	0.87	1.15
Nondurables	0.27	0.86	1.62	1.00	0.94	(1.08)	(2.02)	(1.55)
Semidurables	2.46	(2.33)	3.76	1.29	1.28	1.05	4.45	2.72
Services	1.84	1.87	1.81	2.14	1.92	2.94	2.69	2.82
Durables	12.52	17.30	10.05	6.48	11.41	8.55	1.44	4.87
Government	0.39	1.89	1.08	(0.88)	0.62	1.23	1.46	1.35
Gross capital formation	(17.03)	5.73	16.31	23.57	7.17	48.57	10.24	26.95
Gross fixed capital formation	0.46	7.36	7.56	11.50	6.92	19.20	5.53	11.93
Farming, forestry, hunting and fishing	10.39	14.75	17.06	11.74	13.43	(0.28)	1.33	0.53
Machinery and equipment	(3.41)	(4.02)	5.94	5.61	1.15	20.23	9.45	14.62
Transport equipment	(19.50)	9.11	15.69	25.58	8.58	64.69	(5.05)	23.55
Building construction	29.15	33.29	23.13	33.70	29.84	9.14	18.88	14.14
Civil works	(16.74)	(2.93)	(6.88)	(5.76)	(7.86)	24.68	(10.10)	5.28
Subtotal: Final domestic demand	(1.13)	2.67	4.24	4.70	2.63	7.21	2.40	4.75
Total exports	(2.49)	(2.84)	(7.33)	(4.84)	(4.39)	(0.80)	0.31	(0.24)
Total final demand	(1.36)	1.77	2.32	3.15	1.48	5.91	2.07	3.96

(p) Provisional.
1/ Includes foreign purchases by residents, but not purchases in Colombia by non-residents.
2/ Pertains to final consumption in Colombia by resident households.
Source: DANE.

in upper-income neighborhoods) and a larger turnover in property offered for rent are evidence of a more dynamic real estate market.

Contrary to what was predicted in the last report, spending on household consumption rose by only 0.98% in the first six months of the year. According to DANE, spending on consumer non-durables, particular food, declined sharply. Inasmuch as food industry sales rose by 3.7% during the first six months of 2003, unprocessed food consumption must have declined sharply. This may be related to less domestic farm supply and fewer food imports, as a result of increased devaluation and high international prices. The rise in food inflation up until April reflected these factors. Spending on the other types of goods stayed at acceptable levels.

b. Government Spending

Six-month figures show moderate growth in government consumption and more spending on investment in civil works (Table 2). Data on the Treasury Office cash flow for the first half of the year show a sizeable reduction in transfers for investment, due to the government's fiscal adjustment program. Accordingly, the increase in spending on civil works must be associated with regional and local governments.

c. Exports

As predicted in the last report, total exports continued to rise. This was due to good performance by traditional exports, particularly coal. Gold exports also remained favorable. The behavior of these items is explained by the increase in international prices, which is an incentive to their mining. (Table 3).

Non-traditional exports (excluding gold and emeralds) fell by 12.3%. This was due primarily to the sharp reduction in exports to Venezuela and, somewhat less, to the decline in exports to Ecuador. In contrast, exports to the United States have showed considerable momentum, particularly those associated with ATPDEA, such as textiles, clothing and leather goods. They grew by 11.5% in the first

TABLE 3
EXPORTS: II QUARTER OF 2003

	FOB Value (US$ millions)			Thousands of net metric tons		
	2003 (p)	2002 (p)	Variation	2003 (p)	2002 (p)	Variation
Total exports	3,177.0	3,118.0	1.9	23,428.8	15,435.4	51.8
Traditional exports	1,484.5	1,337.6	11.0	21,354.1	13,153.4	62.3
Coffee	193.6	185.8	4.2	140.8	133.1	5.8
Petroleum and petroleum by-products	727.0	845.8	(14.0)	4,114.3	5,144.8	(20.0)
Coal	465.9	246.6	88.9	17,063.9	7,850.0	117.4
Ferronickel	98.0	59.4	65.0	35.1	25.5	37.5
Non-traditional exports	1,692.5	1,780.4	(4.9)	2,074.7	2,282.0	(9.1)
Gold and emeralds	156.4	28.1	456.9	0.0	0.0	1.235.7
Excluding gold and emeralds	1,536.1	1,752.3	(12.3)	2,074.7	2,282.0	(9.1)

(p) Provisional.
Source: DANE

half of the year, and continued to pick up during July and August.

c. Prospects

The rate of economic growth in the second half of the year is expected to be similar to that of the first six months. Domestic demand, especially investment spending, will continue to be the most dynamic component of the economy.

Available indicators for the building construction sector suggest its growth could accelerate. Building permits approved by July reflect a 21.8% increase during the current year. On the other hand, the building census in the second half of 2003 shows a 17.7% rise in initiated works. The trend in disbursed loans to builders and homebuyers continues to be favorable.

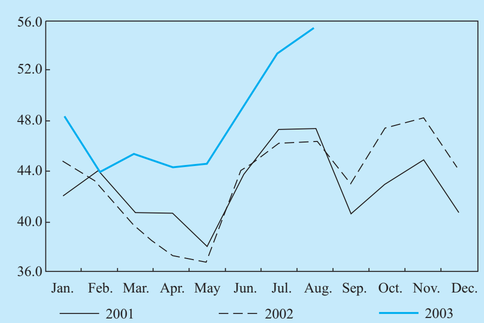
Several important projects scheduled to begin during the second half of the year will boost investment spending. Inauguration of a new bus line in the Bogotá transit system will have a positive impact on investment spending for transportation equipment. The personal communication system (PCS), scheduled to begin operating in the fourth quarter of 2003, will imply a major investment in facilities and equipment.

Judging by the behavior of different indicators, household consumption could pick up. As to consumption of non-durables, the lower increase in food prices might reflect a larger supply of farm products. As to other consumer goods, a survey by the Colombian National Federation of Merchants (Fenalco) indicates a major recovery in sales during the third quarter. This is in keeping with the trend in credit card sales and the consumer loans. The third quarter also saw an important surge in hotel occupancy (Figure 23). Lastly, the recovery in the level and quality of employment should be an incentive to household consumption at the end of the year and in early 2004.

Several announcements on the external front have changed the prediction on the performance of external demand in the last half of the year. July and August saw a continuation of sizeable increases in coal exports (respective annual growth in export volume was 287.1% and 26.1%). On the other hand, resumption of the Aladi payment mechanism with Venezuela was announced several days ago, and the Exchange Control Commission (CAVIDI) decided to add Colombian-made clothing and automobile parts to its list of import licenses. Imports to Venezuela may begin to revive as a result (Figure 24).

