Inflation in September and the Outlook

- Non-food inflation and other basic indicators of inflation have fallen in recent months and averaged 5.4% at September. However, the past month saw a rise in food inflation from 6.6% to 7.2%, partially because of the transportation strike. This kept total inflation at 6.0%.

- Although influenced by temporary factors such as less inflation in certain controlled prices, the downturn in non-food inflation was basically a question of the trend in prices for tradable goods. Tradables inflation offset the rise in non-tradable inflation, which went to 4.9% in June and 5.4% in September. This trend in tradables inflation is now almost a year old and is associated with appreciation of the Colombian peso. However, the last quarter witnessed a far more moderate reduction in tradable inflation than in previous quarters, despite increased appreciation in the exchange rate. This might have been due to inflationary inertia and expectations of how tradables inflation would perform.

- The steady increase in non-tradables inflation over the past year suggests that the output gap continues to close and demand is having an increasingly significant impact on inflation. Expectations and costs also affect inflation. The quarter saw no major changes in inflationary expectations. As to costs, there are signs of pressure in certain sectors that produce raw materials such as steel and some building materials. The rise in fuel prices also had a certain impact. However, these pressures have been neutralized by appreciation and, consequently, there was no generalized increase in overall costs during the last quarter, or during the course of the year.

- External and internal conditions favorable to growth of the Colombian economy continued throughout the third quarter. External demand and private investment were the primary sources of economic growth.

- The world economy has continued to recover, despite higher fuel prices and the gradual rise in interest rates set by the United States Federal

Reserve (the Fed.). However, this adjustment has yet to become a major constraint on international liquidity and has not affected capital flows to emerging economies, which continue to grow. The drop in spreads, following increases in the second quarter, mirrored the added influx of capital. Prices for major export commodities stayed relatively high, and oil prices have gone well beyond the forecasts established three months ago.

- In this context, the Colombian economy reflected two tendencies throughout the year. The first is healthy growth in exports and gross domestic product (GDP) in tradable sectors. The second is exchange appreciation.

- Favorable conditions in the external sector bolstered export growth, thanks to high international prices (in some cases above predictions, as with oil) and solid growth worldwide (the recovery of the Venezuelan economy has been particularly important). These factors were mirrored in good performance by traditional and non-traditional exports, particularly those to the United States and Venezuela. Non-traditional exports to other countries saw increases in the 10%-to-15% range (accumulated over 12 months). Good GDP performance in tradable goods sectors, with a 4.4% rise during the first half of the year, reflects the momentum in exports.

- Peso appreciation in recent months was associated with several factors; namely, good export performance, a larger net flow of external capital (via foreign direct investments (FDI), especially in oil, and shifts in assets) and more confidence on the part of foreign and domestic investors as a result of better security and positive economic results in recent quarters. Exchange appreciation was more pronounced in July and August, prior to a partial reversal in late September and early October, which was due to measures taken by the Board of Directors of Banco de la República (BDBR). Average annual appreciation during the course of the year was 6.6% by the end of September. The trend towards appreciation was evident in other countries of the region as well. In this sense, appreciation of the Colombian peso is not an isolated phenomenon and should be understood in the context of world growth, high international prices for commodities, and a generalized weakening of the dollar against most currencies, including those of Latin America.

- Conditions at the internal level continued to favor growth in domestic demand. The recovery in private disposable income, thanks to job conditions, was a factor. In August, unemployment in the 13 major cities was 15.3%, having been 17.3% during the same month in 2003. Unemployment nationwide dropped from 14.4% to 13.4%. A better job situation contributed to growth in "formal" employment, or occupation not reported as under-employment, and an absolute reduction in the latter.

- A reduction in the global participation rate (GPR) contributed to the drop in unemployment over the last two quarters. This could mean the rise in employment and job conditions is beginning to be reflected in better and more stable levels of family income. The increase in the number of self-declared unemployed who enrolled in the educational system in recent months is one indicator that might confirm this interpretation. These factors continued to permit GDP growth in the non-tradable goods sectors, which increase by 4.1% during the first six months of the year.

- The outlook for the global economy over the short and medium-term continues to be favorable, despite the rise in oil prices and external interest rates. Expectations of economic growth worldwide are the highest they have been in several years, although growth forecasts for the United States have been adjusted downward slightly. The outlook for 2005 is less optimistic, although the slowdown in growth is expected to be moderate.

- In Latin America, economic conditions are now the best they have been since before the last crisis, which was in the late nineties. The weighted growth of Colombia's trading partners is expected to decline from 4.3% to 3.3% in 2005. Accordingly, for 2005, several analysts expect to see no major changes in the influx of capital into emerging markets, compared with the levels observed in 2003 and 2004. These forecasts are reinforced by expectations of a weak dollar against most currencies, due to the fiscal and external imbalances in the U.S. economy. This being the case, mid-term commodity prices could stay relatively high, which would spell good terms of trade for emerging countries in the subregion, Colombia included.

