



# INFLATION REPORT

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M A R C H 2 0 0 5

BANCO DE LA REPÚBLICA

(CENTRAL BANK OF COLOMBIA)

BOGOTÁ, D. C., COLOMBIA

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## I. INFLATION AT MARCH 2005

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## INFLATION IN MARCH AND THE OUTLOOK

- ✧ First-quarter inflation was characterized by:
  - ✧ A decline in total inflation and all core inflation indicators, especially non-food inflation.
  - ✧ Fewer expectations of inflation in the first quarter of 2005, as indicated in surveys and by the differentials between fixed and variable TES interest rates.
  - ✧ Lower non-tradable inflation, partly because of fewer inflationary expectations, but also perhaps because of the absence of significant pressure from demand.
  - ✧ A reduction in tradable inflation associated with appreciation in the exchange rate.
- ✧ The Colombian economy continued to grow amidst a favorable external environment. The world economy and that of our major trading partners was very vigorous, although 2005 is expected to see less growth than in 2004. Terms of trade remained high, and prices for certain export commodities might be even higher than last year.
- ✧ The figures for gross domestic product (GDP) in the fourth quarter show continued economic expansion in 2004. They also indicate the GDP slowdown in the third quarter was mostly temporary and associated with supply shocks, as indicated in the last report. Average growth during the last six months was above 4%, and internal demand has been up by more than 5% since the third quarter of 2003.
- ✧ In 2004, the most dynamic factors on the demand side were private investment and exports. The increase in investment placed it above the 1970 -2004 average as a percentage of GDP (17%). Household consumption continued to recover and, in per capita terms, reached the levels observed prior to the crisis in 1999.
- ✧ Growth in potential GDP may have increased during the last two years, given the force of investment and the rise in total factor productivity. However, it is important to remember that potential GDP is something that cannot be observed and its estimate is plagued by a degree of uncertainty.
- ✧ An analysis of various indicators shows conclusive evidence of a change in the output gap (difference between potential and actual GDP) compared with the last inflation report:

- ✧ Some indicators point to a smaller gap. Use of installed industrial capacity saw an increase in January, but is still close to the historic average. Answers to questions about the importance of demand problems in industry suggest the gap continued to close up to January 2005. The percentage of companies with installed capacity utilization above the historic average remained on the rise. However, these indicators refer exclusively to industry and may ignore what happens in other sectors of the economy.
- ✧ Other events suggest the output gap is not closing. Prices for non-tradables, particularly various services, would seem to indicate no quick narrowing of the gap. On the other hand, the unemployment rate is still above the level that is thought to indicate a possible acceleration in inflation.
- ✧ Economic performance in the coming quarters will depend largely on what happens with the external context. The main sources of uncertainty in this respect are the trend in oil prices and adjustments in U.S. monetary policy.
- ✧ Analysts agree as to how much the U.S. Federal Reserve (Fed) will have to raise interest rates, but remain uncertain about the pace at which these hikes might occur. The macroeconomic forecasts contained in this report assume the Fed will continue to adjust interest rates gradually and in the direction of a neutral stance on monetary policy.
- ✧ If so, the main tendencies in capital flows towards the emerging economies would continue. These flows are characterized by broad liquidity on international markets, with no major surge in country-risk premiums. Nevertheless, this perception is dogged by uncertainty about how fast the Fed will adjust interest rates and what will happen in terms of the external deficit and the shortfall in tax revenue in the United States economy.
- ✧ According to the latest forecasts on Colombia's balance of payments, current account income in 2005 could exceed the prediction in the last report. On the one hand, terms of trade have increased and could remain up throughout 2005. Also, demand from our trading partners, especially Venezuela, might be more vigorous than it has been so far.
- ✧ The trend in private capital flows will depend on the international situation and how international and domestic investors respond to the changes in U.S. monetary policy. If the rise in interest rates is higher than expected, net capital inflows could be less, and we might see net capital outflows, which would cause the exchange rate to increase in comparison with its current levels.
- ✧ The results of the inflation forecast models and the central monetary policy simulation model show the target for 2005 is likely to be met (between 4.5% and 5.5%, with 5% as the specific goal) and inflation should drop towards the target range announced for 2006 (between 3% and 5%). This would be the case even with moderate peso devaluation and is consistent with a path in short-term interest rates (interbank rates-TIB) at levels equal to or slightly below the current ones (6.3%).

- ✧ However, some models show that more than 4% growth in the Colombian economy in 2005, which implies a narrower output gap, would leave no margin for the TIB to drop below its present levels. In this case, the intervention rates used by Banco de la República should move towards a more neutral monetary stance in the coming year, as is the case with the central banks in most economies, both developed and emerging.
- ✧ As mentioned earlier, supply factors (a larger stock of capital and more productivity) could imply an initially smaller gap or slower closure. This would make it possible to maintain the monetary stimulus with which the economy now operates. However, given the uncertainty about the state of the gap and how it will change, it is difficult to say which of these scenarios is more likely.
- ✧ The same is true of the exchange rate. Forecasts for this variable are extremely sensitive to balance-of-payment scenarios. These vary as more relevant information becomes available and depending on the pace and duration of any adjustment in external interest rates. Again, this context makes it difficult to arrive at a definite projection on how the exchange rate will behave in the short and medium-term.
- ✧ Finally, it is important to remember that the forecast models failed to predict a portion of the downturn in first-quarter inflation, which is why it still is impossible to determine if that trend is permanent or temporary.
- ✧ Uncertainty about the extent of the output gap, how the exchange rate will behave in the future, and the depth of the recent decline in inflation necessitate having more information before making any change the country's monetary policy.

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

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

Board of Directors  
Banco de la República



# INFLATION REPORT

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# I. INFLATION AT MARCH 2005

*External conditions are still favorable for Colombia. Despite more economic growth, there is no evidence of demand-pulled inflationary pressures.*

The United States economy continued to grow during the first quarter of 2005, but at a slower pace than in 2004. The emerging economies remained dynamic, thanks to high commodity prices and increased world demand. However, the rise in oil prices and the fear that the U.S. Federal Reserve will adopt a more aggressive monetary policy made the world financial markets more volatile. However, despite the increased perception of risk, the Latin American currencies continued to gain strength against the dollar.

External conditions are still favorable for Colombia. The growth figures for 2004 show consolidation of a new phase of expansion in the economy and confirm that the slowdown in the third quarter was only temporary. Exports and private investment were the sources of demand that propelled growth throughout 2004.

Core inflation slowed, partly because of fewer inflationary expectations. This also suggests that, despite more economic growth, there is no evidence of demand-pulled inflationary pressures and the output gap (difference between actual and potential GDP) remains negative. However, part of the decline in core inflation was surprising, and it is still impossible to determine whether it is permanent or temporary.

## A. THE EXTERNAL CONTEXT

*Core inflation slowed, partly because of fewer inflationary expectations.*

International financial figures for the year to date, and particularly in March, showed a rise in volatility and in the market's perception of risk, contrasting with the tranquility observed in the second half of 2004. This phenomenon was associated with two events: (a) a much higher than expected increase in

oil prices and (b) growing fears that the United States will tighten its monetary policy faster than expected.

As to the first of these events, oil prices passed the US\$50/barrel mark in late February and early March (for West Texas Intermediate - WTI) and approached US\$60 (Graph 1). This was due to stronger than expected world demand and to nervousness caused by the fact that the Organization of Petroleum Exporting Countries (OPEC) announced at the beginning of the year that it might cut production. Although these reductions never materialized, the market remained volatile. In recent weeks, the price of oil has dipped slightly, but is still above US\$50 a barrel.

As to monetary policy in the United States, the latest figures on growth in demand and the trade deficit, coupled with a possible surge in inflationary pressures as a

result of higher fuel prices, generated concern on the market that the Fed would be quicker to raise interest rates. These fears were accentuated by new evidence that suggests more price-fixing power on the part of companies, in addition to slower growth in productivity and higher labor costs.

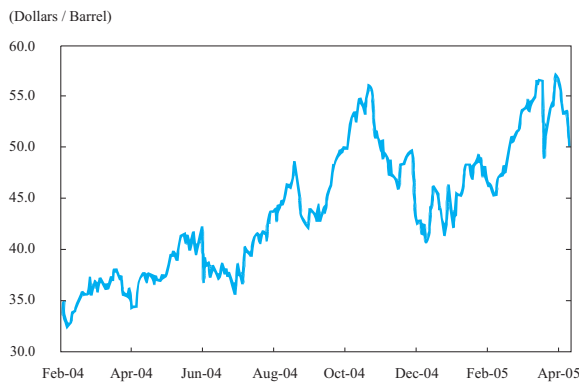
Part of the increased volatility in financial indexes was associated with negative figures for the U.S. trade balance. Economic growth in the United States and high oil prices spell more imports. Coupled with lagging exports, these continue to elevate the trade deficit, which hit another high in February (US\$61 billion (b)), causing further uncertainty about its long-term sustainability.

Figures on economic activity in the United States make it impossible to rule out a move by the Fed to tighten monetary policy. The U.S. economy performed well in the last two quarters. Real growth during the fourth quarter of 2004 was 3.9% (annualized quarterly), thanks to strong internal demand (Graph 2). The figures for 2005 to date are also favorable, but the pace of growth appears to be less than what it was last year. For example, the industrial production index showed an annual increase of 3.9% at March, as opposed to 4.4% at December.

Retail sales rose by 5.8%, which is less than in previous months, and the job market improved,

**GRAPH 1**

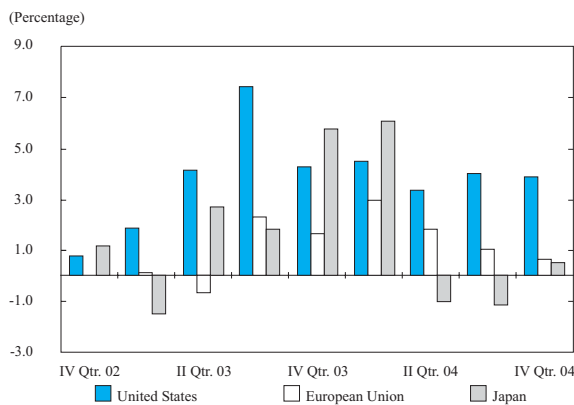
**PRICE OF OIL (WTI)  
ON THE NEW YORK EXCHANGE**



Source: Bloomberg.

**GRAPH 2**

**ANNUALIZED QUARTERLY GDP GROWTH  
IN THE UNITED STATES, THE EURO ZONE AND JAPAN**



Source: Datastream.

but not as quickly. Good growth in the United States and accelerated expansion in China continued to boost the world economy. In contrast, the economies of Japan and the Euro zone have weakened.

*The external context continued to favor the emerging economies.*

The fourth quarter saw 0.5% growth in the Japanese economy (annualized quarterly). This is more than in the second and third quarters, but far less than in all the other developed economies. The reason is less household consumption and poor export performance. The latter seems to be due to the yen's sharp appreciation against the dollar since the second half of 2004.

Fourth-quarter growth in the Euro zone was 0.6% during 2004 (annualized quarterly), which is lower than in recent quarters. This slowdown is explained by less external demand and the slack recovery in domestic demand. Private consumption improved after a two-quarter standstill and the job market was stable, with unemployment rates showing no change in the last twelve months.

The external context continued to favor the emerging economies. In recent months, the rate of growth in China has gone beyond what analysts expected and gives no indication of a cooling off in the Chinese economy. Economic growth in the Latin American countries has been vigorous as well. The regional economies continued to benefit from increased world demand in 2004 and early 2005, and high prices for certain commodities. This favorable environment has encouraged household consumption and improved financing terms for most countries, making them less vulnerable to outside shocks.