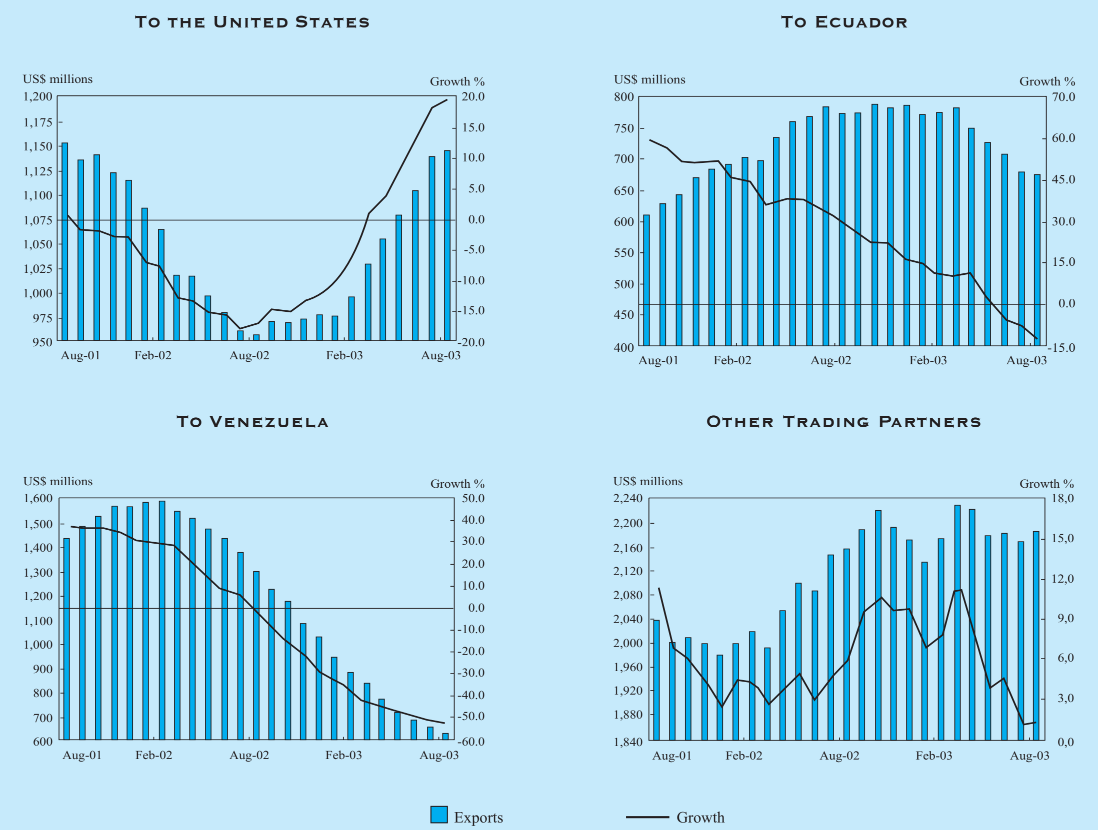
Although the process is still in the early stages, the announcement that a free trade agreement with the United States could take effect in early 2005 might have a favorable affect on expectations and decisions about investment spending in the productive sector during 2004.

FIGURE 23
HOTEL OCCUPANCY
(PERCENTAGE)



Source: Cotelco.

Figure 24
Non-traditional Industrial Exports
Accumulated in the Last 12 Months



Source: DANE.

For these reasons, external demand is expected to continue to contribute to growth, even more so than in the second quarter of 2003.

C. Employment, Wages and Productivity

The recovery in economic activity is mirrored in a rise in employment. However, labor-market variables show no major pressure on inflation.

1. Employment

The recovery in employment is a reflection of the increase in economic activity. During the third quarter of 2003, the number of employed in the 13 major cities rose by 5.1% compared with the same period in 2002 (Figure 25). In September, due to higher employment, urban unemployment declined by 1.1 percentage points in relation to the rate a year earlier. At national level, unemployment dropped from 14.3% in September 2002 to 13.9% during the same month this year.

The increase in the number of employed exceeds the rise in the number of people who claim to be underemployed. The third quarter saw an increase of 381,944 in the average number of employed workers. The number of underemployed rose by 7,364 and the number of hourly underemployed declined by 54,378 compared with the same period in 2002. This lowered the rate of hourly underemployed from 17.7% to 16.1%, on average.

2. Wages

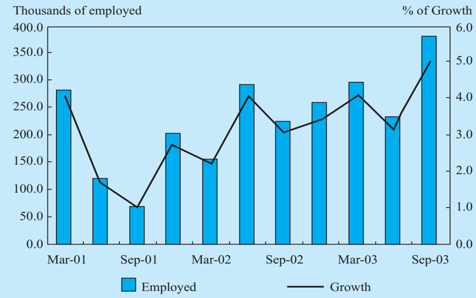
Table 4 shows the percentage of workers covered by collective bargaining agreements reported to the Ministry Labor and Social Security at September 2003. The information is broken down according ranges of one-year pay increases. Most beneficiaries (72.7%) are in the 6.0%- 8.0% range. This proportion is less than in March 2003 (77.3%). The percentage of workers who agreed to wage increases of less than 6% rose compared with the first quarter of the year (16.6% versus 10.2%). Two-year agreements continue to have a high inertial component, since 64.6% are negotiated on the basis of past inflation rather than the inflation target.

On the other hand, the upward trend in nominal wages for industrial workers and employees has been reversed (Figure 26). Although some wages continue to be adjusted above target inflation, the negative trend in nominal wage increases can be interpreted as a decline in inflationary pressures via labor costs.

3. Industrial Productivity

There continues to be an important increase in hourly labor productivity. According to the DANE monthly manufacturing sample, industrial productivity at July 2003 showed a 3.3% increase in the accumulated figure for the last 12 months

FIGURE 25
ANNUAL GROWTH IN THE NUMBER OF EMPLOYED IN THE 13 MAJOR CITIES



Source: DANE. Calculations by Banco de la República.

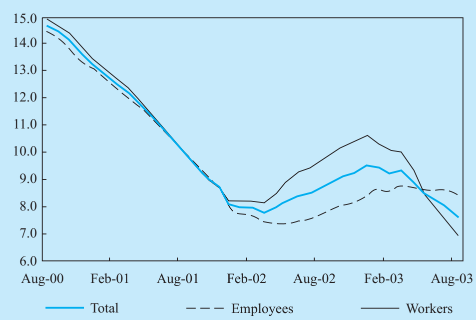
TABLE 4
PERCENTAGE OF BENEFICIARIES PER AGREED WAGE RANGE
JANUARY - SEPTEMBER 2003

One-year pay increase			
<6.0	[6.0-8.0]	[8.0-10.0]	[10.0-12.0]
10.2	72.7	16.0	1.1

Two-year pay increase			
<6.0	[6.0-8.0]	[8.0-10.0]	IPC
16.6	7.3	0.4	42.4
	IPC+[0,5-2,0]	SML	Otros
	22.2	10.7	0.5

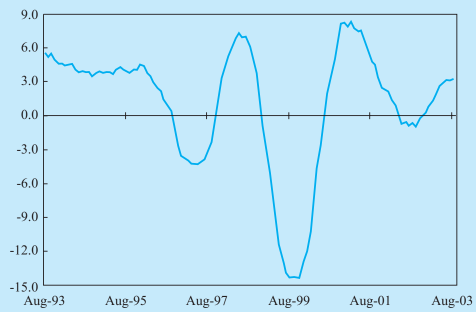
SML = minimum wage provided for by law
Source: Ministry of Labor and Social Security.

FIGURE 26
ANNUAL GROWTH IN THE NOMINAL INDUSTRIAL WAGE (LAST 12 MONTHS)
(PERCENTAGE)



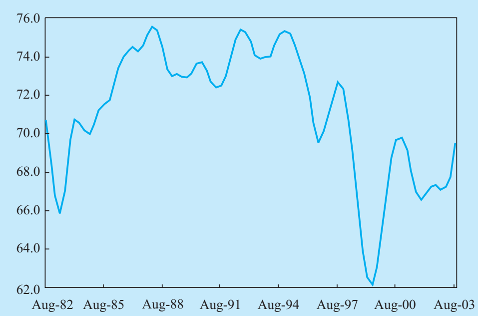
Source: DANE.