- The trend in oil prices is one of the paramount risks associated with the external situation described in this report, as are larger than expected increases in external rates. However, a number of analysts believe the emerging countries are probably now less vulnerable to a rise in internal interest rates than in earlier economic situations, thanks to a better macroeconomic base.

- As for the remainder of the year and early 2005, several factors will continue to favor growth. These include business and consumer expectations, low interest rates and broad liquidity in the economy, more willingness on the part of business and consumers to rely on credit, the rise in business profits during 2004, and a general recovery in private disposable income. Consequently, the pace of economic growth is expected to be similar to what it was in the last four quarters. External and domestic analysts expect to see 4.0% growth, on average, for 2005. Consumption and private investment will be the most dynamic components of demand next year. Exports could make less of a contribution, due to the slowdown in non-traditional exports and less economic growth for the country's trading partners, as well as the impact real appreciation could have on the peso.

- Inflation in the coming quarters will continue to be associated with two opposite forces: a) accumulated exchange appreciation and its effect on tradables inflation, and b) gradual closure of the output gap and the impact this has on non-tradables inflation. Tradables inflation is expected to stay below total inflation and target inflation, which would help to lower core inflation rates. How much this contributes would depend on inflationary expectations with respect to future targets and on the inertia of inflation itself.

- Non-tradables inflation should continue rise as the output gap narrows, provided there is no major change in inflationary expectations, as has been the case in recent months. These expectations could help to lower inflation in 2005, more so than in other years, since the inflation target for 2004 likely will be met and in view of the trend towards exchange appreciation.

- In short, whether or not future targets are met will depend on the extent to which tradables inflation continues to decline and point where non-tradables inflation stabilizes. Shocks caused by fuel and public utilities will continue to pose considerable risk in the year ahead, and El Niño is likely to be a factor in late 2005. This could exert important inflationary pressure on overall inflation for 2005, but would only be temporary.

- According to inflation forecasts, total consumer price inflation will be near the middle of the target range for 2004. There were two fundamental changes in the basic scenario of the transmission mechanism model (TMM): 1) the exchange rate path was reduced for 2004 and 2005, and 2) the short-term forecast for inflation was also revised downward. The basic scenario does not include eventual shocks caused by VAT, or the impact El Niño could have on food inflation in 2005, which is an important factor to consider. In the basic scenario, the model points to less of a rise in interest rates during the remainder of 2004 and in 2005, compared with the situation described in the June report, although interest rates will increase in the medium and long-term to come together at their long-term level.

- Two alternative scenarios were considered. The first assumes a narrower gap in 2004; the second, greater exchange appreciation in 2005. A narrower output gap would imply a substantial rise in interest rate requirements as of the fourth quarter of 2004, compared with the basic scenario. On the other hand, depending on the extent of appreciation in 2005, rates would not have to increase this year and would do so to a lesser degree the year after.

- In this context, monetary policy should focus on narrowing the existing output gap at a pace that would prompt no sudden changes in the prices of tradable goods. For example, the likelihood of a positive gap in a situation characterized by real appreciation should be minimized, as the full weight of deflation would fall on the exchange rate, with the resulting costs being brought to bear on economic activity in the tradable sectors. Monetary policy also should attempt to influence inflationary expectations in a way that aligns them to future targets. As indicated, fewer expectations of inflation would help to reduce inflation for both tradable and non-tradable goods.

- As to policy instruments, the foregoing means it is absolutely necessary that real interest rates do not stay too low for a prolonged period of time, if the close in the output gap is to be moderate. The Bank's intervention rates will have to be raised at some point, and the decision as to when must consider monetary policy lags. If monetary policy reacts only to an obviously accelerated narrowing of the output gap, the anticipated impact on price stability will not be forthcoming and/ or extremely large hikes in interest rates would be required. By the same token, reducing interest rates for the sake of further depreciation would be inadvisable, because of the impact this would have on the output gap and on inflationary expectations. Also, it probably would not be effective in achieving more exchange depreciation over the short term.

- Therefore, the suggestion is that interest rates in the near future will have to be adjusted towards their long-term level. However, this need not begin immediately, particularly with the trend in the nominal exchange rate forecast for 2005 (See Chapter II).

- Given these considerations, the Board of Directors decided not to alter the intervention rates charged by Banco de la República during the third quarter of 2004 and voiced a commitment to reducing inflation targets towards levels that are consistent with long-term price stability.

Board of Directors
Banco de la República