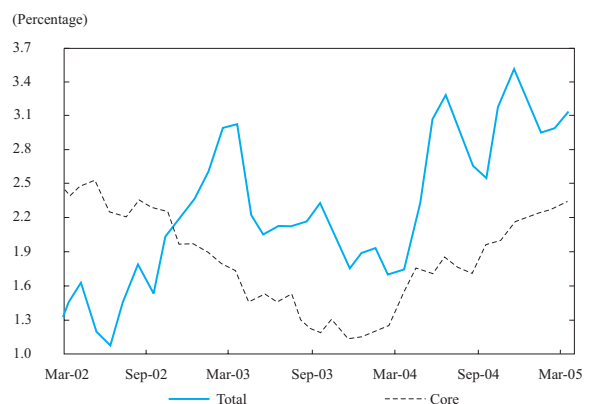
Inflationary pressures in the United States were contained, at least with the figures at February, despite the relatively solid rise in demand, the hike in oil prices and a weaker dollar (Graph 3). However, the figures for March<sup>1</sup> are not as clear.

It was in this environment that the Fed continued to raise interest rates gradually (25 basis points (bp) per meeting). They are now at 275 bp, which is 50 bp more than in December, but still well below their estimated long-term levels (5%) (Graph 4).

Despite the Fed's moderate policy, the growing uncertainty made world financial markets more volatile and interrupted the downturn in variables

GRAPH 3

ANNUAL INFLATION IN THE UNITED STATES

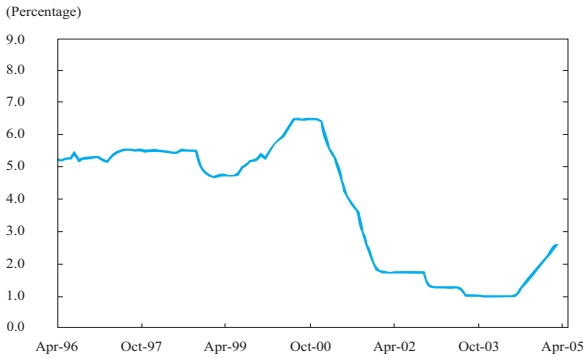


Source: Datastream.

<sup>1</sup> Released to the public on April 20, 2005.

GRAPH 4

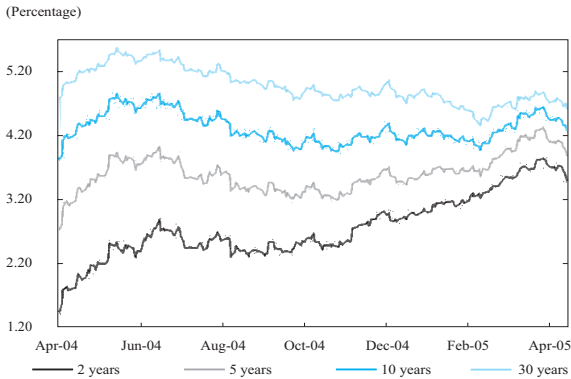
INTEREST RATES SET BY THE FED



Source: Datastream.

GRAPH 5

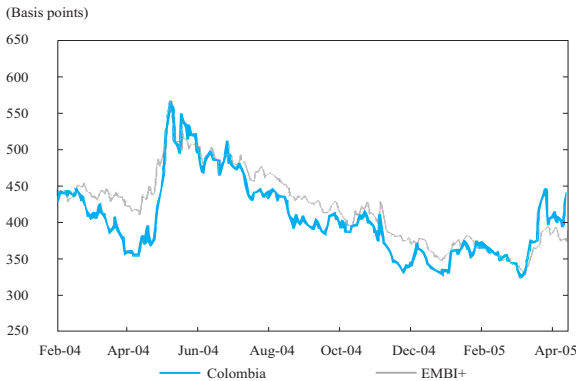
INTEREST RATES ON U.S. TREASURY BONDS



Source: Datastream.

GRAPH 6

COUNTRY-RISK PREMIUM EMBI + LATIN AMERICAN COUNTRIES (\*)



(\*) April 15. Source: Bloomberg.

such as long-term interest rates in the United States and the country-risk premiums of the emerging economies. Long-term interest rates in the United States rose for the first time since mid-2004 (Graph 5), while the country-risk premiums recovered from the low levels observed in February (Graph 6).

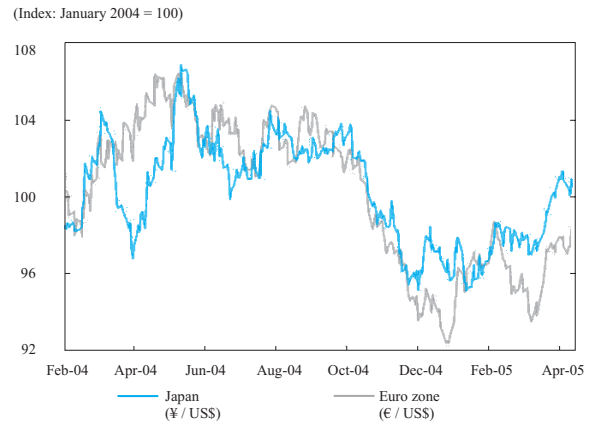
The interest rate hikes ruled by the Fed and the possibility of quicker adjustments in the months ahead kept the dollar from losing more ground against the world's major currencies, and allowed for a marginal recovery in March (Graph 7). Even so, the growing external imbalance in the United States economy has affected that country's currency (Graph 8).

For Colombia and the other emerging economies in the region, the higher perception of risk raised exchange rates at the end of February and March. However, the surge was temporary and recent weeks have seen the peso exchange rate return to the levels seen in February (Graph 9).

Generally speaking, the first quarter witnessed a trend towards appreciation in the exchange rates of the Latin American countries. Colombia was no exception, and 2.4% appreciation between

GRAPH 7

EXCHANGE RATE OF DIFFERENT CURRENCIES AGAINST THE DOLLAR



Source: Datastream.

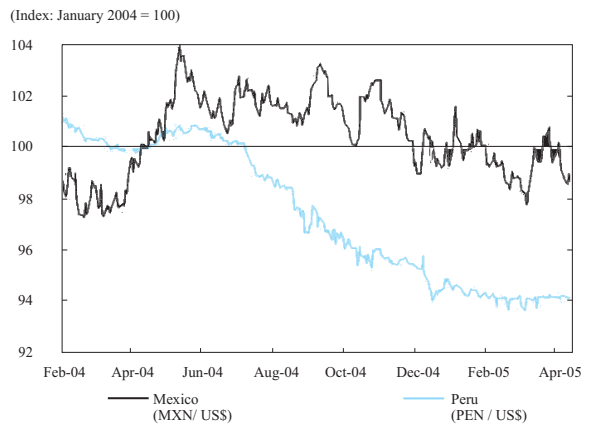
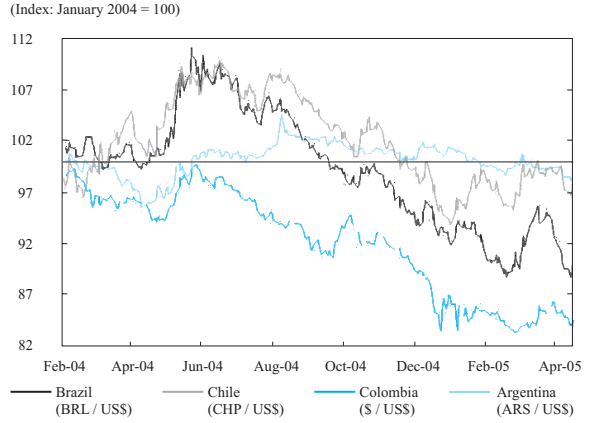
December and March (11.9% annual) exceeded the predictions in earlier reports (Graph 10). However, what happened this month shows the market will pay closer attention to any event denoting a possible change in the Fed's position that might make it more attractive to invest in the United States than in other parts of the world.

In the Colombian case, the external events in March boosted treasury bond rates (TES) as well, particularly for those with longer maturities. This has not happened since mid-2004. Even so, some of the recovery was corrected in recent weeks, following the trend towards appreciation in the exchange rate (Graph 11).

Inasmuch as the world economy has continued to grow at a relatively fast pace, prices for commodities, particularly those exported by Colombia (mainly oil, coffee, nickel, coal and gold) remained high or increased in the last few months. Coffee is a good example, with a more than 46% rise in price during the first three months of the year compared with the average increase in 2004. The same was true of nickel, which was up by 11% in

GRAPH 9

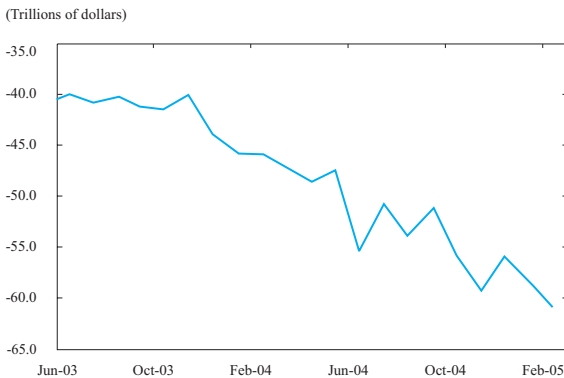
**U.S. DOLLAR EXCHANGE RATE FOR DIFFERENT LATIN AMERICAN CURRENCIES**



Source: Datastream.

GRAPH 8

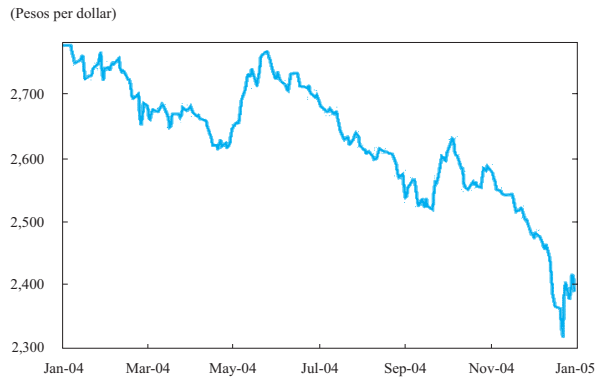
**UNITED STATES TRADE BALANCE**



Source: United States Department of Commerce.

GRAPH 10

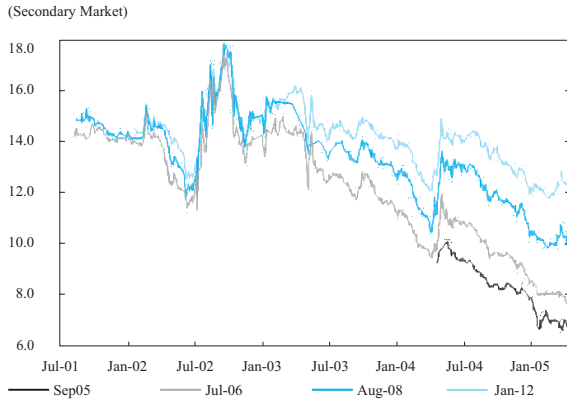
**REPRESENTATIVE MARKET RATE (\*)**



(\*) Rate calculated on 25 April 2005.  
Source: Banco de la República.

GRAPH 11

SECONDARY MARKET INTEREST RATES FOR TES (\*)

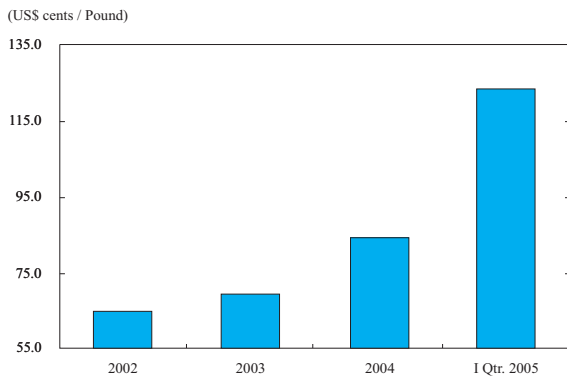


(\*) Information at April 18, 2005. Source: Banco de la República.