Figure 27
Annual Growth in Industrial Productivity (Accumulated in the Last 12 Months)
(Percentage)



Source: DANE.

Figure 28
Use of Installed Industrial Capacity, According to Fedesarrollo
(Tendency Component)



Source: Fedesarrollo. Calculations by the Economic Studies Division (SGEE), Banco de la República.

(Figure 27). Consequently, nominal wage increases above the inflation target probably could have been accommodated, due to the increase in productivity, without having generated additional inflationary pressure through industrial labor costs.

D. Output Gap and Use of Installed Capacity

Although the different indicators estimated by Banco de la República continue to show the economy is operating below its potential, the output gap has been closing faster than predicted, due to better-than-expected economic performance.

Use of installed industrial capacity has seen a systematic increase throughout the year (Figure 28), reflecting the rise in economic activity. Therefore, while use during the first quarter was 5.3% below the historic average, this difference declined to 2.3% in the third quarter.

Because the production gap might be closing faster than predicted, it is likely to do less in 2004 when it comes to keeping demand-pushed inflationary pressures low.

III

The International Context

Third-quarter prospects for world economic growth improved in relation to what was expected three months ago. This was largely due to performance of the US economy. There were indications in the third quarter that the world's largest economy is consolidating its economic recovery. This situation could boost growth in other regions. Japan and the euro zone also showed signs favorable to growth, but they were less impressive.

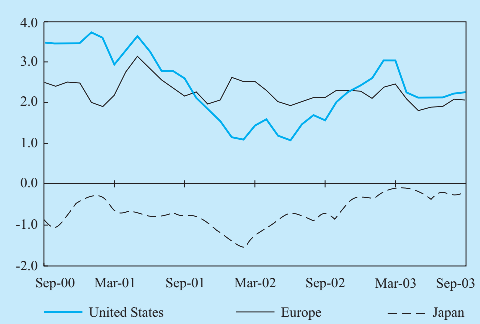
Although growth has picked up, it has yet to generate inflationary pressures. In the United States and the euro zone, inflation remained relatively stable throughout the third quarter (Figure 29), while core inflation in the United States continued to decline, reaching record lows. This allowed for a loose monetary policy, with historically low interest rates that could continue for several months until more sustained economic growth is achieved.

In Latin America, the international situation allowed for a continuation of good financial conditions throughout the third quarter. The country-risk premium remained stable, at low levels, and the perception of the markets stayed relatively favorable. More growth in the United States economy has improved prospects for the region's exports to that market. This factor, coupled with the revival of demand in Southeast Asia following the SARS crisis (severe acute respiratory syndrome), has improved the outlook for international commodity prices and, consequently, for the region's terms of trade.

In effect, the third quarter saw a rise in international commodity prices, which are expected to continue to increase gradually during this year and the next. Oil prices are expected to remain high in the coming months, before declining in 2004 due to an anticipated increase in supply that year.

Although favorable conditions for growth of the world economy and for Latin America presumably will remain in place during the remainder of the year and in early 2004, there are serious causes for uncertainty. The most

FIGURE 29
INFLATION
INDUSTRIALIZED ECONOMIES
(PERCENTAGE)



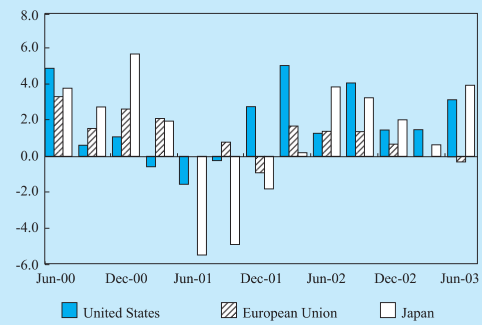
Source: Datastream.

important one concerns the sustainability of economic growth in the United States, because of its fiscal and current-account deficits, the latter in spite of a very low dollar. Therefore, it is reasonable to expect interest rates to increase at some point during the second half of 2004 in response to possible inflationary pressures in the United States brought on by devaluation, economic growth and higher commodity prices. In Latin America, higher international prices, especially for farm products, could exert temporary inflationary pressure in countries that import food, such as Colombia.

A. Developed Economies

Second-quarter growth in the United States was 3.1% (Figure 30) and the forecast for growth this year and the next is up from the prediction in the June Inflation Report[7] (Table 5). Third-quarter signs of a stronger United State economy appear to indicate a consolidation of economic recovery. The upward trend in stock indexes (Dow Jones[8]),

Figure 30
Annualized Quarterly GDP Growth: United States, Euro Zone and Japan
(Percentage)



Source: Datastream.

[7] Figures on third-quarter growth of the United States economy were announced at the time this report was being published. With a rate of 7.2%, growth for the year should exceed the forecast in this report.

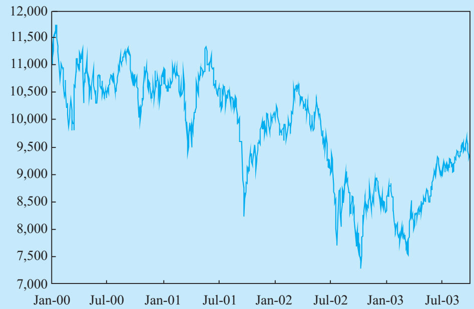
[8] One of the most important United States stock indexes, the Dow Jones Industrial Average is the oldest and certainly the most widely quoted of all the market indicators. It is the price-weighted average of the 30 largest and best known industrial companies listed on the New York Stock Exchange (NYSE).

Table 5
Growth Forecasts
(Percentage)

	Actual	Forecast for			
	2002	2003 1/	2004 1/	2003 2/	2004 2/
Developed Countries					
United States	2.4	2.6	3.9	2.3	3.6
Euro Zone	0.8	1.0	2.4	1.0	2.4
Japan	0.3	1.9	1.2	0.9	0.6
Latin America					
Argentina	(11.0)	5.5	3.9	4.9	3.8
Brazil	1.5	0.7	3.0	1.7	2.9
Chile	2.0	3.2	4.3	3.4	4.2
Mexico	0.9	1.7	3.6	2.1	3.9
Peru	5.2	3.8	3.7	3.9	3.9
Ecuador	3.0	2.7	3.6	2.9	3.4
Venezuela	(8.9)	(12.1)	6.1	(13,3)	5.7

1/ Forecast on October 8, 2003.
2/ Forecast on July 16, 2003.
Sources: IMF actual figures and Datastream forecasts.

Figure 31
Dow Jones
Industrial Average

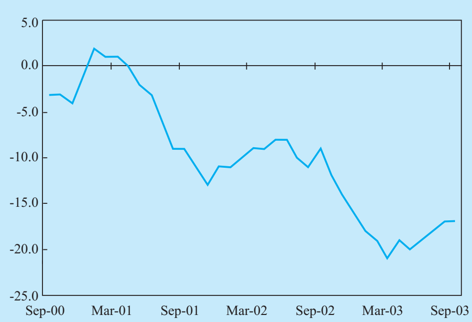


Source: Datastream.

Figure 32
Consumer Confidence
Index

United States

Euro Zone



Source: Datastream.

which began at the end of the US incursion into Iraq, continued (Figure 31). At the same time, the Fed[9] reported an improvement in economic activity in most of the country's 12 economic districts during the third quarter, together with an increase in consumer spending and manufacturing.

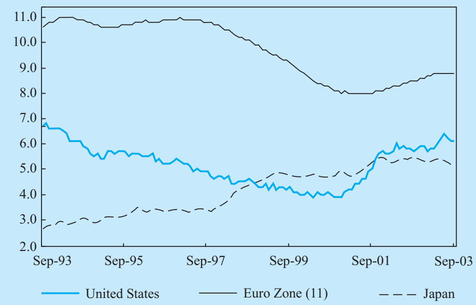
Even so, there are still elements of uncertainty that could eventually affect the speed of economic recovery in the United States, particularly the high fiscal and current account deficits. These deficits will continue to grow during 2003 and no reduction is expected in 2004. Although the fiscal deficit could boost short-term growth, its effect on long-term macroeconomic stability would be negative.

In addition the external and fiscal imbalances, household borrowing is high, as reflected recently in real estate purchases. Prices for real estate have gone up considerably as a result. Given the currently low interest rates, this situation seems to be sustainable. However, with a tighter monetary policy, which means higher interest rates, the real estate market could experience an adjustment, with consumption eventually being affected by wealth. Another element of uncertainty is weak consumer sentiment, which remains low, as indicated by the consumer confidence index (Figure 32). Lastly, despite more growth, the job market remains weak and unemployment is above 6.0% (Figure 33).

The nominal exchange rate for the dollar continued to depreciate in the third quarter against the euro, reflecting the impact of low interest rates and a

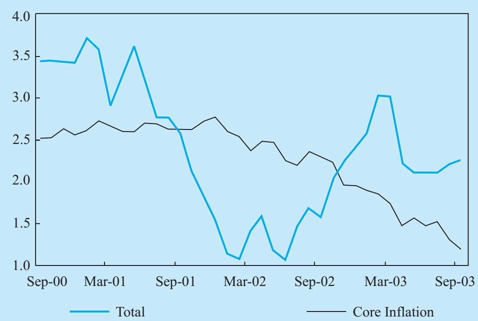
[9] Información obtenida del *Beige Book* del Fed, del 3 de septiembre y de 15 de octubre de 2003.

Figure 33
Unemployment Rate in the Industrialized Economies
(Percentage)



Source: Datastream.

Figure 34
Total and Core Inflation in the United States
(Percentage)



Source: Datastream.

high current-account deficit. Although total inflation rose slightly during the period from July to September, core inflation continues to drop and was 1.2% in September, the lowest in the last 30 years (Figure 34).

In view of the foregoing, monetary authorities are not expected to change their policy this year. Interest rates will rise only when there are clear signs of sustained recovery in the United States economy. The Fed confirmed this[10] when it indicated there are still risks of a reduction in inflation in the future, meaning the loose monetary policy would be sustainable, at least until mid-2004.

In Europe, the second quarter of 2003 saw practically no economic growth (0.2%) (Figure 30). Weak domestic private demand and appreciation of the euro explain most of this standstill. Nevertheless, economic activity appeared to show some signs of recovery during the third quarter, meaning GDP growth in the second half of 2003 might be better than in the first. The moderate rise in the industrial confidence index in August and September, and recovery in the consumer confidence index as of last July, would confirm this (Figure 32). The slight growth in industrial production in July is indicative of the same, prompting expectations of positive growth in the third quarter. Even so, the unemployment rate has not declined and is still at 8.8% (Figure 33).

As indicated in earlier reports, the fiscal deficit is a major concern in the euro zone. Its current level limits the capacity of governments to apply expansive policies that serve as an incentive to economic activity in the short term. In fact, it requires austerity measures that could have repercussions on the speed of economic recovery.

In 2004, we expect to see more growth in the euro zone compared with the forecast for this year, although the difficult situation in Germany would make this recovery relatively slow. Any increase in growth would have to be supported by more private consumption (in an environment of low interest rates) and by the recovery in external demand.

Due to the weak European economy, third-quarter inflation remained at around 2.0% (Figure 29). The

[10] In a press release dated October 28, 2003.

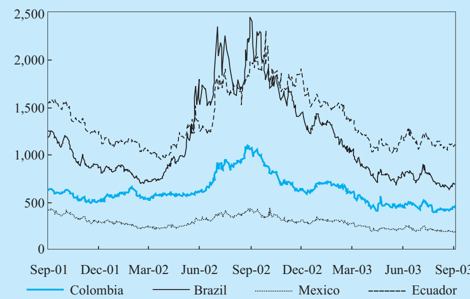
negative aftermath of last summer's weather, the recent tax hikes in several countries, and volatile oil prices could create a certain amount of short-term inflation volatility. However, no demand pressure on prices is expected in the short or mid-term.

As reflected by an increase in stock indexes, second-quarter growth in Japan was better than expected. Coupled with expectations of recovery in the United States economy, especially next year, this has raised growth predictions for 2003 and 2004. Yet, deflation is still a factor and the corporate and banking system remains weak. As a result, recovery is expected to be moderate.

B. Latin America

Low interest rates in the industrialized countries and a better feeling about countries like Brazil helped to keep financial conditions in Latin America favorable during the third quarter of 2003. Thus, the country-risk premium on the debt remained low and exchange rates were relative stable during the period (Figure 35 and Table 6).

Figure 35
Country-risk Premiums (*)
Latin American Countries
(Basis Points)



(*) EMBI plus.
Source: Bloomberg.

Table 6
Devaluation of Latin American Currencies
Against the US Dollar

	Quarterly (*)	Anual at end of September
Argentina	4.2	(21.0)
Brazil	1.8	(23.1)
Chile	(5.5)	(11.8)
Mexico	5.3	7.7
Peru	0.5	(4.1)
Uruguay	5.1	2.5

(*) Devaluation in September versus June (end of period).
Source: Datastream.

According to the latest growth forecasts, most countries expect economic recovery this year, and especially in 2004. The increased momentum in the Latin American economies is primarily the result of two factors: 1) more of an appetite for risk, which has increased the demand for emerging bonds and, in many cases, substantially lowered in the country-risk premium, and 2) expectations of an improvement in the macroeconomic fundamentals of the Latin American countries. Nevertheless, there is uncertainty about the speed of the region's economic recovery, and an eventual mid-term rise in interest rates in the developed countries could have a negative impact on capital flows to the region. However, in the short term, as indicated earlier, this risk is not likely.

At country level, progress towards political reform in Brazil has helped to restore confidence. However, growth remains weak and the considerable need for external financing makes the country vulnerable to any shift in confidence, should the quality of policies deteriorate.

In Venezuela, although oil production has come back, the economy is expected to dip sharply this year (-12.1%). Whether or not macroeconomic stability is achieved depends on fiscal policy and an easing of exchange controls to allow for a recovery in investor confidence. However, current uncertainty over the political situation makes it difficult to lift exchange controls in the short term, given the risk of a resumption in capital flight. In terms of business, the recent authorization of import payments under the Aladi agreement[11] will lessen the negative impact on sales to Venezuela and should enhance the flow of trade, especially with Colombia. The Venezuelan economy is expected to grow by 6.1% next year. This, however, is a purely statistical outcome, given the sharp drop in product this year.