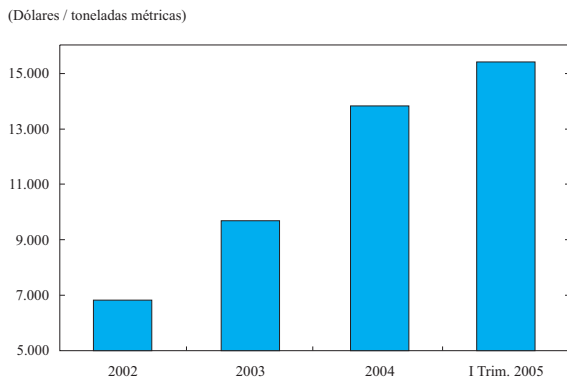
GRAPH 12

INTERNATIONAL PRICES

COFFEE



NICKEL



Source: World Bank (Pinksheet).

price (Graph 12). The December edition of the Inflation Report did not anticipate that prices for Colombia's raw material exports would be so favorable.

B. THE INTERNAL SITUATION

1. Growth in 2004

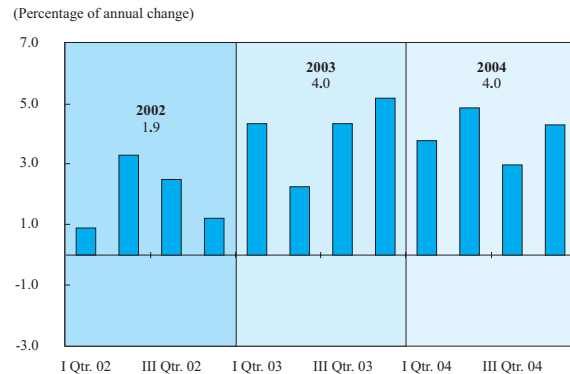
Fourth quarter GDP figures released by the National Bureau of Statistics (DANE) indicate the economy continued to expand in 2004. On this occasion, the increase was 4% for the second year in a row (Graph 13).

The same figures also show the third quarter slowdown was mostly temporary and related to supply shocks, as indicated in the last report. In the fourth quarter, GDP growth came to 4.3% (with a 16% reduction in illicit crops), regaining the growth rate observed since mid-2003.

In this respect, it is important to point out that DANE raised the GDP figures for 2004, especially for the third quarter (from 2.4% to 2.9%) and for 2003 (from 3.8% to 4.0%). This was largely

GRAPH 13

ANNUAL GDP GROWTH



Source: National Bureau of Statistics (DANE). Banco de la República calculations.

because of the change in the method used to calculate civil works. Even so, the cutback in civil works (17.2%) negatively affected GDP in 2004.

In contrast with 2003, the non-tradable sectors such as construction, commerce and services were the most dynamic in 2004, with 4.4% growth for the entire year. The figure for the tradable sectors was 3.2%, primarily because of limited growth in agriculture and livestock (2.1% for the year) (Graph 14).

On the spending side, domestic demand (absorption) accelerated in 2004, having risen 5.4% compared with 2003. The fourth quarter saw important growth (6.5% annual). Domestic demand has been on the rise since mid-2003, at rates around 5%. This is well above the pace of GDP growth (Graph 15).

The most dynamic factors on the demand side in 2004 were private investment (22.5% growth) and exports (9.2%). Last year, total investment as a share of GDP was 19.1%, which is above the historic average for the last 30 years (17.2%) (Graph 16).

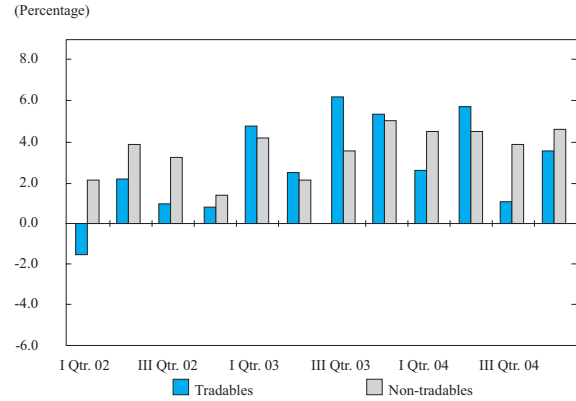
Imports rose during 2004, thanks to economic recovery. Intermediate and capital goods accounted for 80.2% of the imports into Colombia and increased at respective rates of 25.0% and 16.4%. As illustrated in Graph 17, there is a close connection between the economic cycle and imports. For example, in the years when real import growth was above 8%, the economy grew by 4% or more. This is explained by the fact that imports of intermediate and capital goods depend primarily on the pace of economic activity.

## 2. External Demand and Tradable Production

Favorable external conditions allowed for a major increase in Colombian exports during 2004, when

GRAPH 14

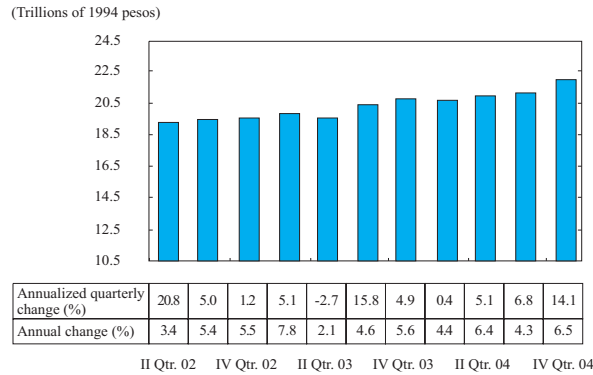
### TRADABLE AND NON-TRADABLE GDP



Source: DANE. Banco de la República calculations.

GRAPH 15

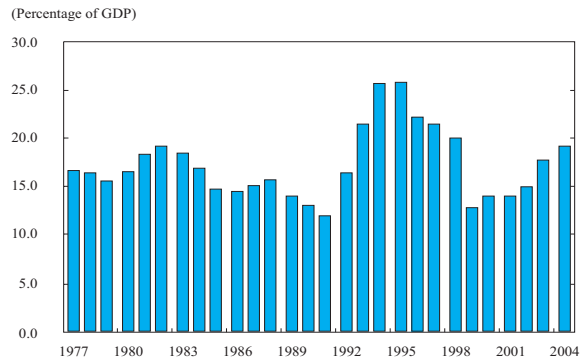
### DOMESTIC DEMAND (SEASONALLY ADJUSTED SERIES)



Source: DANE. Banco de la República calculations.

GRAPH 16

### TOTAL INVESTMENT AS A PORTION OF GDP

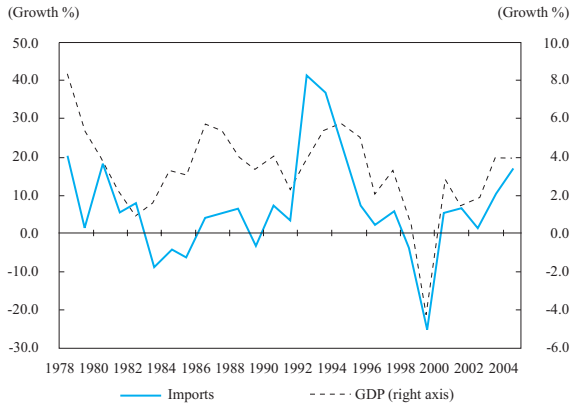


Source: DANE. Banco de la República calculations.



**GRAPH 17**

**REAL ANNUAL GROWTH  
IN GDP AND IMPORTS**



Source: DANE. Banco de la República calculations.

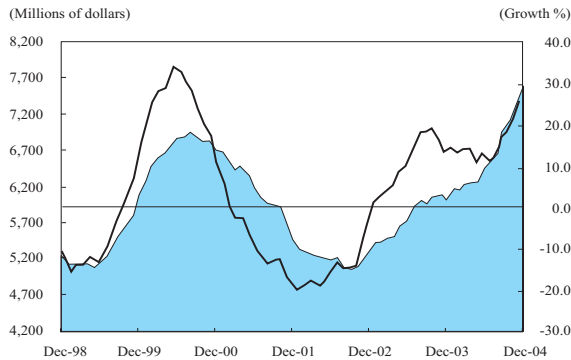
their dollar value rose to US\$16.2 b. This is the highest in the country's history. Compared with 2003, the total rate of export growth was 25.6%, one of the best in recent years, as opposed to 28% for non-traditional exports (Graphs 18 and 19). There was strong growth in exports to all destinations, but mainly to Venezuela and the United States.

The force of exports in 2004 boosted growth in the tradable sectors, especially the manufacturing industry, which saw a 4.8% increase in 2004, the highest since 2001 (Graph 20).

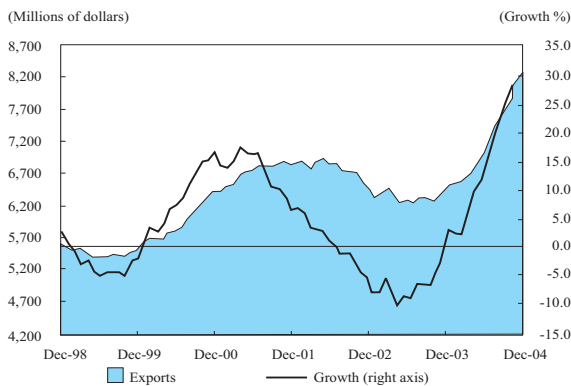
**GRAPH 18**

**EXPORTS  
(ACCUMULATED IN 12 MONTHS)**

**TRADITIONAL EXPORTS**



**NON-TRADITIONAL EXPORTS**

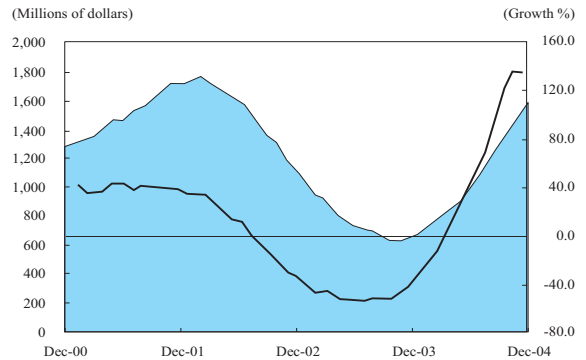


Source: DANE. Banco de la República calculations.

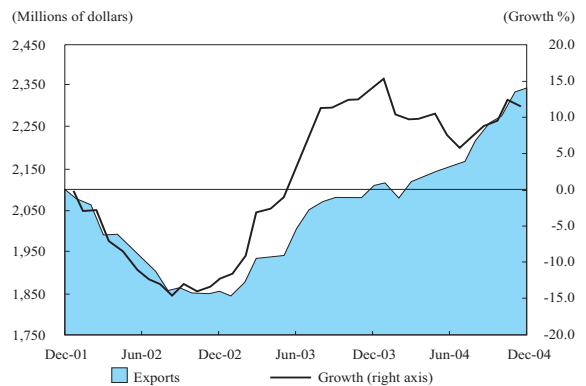
**GRAPH 19**

**NON-TRADITIONAL EXPORTS  
(ACCUMULATED IN 12 MONTHS)**

**TO VENEZUELA**



**TO THE UNITED STATES**



Source: DANE. Banco de la República calculations.

Although the fourth quarter witnessed a slowdown in industry, the pace of growth was important (4%). By January 2005, the figures showed an additional slowdown (growth was 2.0%), but perhaps because there were fewer working days compared with January 2004. Even with an adjustment for this factor, growth is still at the 4% level.

Results in the agriculture and livestock sector varied in 2004, depending on the different branches. For example, agricultural products other than coffee and cattle grew at a good pace. However, average coffee production for the year was down by 1.2%.

The situation in the mining sector was similar. While coal production increased by 16.2% and non-metallic minerals by 8.6%, thanks to private construction, oil production was down by 1.7% and metallic minerals by 5.0%.

### 3. Domestic Demand and Non-tradable Production

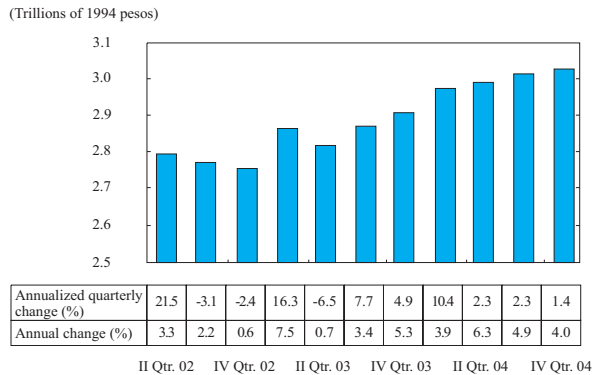
Fourth-quarter information rules out a slowdown in domestic demand due to the possibility of weaker household spending. This variable, which went from 4.4% annual growth in the first quarter to 4.1% and 3.2% in the second and third quarters, bounced back considerably at the end of the year (3.8%).