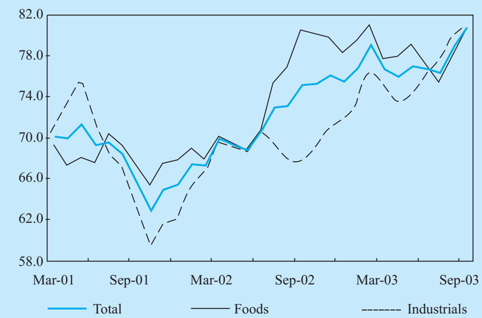
Economic growth In Ecuador was weak during the first half of the year, inflation remained relatively stable, and unemployment continued to be high (9.6% in September). Economic performance during the rest of the year and in 2004 will depend on approval of the government's proposed fiscal reforms and on the volume of oil production. Even so, the economy is not expected to recover during this period, particularly in view of the fact that official forecasts for oil production and export were lowered and international prices for crude are expected to be less in 2004 than in 2003.

C. Commodity Prices

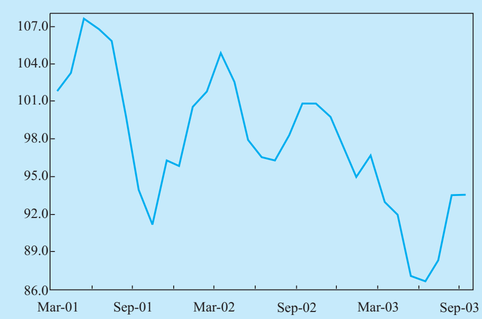
International commodity prices rose during the third quarter of 2003. According to *The Economist,* the index for these items experienced a 5.4% increase between June and September. In September, it was 7.7% above the level observed a year earlier (Figure 36). This behavior was determined by higher prices for food and industrial goods. In effect, the food sub-index rose by 4.5% during the quarter; the industrial goods sub-index saw 6.6% growth during the same period. The annual variation in these sub-groups at September was 0.3% and 19.6% respectively. The quarter saw less of a decline in the price index measured in euros, with an annual variation of -7.1% at September.

Figure 36
Monthly Commodity Price Index
(1995 = 100)

In dollars



In euros



Source: *The Economist.*

[11] The new ruling was published in *Gaceta Oficial* on October 6, 2001. It allows products to be imported into Venezuela from Aladi member countries, with official currency, provided payment is made under the Aladi Reciprocal Payment and Credit Agreement.

These indexes rose because of an improvement in growth worldwide and strong demand in China, especially for minerals and farm products. International prices for the major commodities, except oil, are expected to continue to increase during the remainder of the year and in 2004, thanks to recovery of the world economy. However, the increase will be gradual.

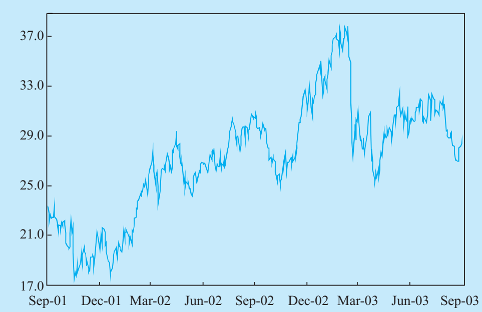
Oil and Coffee

During most of the third quarter, international oil prices remained stable but high (at around US$30 per barrel), fluctuating within the price band[12] defined by the Organization of Petroleum Exporting Countries (OPEC) (Figure 37). The trend in crude prices during this period was a reflection of several factors. To begin with, production in Iraq is recovering slower than expected. Also, inventories in the industrialized countries are low, and there is concern about the sustainability of production in Nigeria and Venezuela. Accordingly, the WTI price averaged US$30.2 per barrel in the third quarter, 6.6% above what it was during the same period a year earlier.

On September 24, OPEC decided to cut production to 24.5 mbd, effective as of November 1. This is a reduction of 900,000 bd. Initially anticipated for the first quarter of 2004, this decision was due to an increase in supply from non-OPEC member countries and because inventories are rapidly approaching normal levels. Production in Iraq is expected to be back on track as well. For OPEC, although demand has revived, these factors could lower prices, necessitating a cut back in the supply of crude oil.

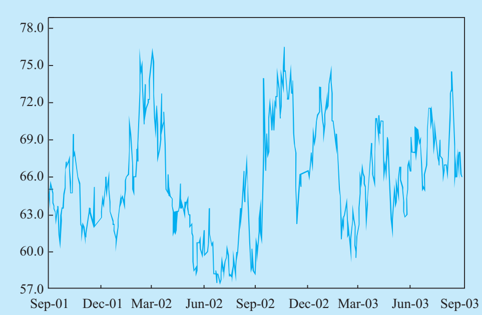
OPEC's decision caused uncertainty on the market, and the WTI price went from US$26.9 to US$30.2 a barrel between September 23 and October 7. As a result, the forecasts in this report are slightly above those in the June Inflation Report. Although high prices are expected to continue during the rest of 2003, they should drop in 2004 due to a larger supply, which would include Iraqi production. This being the case, the average price should be somewhere between US$30 and US$31

Figure 37
WTI Oil Price
New York Stock Exchange
(Dollars/Barrel)



Source: Bloomberg.

Figure 38
Colombian Arabica Coffee Prices
New York Stock Exchange
(US cents/Pound)



Source: Bloomberg.

[12] According to this system, the price of OPEC crude basket items must be between US$22 and US$28. In the United States West Texas Intermediate (WTI) indicator, these prices are equivalent to approximately US$25 and US$30 a barrel.

a barrel in 2003 and US$26 and US$28 a barrel in 2004.

International coffee prices remained low during the third quarter, averaging US$68.3 cents/pound, or 13.2% above the average price reported for the same period in 2002 (Figure 38). For the most part, the behavior of coffee prices continues to be determined by excess supply on the market. During the 2003/2004 coffee year, production in the exporting countries is expected to decline, due to readjustments in production costs sparked by low prices in recent years. This factor, coupled with the campaign to promote coffee consumption, could produce a moderate increase in coffee prices.

IV

Inflation Forecasts

A. Introduction

Non-food inflation and other core-inflation indicators continued to rise during the third quarter of 2003. As explained earlier, this tendency continues to reflect adjustments in regulated prices (fuel, transportation and public utilities) and the lagging effect of devaluation on prices. At September, the different categories of the CPI for tradables showed inflation far above the 2003 target.

Despite the increase in core inflation, total consumer inflation has declined steadily in recent months, largely because of the rapid drop in food inflation caused by a good supply of perishables. The pick up in core inflation occurred in a context of economic recovery where growth has exceeded the predictions in previous reports.

So far, the acceleration in core inflation cannot be attributed to an increase in economic momentum, since the price indicators that are particularly susceptible to pressure from demand (rent, entertainment, culture and recreation, health care and other expenses) remained stable, at inflation rates below the target for 2003. Furthermore, most estimates of the output gap showed that GDP was actually below potential and would stay there until the end of the year. However, signs in the third quarter began to show the output gap was closing faster than expected. Indicators of installed industrial capacity denote a major recovery in August and September, and some branches have already gone beyond historic averages.

In addition to accumulated devaluation, high inflationary expectations have been the main risk to the Bank's price stabilization policy throughout 2003. Inflation expectations began to rise in December 2002 and are now around 7.0% for the end of 2003 and early 2004. To keep them in check and to lessen the impact of devaluation on inflation, intervention interest rates were increased in January and April by 200 bp. The Bank also announced it was prepared to intervene in the exchange market by deaccumulating up to US$ 1 billion in reserves. Since May, there have been no major changes in monetary policy.