The annualized quarterly variations were more consistent throughout the year, showing a surge in growth of household consumption from 1.5% in the first quarter to 6.3% in the last part of the year (Graph 21). Increased household consumption in 2004 was largely because of the growth in consumption of durables (18.5%) and semi-durables (4.0%). Consumption of non-durables and services also rose, but at more moderate rates (2.8% and 2.4%, respectively).

Less unemployment and an increase in formal jobs were among the more important factors that allowed for this expansion. The unemployment rate declined by almost 1.5 percentage points during 2004

GRAPH 20

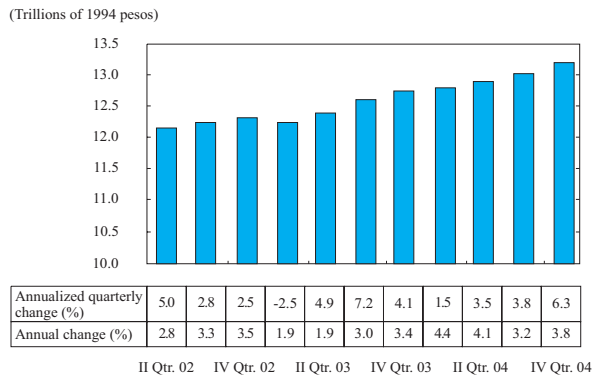
GDP IN THE INDUSTRIAL MANUFACTURING SECTOR  
(SEASONALLY ADJUSTED SERIES)



Source: DANE. Banco de la República calculations.

GRAPH 21

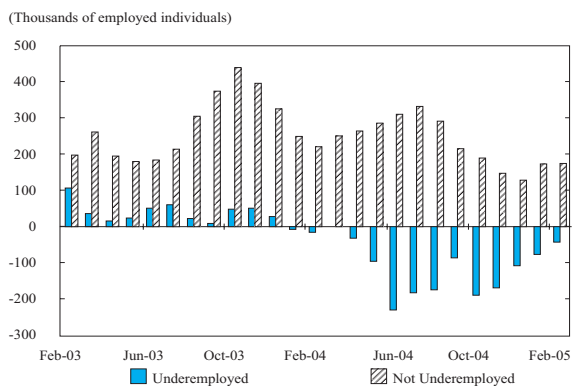
HOUSEHOLD CONSUMPTION  
(SEASONALLY ADJUSTED SERIES)



Source: DANE. Banco de la República calculations.

**GRAPH 22**

**BREAKDOWN OF JOB CREATION IN 13 CITIES**



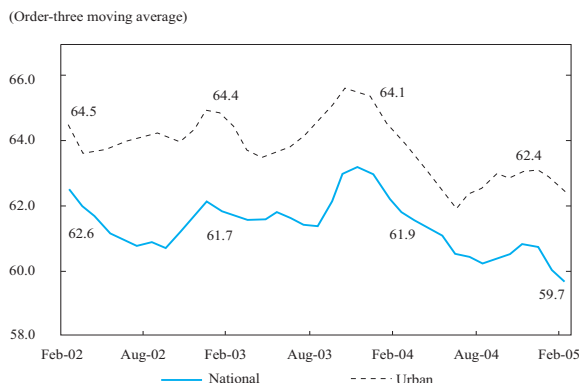
(nationally and in the urban area), and this trend was still evident in February.

Although total employment rose slightly, especially in the second half of 2004, this was due in part to less underemployment. Formal employment, in contrast, continued to grow (although not as quickly in the second half of the year). Available figures for 2005 show this recovery continues (Graph 22).

As noted in previous reports, the rate of unemployment is down because of a major reduction in the labor supply, which is measured by the global participation rate (GPR) (Graph 23). The drop in the GPR could be due to better and more stable family income as a result of more jobs in the formal sector. Higher and more stable family income usually enables secondary workers to leave the job market (i.e., young people, housewives and older adults). These are precisely the groups that have abandoned the job market recently, as indicated by the change in the number of occupied individuals according to age groups (Graph 24).

**GRAPH 23**

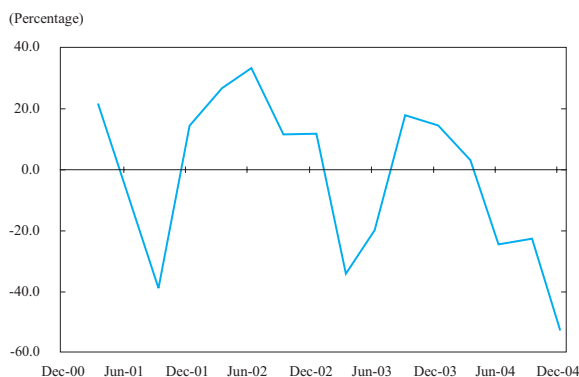
**GLOBAL PARTICIPATION RATE**



Although household consumption helped to perk up private spending during 2004, this increase was mainly the result of private gross fixed capital formation. Private investment was the spending item that contributed the most to economic growth in 2004 (accounting for 2.8% of the 4.0% increase), and offset the 17.0% drop in gross fixed capital formation in civil works. Up to and including the fourth quarter of 2004, investment completed 10 quarters of real annual growth above 10%.

**GRAPH 24**

**CREATION OF JOBS FOR INDIVIDUALS IN THE 12-TO-17 AGE GROUP (\*)**



(\*) Pertains to 2.5% of all those employed.  
Source: DANE. Banco de la República calculations.

Thanks to the increase in domestic demand, private non-tradable GDP (excluding government services and civil works) rose by more than 5% in 2004, maintaining the stability observed in these sectors ever since late 2002 (Graph 25).

### C. MONETARY AGGREGATES, CREDIT AND INTEREST RATES

Liquidity in the economy remains broad. During the year to date, the main monetary aggregates have increased at rates above those of nominal output (more than 10% annual) and tended to accelerate. M3 is a case in point and has grown at an increasing rate since the second half of 2004. The first quarter of 2005 saw this trend accentuate and, at March, the annual nominal rise in M3 was 17.4%, the highest it has been since October 1998. For various reasons related to the economic recession in 1999, with the subsequent financial crisis and the tax on bank transactions, growth in the M3 aggregate was less than dynamic in the last five years. This situation seems to have changed, at least in the last three quarters (Graph 26).

The recent trend in M3 is explained largely by more growth in public M3 as opposed to private M3. This acceleration also suggests that Colombians have more of a preference for assets denominated in pesos, given exchange rate appreciation, low external interest rates and a more favorable country-risk perception.

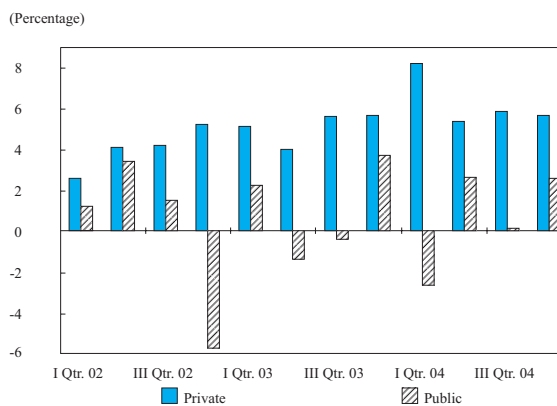
The accumulation of international reserves was one of the main sources of primary growth in the first quarter of 2005. Banco de la República made US\$773.8 million (m) in discretionary purchases of foreign exchange during that period, adding Col\$1,813 billion (b) to the money supply. However, part of the growth in this item is being offset by the net repo balance, as well as an increase in government deposits with Banco de la República and the sale of foreign currency to the government (Table 1).

At any rate, primary liquidity continued to increase at a high rate, as was the case at the end of 2004. Between December 2004 and March of this year, annual growth in the money supply went from 16.3% to 19.2%. The same was true of M1, with an increase in growth from 15.9% to 18.1% during the same period (Graph 27).

Although there is no conclusive information to this effect, the acceleration in base money could suggest a greater demand for money. The increase in base

GRAPH 25

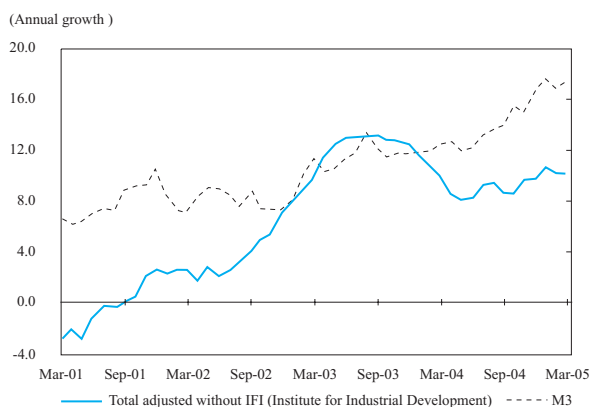
#### NON-TRADABLE GDP



Source: DANE. Banco de la República calculations.

GRAPH 26

#### NOMINAL GROSS PORTFOLIO (\*) AND M3



(\*) In L/C, excluding FEN.  
Source: Banking Superintendent. Banco de la República calculations

TABLE 1

**SOURCES OF BASE MONEY**  
(BILLIONS OF PESOS)

	Annual Variation		Annual Variation Mar-05	Year to Date Mar-05
	2003	2004		
<b>I. Government</b>	1,565	(236)	(1,507)	(1,964)
Profits transferred	1,482	803	454	454
Pesos	830	803	0	0
Dollars	651	0	454	454
Deposits with the Banco de la República	83	(1,039)	(1,961)	(2,418)
<b>II. TES Regulation</b>	568	(2,524)	819	2,759
Definitive purchases	893	1,023	3,819	2,802
Definitive sales		(2,972)	(2,513)	0
Maturity	(325)	(575)	(487)	(43)
<b>III. Repos</b>	1,492	(1,058)	(853)	(1,723)
Expansion <sup>1/</sup>	1,386	(1,086)	(1,199)	(1,723)
Contraction	106	28	346	0
<b>IV. Foreign Exchange</b>	(703)	6,194	3,511	(1,575)
Put options	(703)	4,183	3,075	0
Discretionary intervention	0	3,264	5,076	1,813
Sale of foreign exchange to the government	0	(1,252)	(4,640)	(3,387)
<b>V. Others <sup>2/</sup></b>	(412)	272	453	90
<b>Total variation in base money</b>	2,510	2,647	2,423	(2,413)
<b>Base money balance</b>	16,615	19,262	16,848	16,848

<sup>1/</sup> Includes one-day, overnight and medium-term repos.

<sup>2/</sup> Includes the monetary impact of the P&L, TES A maturities, portfolio recovery and investments by Banco de la República.

Source: Banco de la República.

money during the year to date is associated with a major increase in bank reserves. At present, some of the additional liquidity from closure of the contraction window in late 2004 has added to excess reserves in the banking system.

Another indicator of possibly greater demand for liquidity is the limited movement in interest rates in recent months, despite closure of the contraction window following an downward adjustment of 25 bp in intervention rates, also at the end of last year. The interbank rate was down by 42 bp between December and March, and the term deposit rate (TDR) went from 7.76% to 7.34% (Graph 28).

The drop in lending rates has yet to exert an impact on all the borrowing rates. For example, there was a slowdown in household borrowing (credit cards and consumer credit), but the transmission to credit for companies (preferential, ordinary and treasury) has not been as clear (Graph 29).

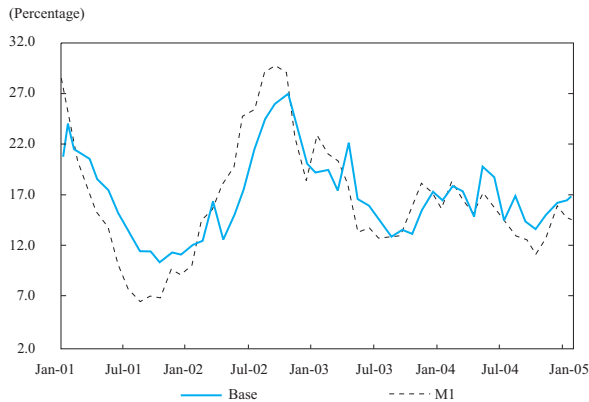
At March, the increase in the gross portfolio in local currency was less than financial savings (M3): 10.3% versus 17.4% (Graph 26). Leading the total gross portfolio were consumer and microcredit, with high growth (31.3% at March) but somewhat down from the percentage registered last December (33.6%). In contrast, the commercial portfolio showed less of an increase (9.5% at March), but was not much different from what it had been seen since mid-2004, while the mortgage portfolio continued to contract.

The portfolio in foreign currency has been far more dynamic, with an annual growth increase from 54% to 77% between December and March (Graph 30). Companies apparently are taking advantage of peso appreciation to obtain loans in foreign currency at very low interest (mostly short-term credit). They cover the exchange risk by purchasing forwards. In the end, the entire operation guarantees them lower rates than what they would be paying on the domestic market.

The build up in other funding alternatives for households and companies may have been affected by the vigor in credit (in local currency). As indicated in the last report, the issue of bonds and paper, coupled with reinvestment of company

GRAPH 27

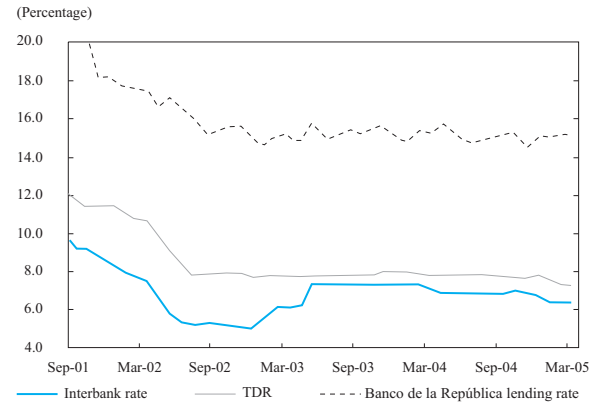
**MONETARY AGGREGATES  
ANNUAL RATES OF GROWTH  
IN THE MONTHLY AVERAGE**



Source: Banco de la República.

GRAPH 28

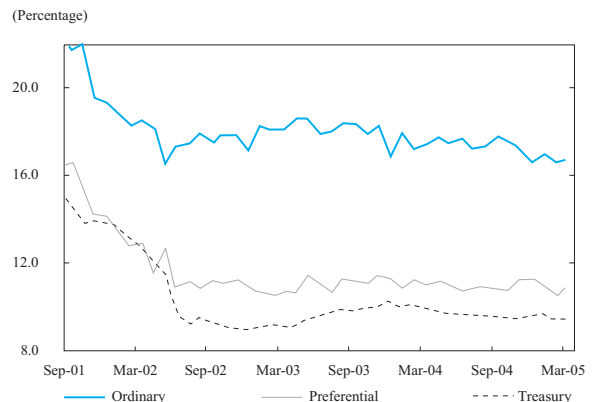
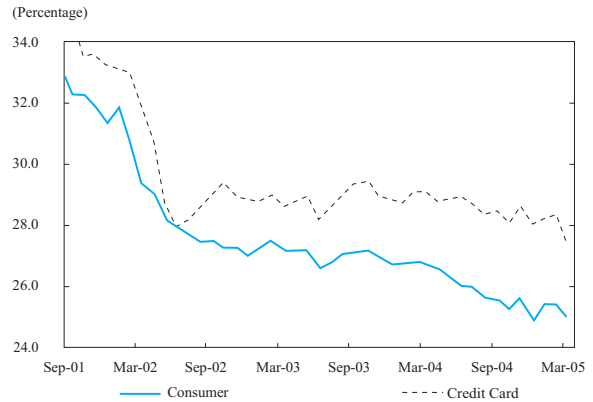
**NOMINAL INTEREST RATES**



Source: Banking Superintendent. Banco de la República calculations.

GRAPH 29

**NOMINAL INTEREST,  
BY TYPE OF BORROWING**

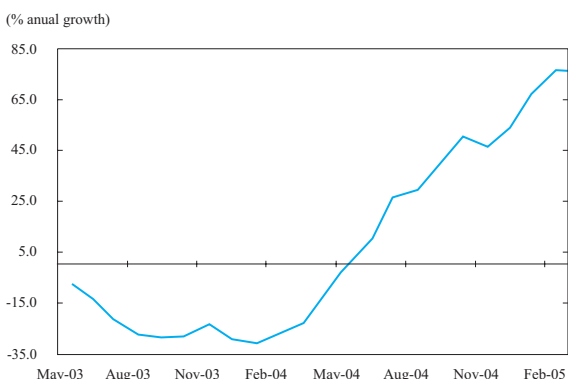


Source: Banking Superintendent. Banco de la República calculations.

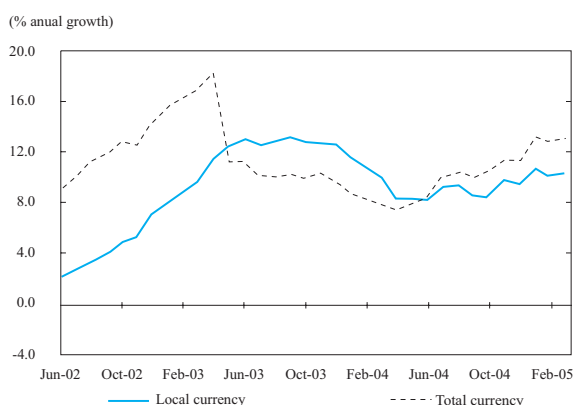
GRAPH 30

GROSS PORTFOLIO

FOREIGN CURRENCY



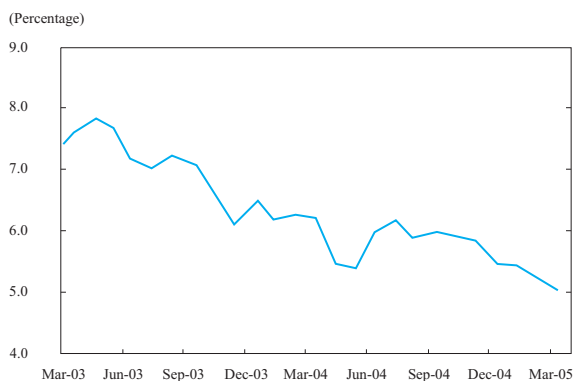
LOCAL CURRENCY AND TOTAL



Source: Banking Superintendent. Banco de la República calculations.

GRAPH 31

ANNUAL CONSUMER INFLATION



Source: DANE.

profits, are a strong complement to commercial credit. In the case of consumption, the substitution spells more household preference for soft credit from funds, especially employee funds and cooperatives. As to mortgage credit, scheduled savings funds (AFC and VIS) are taking the place of direct loans.

D. INFLATION AT MARCH AND ITS DETERMINANTS

1. Figures at March

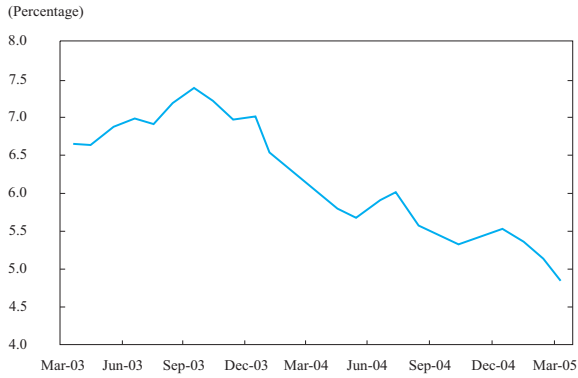
Annual consumer inflation was 5.0% in March, down 48 bp from the figure in December 2004 (Graph 31). Less consumer inflation was possible thanks to a sharp drop in non-food inflation, which was 4.8% at March. This is 70 bp below the rate at the end of 2004 (Graph 32). Food inflation fluctuated around 5.5% in the first quarter (Graph 33).

All the core inflation indicators continued to decline throughout the first quarter of 2005 (Graph 34). At March, the average of the three indicators used by Banco de la República (non-food inflation, nucleus 20, and inflation without staple foods, public utilities and fuel) was 4.8% (the lowest on record) and 50 bp below the figure in December.

A breakdown of non-food inflation between tradables, non-tradables and regulated goods and services shows generalized reductions. Tradable inflation was 2.5% at March (Graph 35), 100 bp below the figure at December (3.52%). Non-tradable inflation was 4.8% (Graph 36), down 50 bp. Inflation in regulated goods and services (9.5%) also declined in relation to December (by 70 bp). Most of the drop in non-food inflation (70 bp) came from tradable inflation (36 bp). However, the decline in non-tradable inflation (26 bp) also was an important factor, something that was not observed in 2004.

GRAPH 32

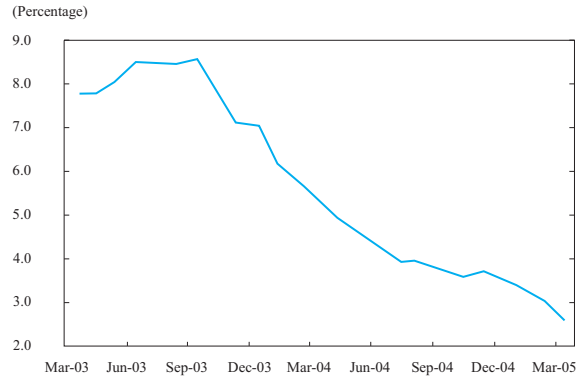
CPI WITHOUT FOOD (ANNUAL VARIATION)



Source: DANE. Banco de la República calculations.

GRAPH 35

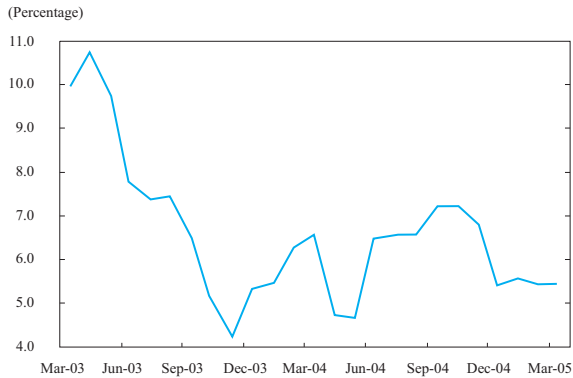
TRADABLE CPI WITHOUT FOOD AND REGULATED GOODS AND SERVICES (ANNUAL VARIATION)



Source: DANE. Banco de la República calculations.

GRAPH 33

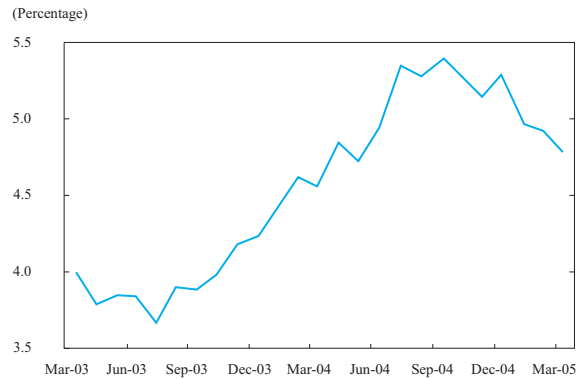
FOOD CPI (ANNUAL VARIATION)



Source: DANE. Banco de la República calculations.