The rise in intervention rates at the beginning of the year has been transferred to the interbank rate, but not to nominal interest rates on the market. As a result, and due to the increase in inflation up to August, real deposit rates have stayed low, and in some cases near zero. This situation has been accompanied by relatively high growth in monetary aggregates and a major recovery in monetary loans, all of which indicates monetary policy in the third quarter remained loose.

The exchange rate has fluctuated between Col$2,800 and Col$2,900 in the last three months, increasing as of September in conjunction with the uncertainty sparked by regional elections and the referendum. This was contrary to the tendency in exchange rates throughout the region. On the other hand, most emerging countries saw their country-risk premiums decline between the second and third quarters. The same was true in Colombia, although this coefficient rose in September compared with the Latin American average (EMBI Plus, excluding Argentina).

B. Macroeconomic Prospects

1. On the External Front

Most notable on the external front in the last three months was the increasingly clear evidence of an upswing in US economic growth and better economic performance in Europe and Japan. Based on the Consensus Forecast and predictions by the International Monetary Fund (IMF), the forecast in this report is for continued growth in the United States economy during the remainder of 2003 and in 2004, which should help to boost growth in the euro zone and Japan.

In general, the emerging economies continued to benefit from more growth on the external front. Capital markets are still willing to accept relatively high exposure to risk. This continued to boost growth of the stock market indexes in the developed economies and kept the price of emerging and corporate debts high.

The foregoing, coupled with extremely low interest rates in the United States, Europe and Japan, besides prospects for added growth, allowed the currencies of emerging countries to appreciate somewhat, especially in Latin America. This has improved the profitability of assets denominated in local currencies, raising investment possibilities as a result.

Growth in the developed economies and conclusion of the SARS crisis allowed the Southeast Asian economies to recover a high rate of growth, which has been particularly vigorous in the case of China.

In line with this situation, growth predictions for Latin America are stepped up in this report, compared with the one in June. The most favorable conditions are related to the increase in growth worldwide, which should boost the demand for exports from the subregion, thereby improving domestic growth. On the other hand, the increase in demand for commodities, largely due to strong economic growth in China, will raise international prices for these products. How this affects terms of trade will depend on each country's relative position as a net importer or exporter of commodities.

In the short and mid-tem, the greatest risk to this optimistic outlook for the region's emerging economies is an eventual increase in the cost of external financing and a loss of appetite for risk. Nevertheless, the expectation in this report is that external interest rates will remain stable, at currently low levels, at least until well into the first half of 2004, favoring capital flows to Latin America.

The increase in actual and predicted growth of the developed economies has yet to generate inflationary pressure in the United States and Europe, and is not expected to do so for some time. The central banks, therefore, have no incentive to raise their rates. Moreover, in the United States, economic recovery seems to be accompanied by a vigorous expansion in productivity, which would leave room for added growth without raising prices.

The external situation in the next six months should be conducive to economic growth in Colombia. Further US economic growth in the months ahead should boost the demand for exports, which also would benefit from tariff preferences under ATPDEA and a currently competitive exchange rate. In fact, exports to the United States picked up considerably in the third quarter, partially compensating for the drop in sales to Venezuela and the standstill in exports to Ecuador.

As to Venezuela, even though no one expects exports to return to pre-crisis levels, the downturn has bottomed out and there are signs of a recovery. Venezuela's decision to eliminate exchange controls on a number of items traded with Colombia and other countries of the Andean Community of Nations could be especially important.

In the long run, the external and fiscal imbalances in the US economy and high private household borrowing are still the biggest risks to the world economy. The weak dollar against other strong currencies is a result of these factors and, in spite of being part of the solution to the problem, has yet to exert an effect. Also, as part of a solution to these imbalances, external interest rates could go up in the long run. These increases would be substantial, considering that current rates are on par with record lows.

Analysts expect 2004 rates to be 50 to 150 bp higher than the current ones, with increases as of the second half of the year. This scenario would complicate the economic performance of emerging countries with economies like the Colombian one. Due to the size of their external and fiscal imbalances, or their debt, these economies are particularly vulnerable to any increase in the cost of borrowing.

2. On the Domestic Front

Second-quarter GDP figures and the various sector indicators for the third quarter show the economy is growing faster than predicted in the June report. This recovery continued to be supported by a loose monetary policy, a revival in credit and more investor and consumer confidence, within an environment characterized by better conditions for domestic security.

Private investment has been the primary source of growth throughout 2003 and this situation is expected to continue until the end of the year. In contrast, consumption increased slowly. However, the remainder of the year is expected to see more momentum, thanks to good economic growth and the improvement in labor variables. Consumer performance in 2004 will depend on the impact of tax measures, the recovery in employment associated with more economic growth, and how confidence generated by the fiscal adjustment program affects decisions on household spending.

In terms of the different branches economic activity, it is felt that building construction will continue to drive economic growth. Persistently good performance in building permits and loans indicates as much. Also notable in recent months is the recovery in real estate prices in the different cities, especially for middle and upper-income homes. Also, the IGBC began to recover at the start of the year and continued to increase throughout the third quarter. The rise in asset prices may reflect added investor and household confidence in future economic performance.

In view of the foregoing, the forecast in this report is for 2.5% to 3.0% growth during 2003, up from the predictions in the June report. The economy is expected to continue to grow during 2004, at least at rates similar to those in 2003, provided external conditions remain favorable and there continues to be progress on domestic security and the fiscal problem.

In this context, the output gap (potential GDP/actual GDP) would remain negative. However, improved prospects for growth would help to close the gap quicker than forecast in earlier reports. Something to this effect might have happened in the third quarter, considering the quick recovery in use of installed industrial capacity in August measured by Fedesarrollo (Chapter II).

3. Inflation Forecasts

As in the previous report, the inflation forecasts continue to depend on four fundamental variables: devaluation, the output gap, inflation expectations and transitory shocks generated by changes in regulated prices or the tax base. Compared with the last report, there has been no substantial change in these assumptions, except for the revised forecast on the output gap. The following are the main assumptions.

- Exchange rate stability in recent months appears to indicate that pressure exerted on costs and prices by the lagging effects of depreciation at the end of 2002 will ease in the months ahead. And, if the nominal rate of exchange stays relatively stable for the rest of the year and in 2004, as assumed herein, the coming quarters should see no serious inflationary pressure on this front.

- The assumptions behind the forecasts in this report imply that nominal depreciation in 2004 will keep the real exchange rate close to its current level. According to the satellite models used by the Bank, assuming a net capital flow similar to the one this year, the deficit in the current account of the balance of payments would have to remain at its present level for the next five quarters if this to happen. This would demand export growth in excess of the rate observed in the first three quarters of 2003, which is considered feasible given the expected recovery in sales to Venezuela and the momentum of exports to the United States.

- The forecasts are based on the assumption that growth will be insufficient to close the output gap completely in 2004, and it will continue to slow inflation. The negative gap in 2003 created a situation where inflation in many goods and services that depend exclusively on the trend in demand, such as rent, entertainment, culture, recreation and health care, stayed below the inflation target for that year, despite the increase in growth.

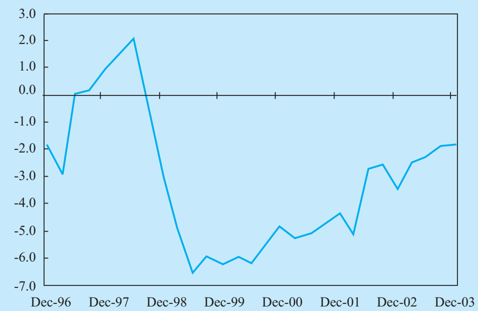
- Nevertheless, because a narrower output gap is expected for 2004, it will do much less to curb inflation than in previous years. The rise in rental prices during 2003 is one indication, and will probably be even higher in 2004, considering the recent recovery in real estate prices. Given its weight in the CPI basket (20.6%), rental price stability in the last few years has been a decisive to reducing total and core inflation.