GRAPH 36

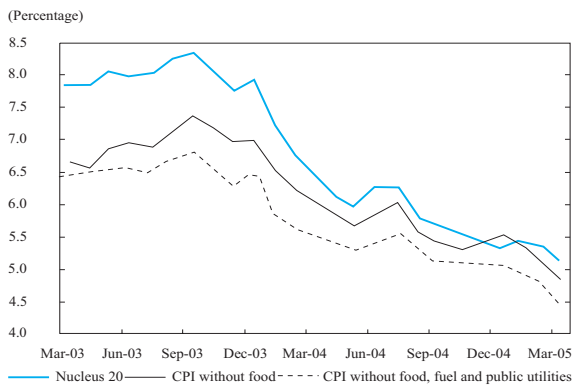
NON-TRADABLE CPI WITHOUT FOOD AND REGULATED GOODS AND SERVICES (ANNUAL VARIATION)



Source: DANE. Banco de la República calculations.

GRAPH 34

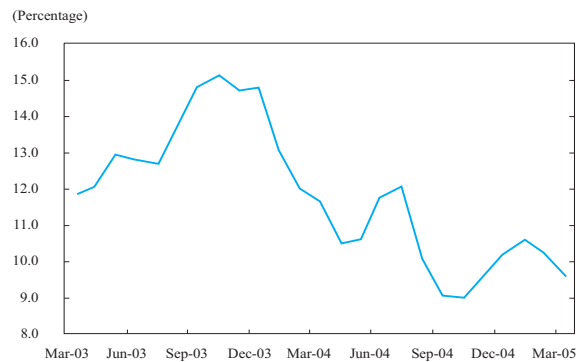
CORE INFLATION INDICATORS (ANNUAL VARIATION)



Source: DANE. Banco de la República calculations.

GRAPH 37

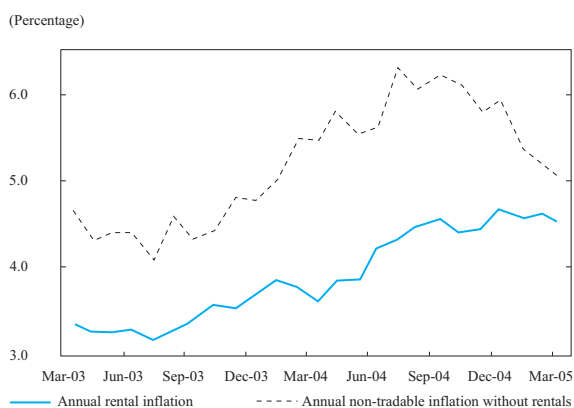
REGULATED CPI (\*) WITHOUT FOOD



(\*) Water and sewage, electricity, gas, fuel and public transportation.  
Source: DANE. Banco de la República calculations.



CPI FOR RENTALS AND THE OTHER NON-TRADABLES



Source: DANE. Banco de la República calculations.

For nearly a year, the reduction in tradable inflation (without food) has been associated with appreciation in the exchange rate. The downturn in inflation for this group was more pronounced in recent months than in the second half of 2004, possibly because of two factors. One is the acceleration in appreciation at the end of 2004, which did not impact prices until early this year, given the normal lag between these two variables. Another is the fact that companies usually revise their prices in the first quarter of the year<sup>2</sup>. Accordingly, the appreciation accumulated in the second half of 2004 did not result in lower prices for tradables until the beginning of 2005.

In terms of tradables, the only subgroup with no reduction was that comprised of texts, notebooks and other school articles and expenses. By March, prices for these items had increased at an annual rate of 8.5%, well above the figure in December (7.3%). During the last five years, inflation in this subgroup has exceeded the targets set by Banco de la República, but reflects a cycle that is associated with developments in the exchange rate.

Non-tradable inflation clearly was on a downward path in the first quarter of 2005, following steady increases between July 2003 and July 2004, and after having been relatively stable during the second half of last year. The break in the trend in non-tradable inflation is generalized within the group. In the case of rentals, the decline in inflation is small but significant, given their weight on the CPI and because the level (4.5% at March) is in the lower limit of the target range (Graph 38). Other goods and services (the “others” subgroup) experienced a sizable drop in inflation (90 bp) to 5.0% at March (Graph 38).

Given the volatility of these sub-indexes, it is still difficult to determine whether the break in the inflation trend for non-tradables (only one quarter old) is permanent or temporary. Much of the reduction should be permanent, provided it was sparked by less pressure from demand and by declining expectations that are consistent with the inflation targets.

Finally, with respect to inflation in regulated goods and services, the first-quarter reduction affected the three major components of the group: public utilities, fuel and regulated transportation. Although the current year has seen several major increases in fuel prices, they were less than those

*It still is difficult to determine whether the break in the inflation trend for non-tradables is permanent or temporary.*

<sup>2</sup> See “Distribution of Changes in Inflation during the Course of a Year,” Box 1 in the *Inflation Report*, September 2004, pg. 33.

witnessed during the same period in 2004. Therefore, annual inflation for this component is lower. The situation with respect to regulated public transportation was similar.

## 2. Inflation Determinants

The reduction in inflation during the first quarter remained linked to accumulated appreciation in the exchange rate. The drop in the representative market rate (RMR) at the start of the year probably put the brakes on price hikes for tradable goods, which are normal at this time of year.

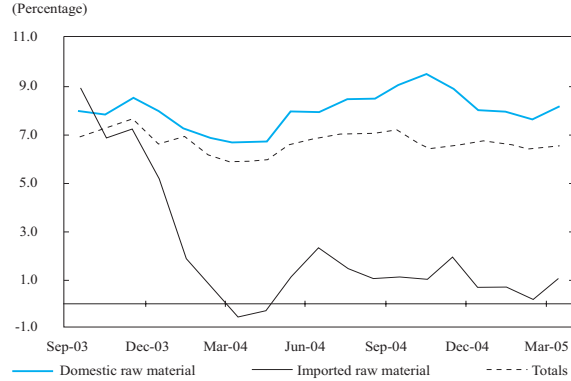
Appreciation also continued to neutralize the upward impact of the rise in fuel prices, transportation fares, and the price of certain imported raw materials and agricultural products. The indicator of total costs, calculated by the Bank using the input-output matrix and the producer price index (PPI), denotes stable annual inflation at 6.5% as of September 2004 (Graph 39). This contrasts with inflation in the cost of domestic raw materials, which is much higher and rising (8.1% at March) (Graph 39).

The sizeable drop in non-tradable inflation also suggests that demand-pulled inflationary pressure is low and there are fewer expectations of inflation. However, given the invisible nature of these variables, it is difficult to determine which of the two factors has done the most to break the trend in non-tradable inflation. However, their influence clearly seems to have increased in recent months. This is something that was not contemplated in the forecasts or in the December report.

In the case of inflationary expectations, the evidence is relatively clear. The various surveys indicate these expectations have declined in recent months to levels that are consistent with the 5% target. Among all the available indicators, the one that has declined the most is calculated with the rate differential between fixed-rate TES and TES UVR (Graph 40). Expectations measured by the quarterly survey in January tell a similar story (Graph 41) and, with the

GRAPH 39

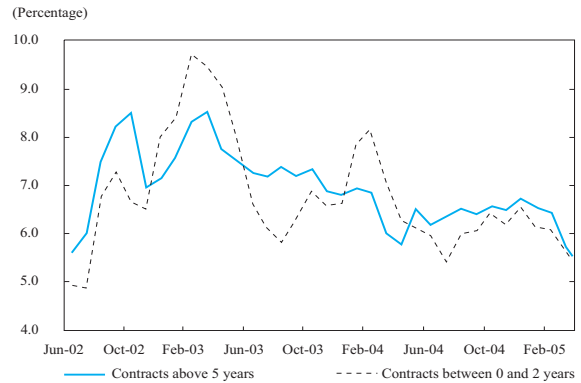
PRODUCTION COST INDICATORS  
(ANNUAL VARIATION)



Source: Banco de la República.

GRAPH 40

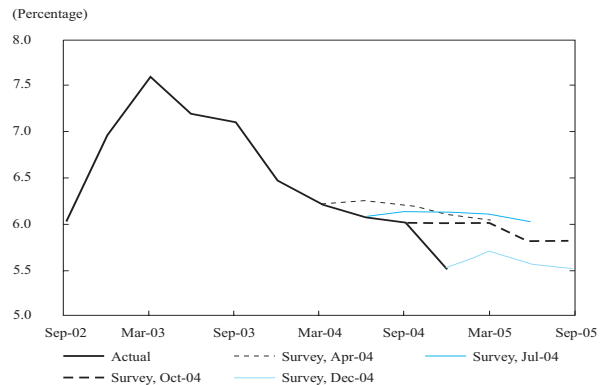
INFLATIONARY EXPECTATIONS DERIVED FROM TES  
CONTRACTS AT FIXED AND VARIABLE RATES (\*)



(\*) With inflation at April 18.  
Source: DANE. Banco de la República calculations.

GRAPH 41

ACTUAL INFLATION AND INFLATIONARY EXPECTATIONS  
(ANNUAL INFLATION)



Source: Banco de la República.

TABLE 2

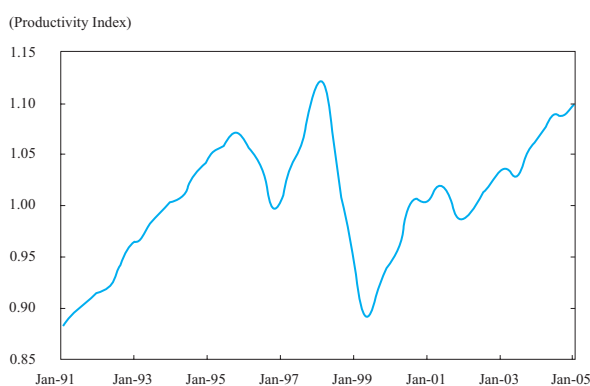
PERCENTAGE OF BENEFICIARIES, BY AGREED WAGE INCREASE LEVEL

Increase	<5	[5.6]	[6.7]	[7.8]	[8.9]	>9
Dec. 2004	1.90	10.66	36.10	41.37	7.92	2.05
Feb. 2005	1.77	64.37	20.43	11.55	1.79	0.09

Source: Ministry of Social Protection. Banco de la República calculations.

GRAPH 42

LABOR PRODUCTIVITY PER HOUR WORKED IN INDUSTRY (SEASONALLY ADJUSTED SERIES WITHOUT THE NOISE ELEMENT)



Source: DANE. Banco de la República calculations.

recent decline in inflation, the April survey is likely to show a new reduction in expectations. Also, according to the monthly survey of financial institutions and brokerage firms in March, the financial system anticipates 5.3% inflation by the end of the year.

The drop in expectations is reflected in wage adjustments, at least those negotiated via collective bargaining agreements. Figures released by the Ministry for Social Protection show a significant reduction in the size of the adjustments for 2005 compared with those in 2004. Wage hikes this year are very much in line with the target range defined by the BDBR. For example, 66% of the workers who are covered by collective bargaining agreements accepted increases under 6.0%, which is far less than in 2004 (12.5%) (Table 2). This also helped to hold down the cost of both tradable and non-tradable goods and services.

Evidence with respect to the output gap is less conclusive. The following supports the assumption that the output gap is wider.

- ✦ The major increase in investment. This phenomenon, now almost three years old, has been an important factor, particularly in sectors like industry, as indicated by several partial indicators such as capital goods imported by that sector.
- ✦ The reduction in core and non-tradable inflation amidst a scenario of relatively satisfactory growth suggests there have been gains in productivity. In this respect, new investments, largely in imported capital goods and in company mergers and reorganization, probably favored technical changes in sectors such as industry and communications, or perhaps in non-tradable sectors such as commerce and transportation.
- ✦ One indication in this direction is the course of labor productivity in industry (adjusted by the number of hours worked), which has risen steadily and to an important degree since 2001. Average annual growth in 2003 and 2004 was around 3% (Graph 42).

⊗ Because of the recent drop in unemployment and the decline expected for the years ahead, provided growth is 4%, the estimated stable inflation rate of unemployment (that is, the unemployment rate with no acceleration in inflation: NAIRU<sup>3</sup>) was revised downward. This widens the gap measured by the labor market figures in relation to the estimate included in the last report. In other words, the situation on the labor market in 2005 is looser than what was anticipated earlier.