✠ Consequently, the forecast in this report is for a continued negative gap in output during the remainder of the year, at around 1.8% of potential GDP (Figure 39).

✠ According to the Bank's most recent surveys, inflation expectations remain high (near 7.0%) and there is not much confidence the target will be met. The Bank's forecast assumes these expectations will subside by the end of the year, considering that inflation is expected to decline. However, it will still exceed the range for the specific target in 2004 (between 3.5% and 5.5%).

✠ Finally, the coming year is expected to see public utility, fuel and transportation charges increase above current inflation for this year and the range announced for the target in 2004. The increase in public utility rates is associated with the revised formulas regulating electricity, water and garbage collection. It also assumes application of legislation on the Development Plan, which defines the inflation target as the ceiling for rate increases at income levels one and two, in the case of basic consumption and the fixed rate.

FIGURE 39
PRODUCTION GAP
(PERCENTAGE)



Source: Banco de la República.

TABLE 7
TOTAL CONSUMER INFLATION FORECAST
FOR 2003 AND 2004
(PERCENTAGE)

Period	Report	
	Current (Figures at end of)	Previous (Quarterly average)
Jun-03	7.2	7.2
Sep-03	7.1	6.9
Dec-03	6.2	6.0
Mar-04	6.0	5.8
Jun-04	5.5	5.3
Sep-04	5.3	5.1
Dec-04	5.0	4.8

Source: Banco de la República.

Based on these assumptions, the Bank's system for inflation forecasts estimates 6.2% consumer inflation at December 2003 (Table 7). As with the previous report, a reduction in total inflation is still possible, thanks to a distinct slowdown in food inflation for perishables and processed goods. This being the case, food inflation is expected to be somewhere between 2.0% and 5.0% at the end of 2003, as opposed to the 3.0%-6.0% range forecast in the June report.

With respect to non-food inflation, the expectation in this report still points to slight reduction in the four quarter. Accordingly, inflation at December could be between 6.5% and 7.2%. The range in the June report was 6.2% to 7.2%.

Total consumer inflation at December would be around 5.0%. This is according to the Bank's forecast system and includes transitory shocks to non-food inflation from rate increases for public utilities, fuel and transportation in excess of inflation at December and the range announced for the 2004 target. The forecasts do not assume a change in the VAT structure, which could affect prices.

Less total inflation at December 2004, compared with the level expected at the end of this year, reflects a downturn in non-food inflation. According to the Bank's main model, non-food inflation should be somewhere between 4.5% and 5.5% at the end of next year, up from the range predicted in the last report (4.0% to 5.0%). In terms of food inflation, the Bank's models suggest a figure between 4.0% and 6.0% for December 2004.

The decline in total and non-food inflation next year would be the result of three basic factors:

1. A moderate depreciation in the nominal exchange rate that would guarantee stability in the real exchange rate and weaken for the lagging effects of 2002 depreciation on prices in the coming months, without new pressure on cost.

2. A negative gap in output to limit pressure from demand, despite the increase in growth. This is the only way increases in excess of 6.0% could be accommodated, such as those that might occur in certain sub-groups of the CPI basket (public utilities, fuel and transportation).

3. Although high at the end of 2003, inflation expectations should drop quickly to levels in keeping with the announced target range (3.5% to 5.5%).

4. Risks

The inflation forecasts presented this report depend, above all, on relative exchange stability. According to the sensitivity studies done for this report, an additional average annual depreciation of four percentage points in 2004, compared with depreciation contemplated in the forecasts herein, would imply an average increase of 40 bp in non-food inflation for 2004 and 2005.

There is still considerable uncertainty about how the exchange rate will behave. To begin with, its stability in the years ahead will depend on good export performance and private capital flows to offset the expected reduction in foreign currency from oil exports. Besides this uncertainty, recent months have seen growing signs of a possible trade agreement with the United States. This would have important current and capital-account repercussions that are not assessed in this report, but could effect equilibrium of the real exchange rate. Finally, developments on the fiscal front also could have short and long-term effects on the level of the exchange rate.

Another highly uncertain factor is the gap in output. As mentioned earlier, it is a crucial measure in the forecasts, because it includes possible inflationary pressure pushed by demand. Alternative estimates of the output gap suggest it could be less than estimated in this report. In general, estimates of this type are highly susceptible to whatever approach is used, and differ widely. Sensitivity analyses suggest that a reduction of 0.8 percentage points in the gap by the end of the this year could push inflation up by 20 bp in 2004 and 30 bp in 2005.

In addition to its magnitude, there is uncertainty about how a specific gap would contribute to inflation or disinflation in a year. Uncertainty of this type is particularly high when the economy is gaining speed, as now seems to be the case. Even with negative gaps for the economy as a whole, it is possible to have demand-pushed inflationary pressures associated with bottlenecks in certain sectors and fed by pressure from localized costs.

How inflation expectations will behave and their effect on the formation of prices also continues to be a source of uncertainty. Inflation during the year has been above the Bank's target for 2003. And, even though a sharp drop is expected in the fourth quarter, this situation could have conditioned price increases for the end of the year and the beginning of the next at levels above those set by the Board of Directors for defining the target in 2004. The fact that the economy is picking up, and there are specific price increases as a result, does not help to keep expectations in check. Moreover, the changes in regulated prices, although temporary in nature, could have a lasting impact if transferred to expectations of inflation.

The forecasts in this report may underestimate food inflation. At the time the report went to press, there were indications of rising international grain prices, which were not included in the forecasts. If maintained, higher external prices would tend to influence domestic prices, as occurred at the end of 2002, and have a major impact on food inflation.

Projections by Local and Outside Analysts for the Principal Macroeconomic Variables

The following is a review of the most recent projections by local and foreign analysts for the principal variables of the Colombian economy in 2003 and 2004. When submitting their projections, the analysts were already aware of the actual rate of inflation at September 2003.

I. Projections for 2003

As shown in Table A, the local analysts who were consulted predicted 6.7% inflation, on average. The average projection declined for the first time since the second quarter of 2002. The average last quarter was 6.9%.

Foreign analysts raised their forecasts for inflation in Colombia at December 2003 to an average of 6.7%. Compared with the last report, the increase amounts to 0.4 percentage points, thanks to adjustments in the projections by analysis at Goldman Sachs and J.P. Morgan-Chase.

Both foreign and local analysts reaffirmed their growth projections for 2003. The two groups believe growth of the Colombian economy this year will exceed the target of 2.0% real growth set by the government at the start of the Uribe administration.

On average, foreign analysts expect 2.6% real growth in the Colombian economy, 0.3 percentage points up from their average prediction in the previous quarter. Average growth predicted by local analysts was 2.5%, up 0.1 percentage points from the earlier average.

As to fiscal matters, local analysts predict an average consolidated public-sector deficit equal to 2.9% of GDP for this year. Foreign analysts are more optimistic. They believe the fiscal deficit will be 2.7% of GDP, on average.

As to the other variables, in the last quarter, local analysts lowered their DTF forecast from 8.1% to 7.9%. They also reduced their forecast for the nominal exchange rate at the end of 2003 and increased the current-account deficit and unemployment forecasts.

II. Projections for 2004

Table B contains the details of the projections by local and foreign analysts for the principal macroeconomic variables in 2004. Both groups expect inflation to decline next year. Local analysts anticipate 5.8% inflation, while the foreign analysts estimate 5.5%.

In terms of growth, local analysts forecast 3.0% on average. Foreign analysts are more optimists and expect 3.4% growth.

Table A

Projections on the Principal Macroeconomic Variables for 2003

	Proyection Date	Real GDP Growth %	CPI Inflation Rate %	Nominal Exchange (End of)	Nominal DTF % 1/	Deficit (% of GDP) Fiscal	C/A	Unemployment Rate %
Local Analysts	Oct-2003							
Revista Dinero		2.4	6.8	3,080	7.8	(2.8)	(2.1)	15.2
Suvalor-Corfinsura		2.6	6.4	2,900	8.0	(2.8)	n.d.	n.d.
Corfivalle		2.5	6.7	3,015	7.9	(3.0)	(2.0)	16.5
ANIF		2.5	6.7	2,920	7.8	(2.8)	(2.9)	16.0
Fedesarrollo		2.5	7.0	2,896	8.0	(3.2)	(2.0)	15.4
Average		**2.5**	**6.7**	**2,962**	**7.9**	**(2.9)**	**(2.2)**	**15.8**
Foreign Analysts	Oct-2003							
Goldman Sachs		2.5	6.5	2,950	7.8	(2.8)	(2.0)	14.7
IDEA global		3.0	6.3	2,775	7.7	(2.7)	(1.5)	15.0
J. P. Morgan Chase		2.5	7.1	n.d.	n.d.	(2.6)	(2.3)	n.d.
Deutsche Bank **2/**		2.5	6.8	2,900	n.d.	(5.5)	(2.2)	n.d.
Average		**2.6**	**6.7**	**2.875**	**7.8**	**(2.7)**	**(2.0)**	**14.9**

n.d. Not available
1/ Average for the year.
2/ Deutsche Bank data at September 4
Source: Analysts, "How We Are Viewed Abroad " Report, SMT September 17, 2003.

Table B

Projections on the Principal Macroeconomic Variables for 2004

	Proyection Date	Real GDP Growth %	CPI Inflation Rate %	Nominal Exchange (End of)	Nominal DTF % 1/	Deficit (% of GDP) Fiscal	C/A	Unemployment Rate %
Local Analysts	Oct-2003							
Revista Dinero		3.0	5.6	3,076	8.1	(2.7)	(1.9)	14.5
Suvalor-Corfinsura		3.0	5.4	3,100	7.8	(2.3)	n.d	n.d.
Corfivalle		3.0	6.0	3,160	8.8	(2.8)	n.d	15.0
ANIF		3.2	6.0	3,156	9.0	(2.5)	n.d	15.0
Fedesarrollo		2.8	6.0	3,078	9.8	(2.5)	(1.7)	13.7
Average		**3.0**	**5.8**	**3,114**	**8.7**	**(2.6)**	**(1.8)**	**14.6**
Foreign Analysts	Oct-2003							
Goldman Sachs		3.3	5.0	3,100	8.1	(2.5)	n.d.	13.5
IDEA global		3.8	5.5	2,875	8.0	(2.4)	(1.6)	13.5
J. P. Morgan Chase		3.3	6.3	n.d.	n.d.	(2.3)	(2.5)	n.d.
Deutsche Bank **2/**		3.0	5.0	3,074	n.d.	(5.8)	(2.4)	n.d.
Average		**3.4**	**5.5**	**3,016**	**8.1**	**(2.4)**	**(2.2)**	**13.5**

n.d. Not available
1/ Average for the year.
2/ Data at September 4, 2003, excluding the figure for the average fiscal deficit, as it refers to the central government deficit.
Source: Analysts, "How We Are Viewed Abroad " Report, SMT September 17, 2003.

As to the other variables, analysts expect interest rates to increase by 60 bp in 2004, on average, compared with the forecast for 2003. They estimate 5.0% average devaluation in the exchange rate by the end of 2004 and a reduction in the deficit to 2.5% of GDP.

II. HISTORIC TREND IN INFLATION AND GROWTH FORECASTS

The following are the average forecasts by of a group of analysts that includes Idea Global, Cesla (Klein-UAM), Corfivalle, Fedesarrollo, Santander Colombia, BBVA Securities, C.S. First Boston, SSB Citigroup, ANIF, Standard Chartered, SuValor, J.P. Morgan Chase and UBS Warburg.

Figure A depicts the historic trend in their average forecasts for inflation at the close of 2003 and 2004. It also shows a gradual increase in the inflation forecast for 2003, from the end of last year up to July 2003. As that point, the forecast was lowered and, in October, this group of analysts anticipated 6.4% inflation.

As for 2004, there was no change in the 5.7% inflation forecast for that year until July 2003, when they raised it to 6.0%. They have since lowered it, and now expect 5.7% inflation in 2004.

Figure B shows the recent trend in average growth forecast by the same analysts for 2003 and 2004. Average growth forecast for 2003 has increased by 0.4 percentage points during the year to date. Likewise, and although slightly more stable, the average forecast for growth in 2004 has increased by 0.2 percentage points.

En materia de crecimiento, el promedio de pronósticos de los analistas locales se situó en 3,0%, los extranjeros son más optimistas y esperan un crecimiento de 3,4%.

Con respecto al resto de variables, los analistas esperan, en promedio, un aumento de 60 pb en las tasas de interés en 2004 frente a lo pronosticado para 2003. De igual forma estiman, una devaluación promedio del 5,0% de la tasa de cambio al final de 2004. En el plano fiscal esperan una reducción del déficit al 2,5% del PIB.

Figure A
Trend in Historic Average Inflation Forecasts for 2003 and 2004
(Percentage)

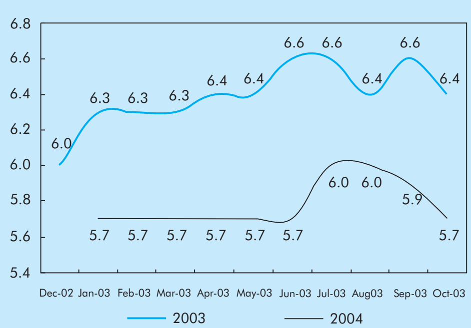
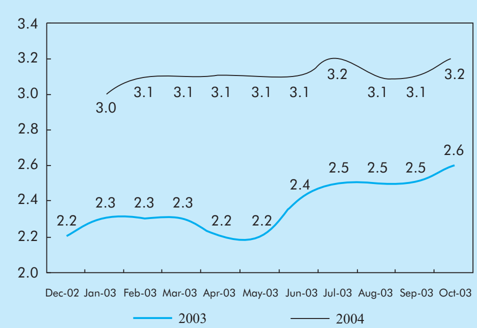


Figure B
Trend in Historic Average Real Growth Forecasts for 2003 and 2004
(Percentage)



Source: Average of the forecasts reported by Idea Global, Cesla (Klein-UAM), Corfivalle, Fedesarrollo, Santander Colombia, BBVA Securities, CS First Boston, SSB Citigroup, ANIF, Standard Chartered, SuValor, J.P. Morgan Chase and UBS Warburg.

Prepared by the Economic Studies Division
of Banco de la República.
Editing and layout by the Publications Section
of the Industrial Communication Department.
Published in December 2003.

Translated by Sharon Terry Navarro