There are, however, signs in the opposite direction that suggest a narrower output gap. One of the most important ones is the percentage of industrial companies that regard the lack of demand as a problem or obstacle to increased production (according to the survey by the National Association of Industrialists-ANDI). This proportion is consistent with various estimates of the output gap, and has been falling steadily for several quarters (Graph 43). Similarly, the gap estimated by the standard statistical method (Hodrick-Prescott filter or the Band-Pass filter) also is fairly narrow for the end of 2004.

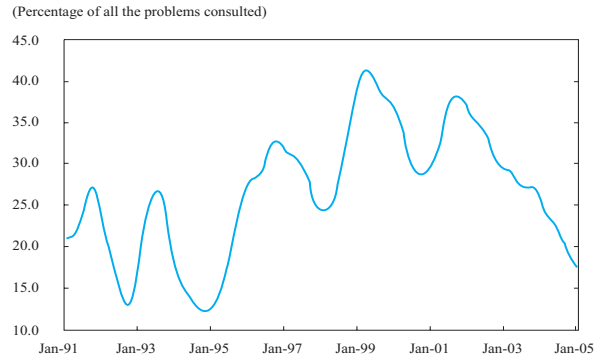
Indicators of use of installed capacity for industry (UCI), specifically the ones calculated by Fedesarrollo (with figures at November) and Andi (with figures at January), suggest the gap is closing<sup>4</sup> (Graph 44), but there is still enough excess production capacity to satisfy an increase in demand through quantity more than price. An alternative indicator derived from the Fedesarrollo survey in November; namely, the proportion of companies with a UCI above their historic average, also indicates similar results (Graph 45).

<sup>3</sup> The non-accelerating inflation rate of unemployment.

<sup>4</sup> When considering more than just the tendential component, the January figure for ANDI does show a large jump compared with the same month in previous years.

GRAPH 43

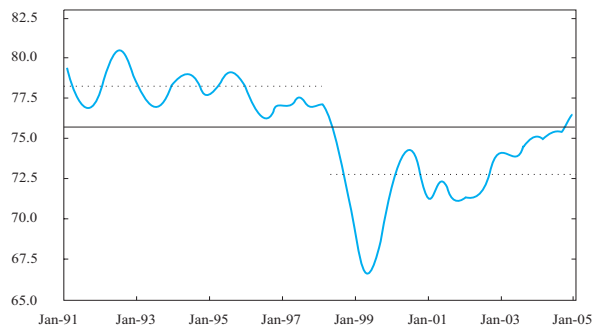
**DEMAND AS THE MAIN PROBLEM FACING BUSINESSMEN (\*)**  
(TENDENTIAL COMPONENT)



(\*) Percentage of industrial companies that believe insufficient demand is the main obstacles to expanding production.  
Source: ANDI. Banco de la República calculations.

GRAPH 44

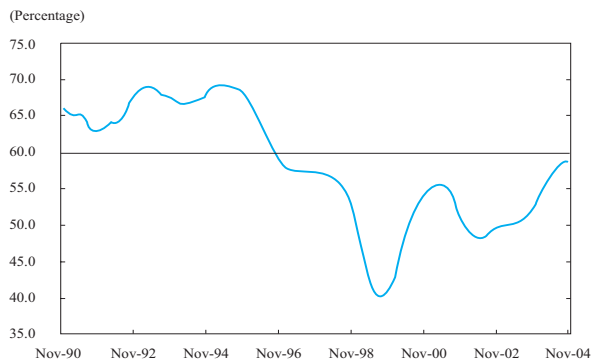
**USE OF INSTALLED CAPACITY, ACCORDING TO ANDI**  
(TENDENTIAL COMPONENT)



Source: Fedesarrollo and ANDI. Banco de la República calculations.

GRAPH 45

**COMPANIES WITH INSTALLED CAPACITY ABOVE THE HISTORIC AVERAGE**



Source: Fedesarrollo. Banco de la República calculations.

Finally, the models used by Banco de la República overestimated core inflation in the first quarter by quite a bit. For example, in the case of the transmission mechanism model (TMM), the projection for non-food inflation was 5.3% in the December report (and 4.8% in fact). These forecast errors suggest a disinflationary surprise in the first quarter of the year. However, it is not known if this surprise is temporary and will reverse itself during the second quarter, or if it is permanent.

## IMBALANCES IN THE UNITED STATES ECONOMY AND A WEAKER DOLLAR<sup>1</sup>

Since March 2002, the dollar has depreciated against the currencies of all major U.S. trading partners (Table B1). Although average appreciation of the Colombian peso was 11.5% in nominal terms during 2004, the peso devaluated 1.87% against the dollar between 2002 and 2004.

**TABLE B1**  
**AVERAGE NOMINAL DEVALUATION**  
**(PERCENTAGE)**

	Japan	United Kingdom	Mexico	Canada	China	Euro zone
<b>2002</b>	4.16	(4.20)	3.35	1.45	0.00	(4.92)
<b>2003</b>	(7.25)	(7.88)	11.72	(10.88)	(0.16)	(16.63)
<b>2004</b>	(7.47)	(11.14)	4.63	(7.03)	0.09	(8.94)
<b>2002-2004</b>	(14.18)	(18.15)	16.89	(17.14)	(0.07)	(24.08)

Source: Datastream.

Most analysts believe the dollar has weakened because of the huge imbalances that exist in the U.S. economy. With figures at September 2004, the current account deficit in the U.S. economy was equivalent to 5% of GDP (US\$577 b), mainly because of the merchandise trade deficit (5.4%) (Graph B1). In spite of a service trade surplus (0.5%), with a debt close to 30% of GDP, interest payments in 2005 are expected to surpass the return on investments abroad<sup>2</sup>. This will be the first time this happens.

Although not overly high, this level of indebtedness is growing at an increasing rate. According to some calculations, if the United States begins to reduce its deficit as of this year, its borrowing level would rise to 50% before it stabilizes<sup>3</sup>. Countries like New Zealand and Australia have lived with higher levels of indebtedness. Yet, because of the size of their economies, their deficits exert no pressure on world savings<sup>4</sup>. Moreover, the reserves of the other countries in the world are not denominated in their currencies<sup>5</sup>. The following is an explanation of the primary reasons for the macroeconomic imbalances in the United States and how they might be resolved.

<sup>1</sup> For a more detailed analysis, see Torres, J.L. and J.M. Ramírez (2005), «El Debilitamiento del Dólar», Programming and Inflation Department, Banco de la República.

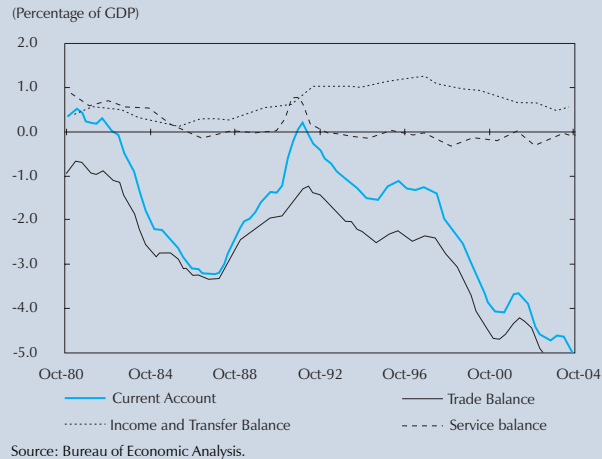
<sup>2</sup> This is something new, inasmuch as most U.S. investments outside the country are foreign direct investments and stocks (with an average yield of 7.6% e.a. in 2004), while the debt is mostly treasury and agencies (with an average yield of 3.4% e.a. in 2004).

<sup>3</sup> HSBC (2005). «Global Economics. The U.S. Current Account Deficit: A Ticking Time Bomb», Q1.

<sup>4</sup> Funding the deficit in the U.S. economy absorbs 85% of the surplus of the other economies in the world.

<sup>5</sup> Nearly 65% of all international reserves the world over are denominated in dollars.

**GRAPH B1  
TRADE BALANCE**

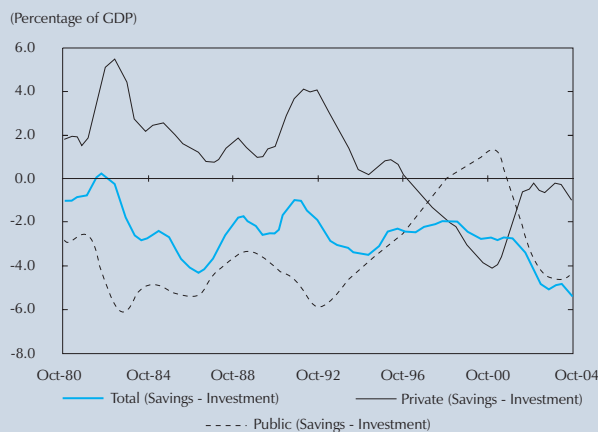


## I. Savings-Investment Balances

Using basic macroeconomic identities, the current account deficit can be related to the savings and investment balances of the different agents in an economy. As illustrated in Graph B2, the private sector in the United States generated more savings than investment (income over expenses) during the eighties and up until the mid-nineties, while the public sector was in deficit. This situation reversed itself between 1997 and 2000. However, since the onset of the Bush administration in 2001, the public sector went from a fiscal surplus of 1.3% to a deficit of 4.4% in September 2004.

On the other hand, the fall-off in the private imbalance (from 4% in 2001 to 1% in 2004) is explained by more company savings (which rose from 2% to 4%) and by less private investment

**GRAPH B2  
SAVING AND INVESTMENT BALANCES**



of a similar magnitude. In contrast, the long-term trend in household savings is downward (from 9% in 1982 to 1% in 2004).

In the public sector, fiscal deterioration can be traced to the decline in federal savings. During the Clinton era, federal revenue increased from 18% to 21% (between 1993 and 2000), while expenses declined from 23% to 19%. However, in the Bush administration, revenue went from 21% to 17% (between 2000 and 2004), while expenses were up from 19% to 20%<sup>6</sup>. The variation in revenue is explained primarily by changes in personal income tax. During the Clinton years, the tax burden rose from 7.5% to 10.5%, but was lowered to 6.7% at the end of the first Bush administration<sup>7</sup>. So far, the U.S. government has showed no interest in dismantling the tax relief measures introduced during the recession in 2001. The Budget Office plans to cut the deficit in half during the next four years through less government spending (with lower farm subsidies and less spending on health and education, and by doing away with a number of social welfare programs and agencies). However, it is considered unlikely that Congress will pass a law to this effect<sup>8</sup>. Therefore, it is difficult to expect the shortfall in tax revenue to be reduced anytime in the near future, at least with the policies outlined to date.

## II. Financing the Imbalances

How have the imbalances been financed? Graph B3 shows the capital account registered a net capital entry of six point GDP. This is explained by a net foreign direct investment of -1% and a net debt of 7% (different from FDI). In other words, the debt in the current account can no longer be financed with long-term investments. It will have to be financed with portfolio investments, which probably are far more liquid and susceptible to changes in agents' perception of risk.

On the other hand, net external financing for the public sector increased from 2% to more than 6% of GDP between 1999 and 2004. A good portion has been with treasury paper, most of which has been purchased by the central banks of foreign countries. They often accumulate reserves in dollars to defend their currencies against the weakening U.S. currency. Worldwide reserves denominated in dollars rose by 1.8 trillion<sup>9</sup> in eighteen months, financing 60% of the United States deficit in 2004<sup>10</sup>.

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<sup>6</sup> Expenses would have increased at least another point, had interest payments on the sovereign debt not declined as a result of the Fed's decision to lower interest rates six times in 2001 and another six times in 2002. This cut the overnight rate from 6.5% to 1%.

<sup>7</sup> Modest tax relief on company profits was introduced during the Bush administration, but led to no more than a half point reduction in GDP (from 2% to 1.5%).

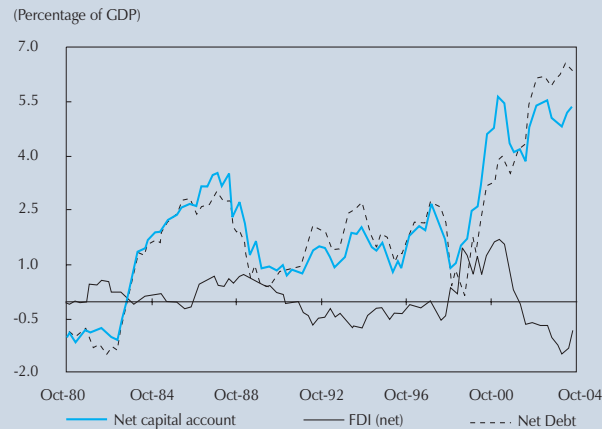
<sup>8</sup> Last year, the Bush administration sent Congress a bill to eliminate 65 government programs in an effort to save five billion dollars. Congress only agreed to eliminate four, saving the government 200 million dollars. The proposal this year is to cut 150 programs at a saving of 15 billion dollars.

<sup>9</sup> The last addition of one trillion in reserves denominated in dollars took a decade. This gives an idea of the fundamental changes in the way the world economy has been operating recently.

<sup>10</sup> The Asian banks (including the Japanese) have been the most active, raising their reserves from 1.1 to 1.8 trillion dollars between 2002 and 2003. The Japanese banks added US\$265 b, the Chinese US\$191 b and the Indian banks, US\$52 b.



**GRAPH B3**  
**NET CAPITAL ACCOUNT**



Source: Bureau of Economic Analysis.

Accordingly, these central banks could incur sizeable losses (by investing in paper at negative real rates). It also exposes them to huge capital losses if the dollar depreciates further.

### III. What are the options?

The macroeconomic imbalances in the United States are not easy to solve. Given the size of the trade deficit, the surplus in services cannot be expected to compensate for the deficit in goods, nor can the high profitability of U.S. foreign investments be expected to offset the trade deficit. On the other hand, the possibility that central banks (e.g. in Japan, China and some emerging economies) will continue to purchase large quantities of U.S. treasury bonds does not appear to be sustainable in the mid-term. In fact, countries such as Russia, South Korea, India and Indonesia already have expressed an interest in beginning to diversify the currencies in which their international reserves are denominated<sup>11</sup>.

Certain factors suggest the required adjustment in the dollar might be even larger than it has been up to now. To begin with, the United States is a relatively closed economy, where foreign trade (the sum of exports and imports) accounts for only 25% of GDP. This means sizable variations in the exchange rate are required to achieve any significant adjustment in the current account deficit. However, they have yet to occur. Furthermore, elasticity of the demand for imports with respect to income in the United States is estimated as being much higher than elasticity of the demand for imports from the United States compared with the increase in

<sup>11</sup> Even China has reduced the proportion of all new purchases represented by assets in dollars.

income in the rest of the world (the Houthakker-Magee effect). Therefore, in a scenario where the United States economy grows at a rate equal to that of its trading partners, the U.S. trade deficit will grow as well. The United States accounts for nearly 35% of world GDP. For this reason, any reduction in its deficit means the rest of the world will have to absorb part of the supply of tradable goods. This would be difficult, given the high savings rate in the Asian countries and the low growth of domestic demand in Europe. Under these circumstances, a lower U.S. trade deficit could spell less global economic growth.

For these reasons, the U.S. deficit should continue to grow in the short term, the dollar should continue to weaken against the currencies of all U.S. trading partners, and the U.S. economy probably will increase its borrowing. According to most analysts, any effort to alter these tendencies would necessitate an increase in taxes to reduce the shortfall in tax revenue. It also would require further depreciation of the dollar against the currencies of U.S. trading partners (including the Asian countries) and a rise in interest rates by the Fed to at least to their historic levels (5%). Measures of this type probably would reduce investment and household consumption among Americans, and would increase savings. In all, these policies would lessen the pace of economic growth in the United States and that of the world economy as well.

Does this mean the U.S. economy will have to make a forced landing? Under similar conditions, any emerging economy certainly would have been obliged to do so. However, the United States has no need to defend its exchange rate, and its legal tender is still the main reserve currency of central banks the world over. In spite of this and the fact that most analysts rule out any drastic correction in the U.S. deficits, at least for the time being (also because of the serious implications this would have for the world economy), many of the economic decisions taken during the current administration seem to be doing little to correct these imbalances.

## II. MACROECONOMIC PROSPECTS

*The forecasts point to vigorous world growth. Exports and investment will continue to drive economic growth, without expectations of inflationary pressure.*

The recent rise in oil prices and the growing external deficit in the United States economy suggest more risk for world economic performance. These circumstances, coupled with higher interest rates, point to a slowdown in economic growth in the United States and in other developed economies during 2005. Even so, the forecasts are for vigorous world growth. This is partly because the economic slowdown in the U.S. is not expected to be large. The expansion in China and good performance by most of the emerging economies is also a contributing factor. The Fed is expected to continue to raise interest rates gradually, and no abrupt correction in the U.S. macroeconomic imbalances is anticipated.

Accordingly, capital will flow into the emerging economies during 2005 and international export prices for raw materials will remain high, near the levels observed in 2004. These conditions will be favorable for Colombia and should result in a lower external deficit for 2005, compared to the forecast three months ago. This is a scenario where exports and investment will continue to drive economic growth. The rise in domestic demand should exert no significant inflationary pressures in the coming quarters, as the economy still has surplus production capacity and there have been major increases in investment and productivity. These factors should raise the potential for economic growth. By the same token, fewer expectations of inflation and less anticipated pressure for depreciation in the coming months could sustain the downward trend in non-food inflation.

*Surplus productive capacity, fewer expectations of inflation and less anticipated pressure for depreciation in the coming months could sustain the downward trend in non-food inflation.*

### A. THE EXTERNAL CONTEXT AND THE EXCHANGE RATE

The prospects for world economic growth in 2005 are good, although less so than in 2004 (Table 3). The forecast for economic growth in the United

States is 3.7%, slightly above the expectation last quarter (3.5%) but down from the increase in 2004 (4.4%).

In this context, household consumption is expected to decline. The gradual rise in interest rates in the U.S. economy last year also is a contributing factor in this respect. Less economic growth and less household consumption would keep inflationary pressures in check. Even so, there are inflationary risks associated with oil prices and with the impact of continued depreciation of the dollar. Nevertheless, these risks are not expected to materialize in the coming quarters.

Economic growth in the euro zone should remain moderate. The forecast for 2005 is 1.9%, which is similar to the growth rate in 2004 and is favored by investment and consumption, although the latter could be affected by high oil prices. On the other hand, a reorganization of public finances for several countries within the Euro zone does not appear to be feasible in the short term.

The prospects for growth in Japan are far more moderate than those observed in 2004. During the last few quarters, growth has been very poor and is not expected to improve. The forecast for 2005 is 1%, down considerably from the prediction three months ago (1.5%) and from actual growth in 2004 (2.6%). The loss of momentum in exports and domestic demand is the main reason for this slowdown.

Unlike Japan and the euro zone, prospects for economic expansion in the developing countries are far more encouraging. Growth in the Asian countries will still to be led by the Chinese economy, which continues to gain force, contrary to expectations. The steps taken by monetary authorities to control inflationary pressure will be a contributing factor as well. The outlook for growth in 2005 is now 8.6%, exceeding the forecast three months ago (8.0%). Although Chinese authorities have fueled speculation for quite some time about the possibility of relaxing their exchange rate, this process could be slower and more complicated than expected. For example, a number of studies estimate that sudden appreciation of the remimbi (Chinese currency) could provoke a sharp rise in interest on U.S. treasury bonds, adding to the perceptions of risk on international financial markets. Furthermore, given the frailty of China's financial system, appreciation could endanger the sustainability of that economy's growth.

TABLE 3

**GROWTH FORECAST FOR THE PRINCIPAL TRADING PARTNERS (PERCENTAGE)**

	Actual 2004	Forecast for 2005, at:	
		Apr-05	Jan-05
<b>Principal Partners</b>			
United States	4.4	3.7	3.5
Ecuador	6.5	3.5	3.4
Venezuela	17.3	5.4	4.6
<b>Other Partners</b>			
Euro zone	1.8	1.9	1.9
Japan	2.6	1.0	1.5
China	9.5	8.6	8.0
Peru	5.1	4.6	4.2
Mexico	4.4	3.9	3.7
Chile	5.9	5.7	5.4
Argentina	9.0	6.7	5.1
Brazil	5.2	3.7	3.7
Bolivia	3.6	3.5	3.8
<b>Total Trading Partners (*)</b>	<b>5.8</b>	<b>3.8</b>	<b>3.3</b>

(\*) Balance of payments calculated according to non-traditional exports.  
Source: Datastream – Consensus.

*A number of studies estimate that sudden appreciation of the remimbi (Chinese currency) could provoke a sharp rise in interest on U.S. treasury bonds, adding to the perceptions of risk in international financial markets.*

*Economic growth is still good in Latin America, thanks to favorable external demand, primarily from the United States and China, plus the increase in domestic demand.*

Economic growth is still good in Latin America, thanks to favorable external demand, primarily from the United States and China, plus the increase in domestic demand. The region also has benefited from good prices for certain commodities. These favor most of the countries in Latin America. In this respect, the forecasts for 2005 are promising, although down from what was observed in 2004.

Venezuela and Ecuador - two of Colombia's most important trading partners - expect good growth because of the substantial revenue oil exports will continue to provide. However, factors such as a more restrictive external policy, as is now the case, plus the political and social upheaval in Ecuador, and the upcoming elections for 2006, could create uncertainty about how these economies will perform in the future.

In all, the last quarter saw no change in the growth forecast (weighted average) for Colombia's major trading partners (3.5% for 2005). Average growth, weighted by the share of non-traditional exports, is 3.8%. This is down from what was observed in 2004 (5.8%).

Despite less world demand in 2005, no sharp drop in commodity prices is expected. In fact, the latest forecasts are slightly higher than those in January. However, they still are below those observed in 2004. The current forecasts show higher prices for commodities such as metals and coffee, which have performed well in 2005. Compared with 2004, forecasts by the Economist Intelligence Unit (EIU) point to a drop of 2.2% in the WCF total commodity index (World Commodity Forecasts). The forecast three months ago was 4.3% (Graph 46).

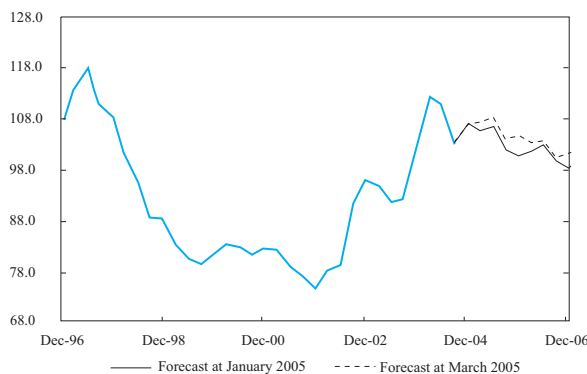
Moreover, unlike the last quarter, there has been a sharp increase in the forecasts for oil prices. Given the trend in oil prices at the beginning of 2005 (because of greater demand and some supply problems), the price could remain relatively high throughout the year. According to the EIU, the WTI price for 2005 could average US\$45.67 per barrel, well above what was expected three months ago (US\$39.21).

Growing uncertainty about the price of oil is rooted in OPEC's low surplus production capacity, which makes prices more susceptible to any shock, and in the continued strength of world demand, which is expected to ease compared with 2004, but still could keep the price between \$45 and US\$50 per barrel.

Colombia will see its terms of trade increase in 2005, although less so than in 2004. This is

**GRAPH 46**

**COMMODITY PRICE INDEX (WCF)**



Source: EIU.

because the outlook for oil prices and most of the country's traditional exports rose in relation to actual prices in 2004. Coffee and gold are two examples (Table 4).

The main sources of uncertainty in the international context are the trend in oil prices, how fast the Fed will raise interest rates, and what happens with the U.S. deficits. More of an increase in oil prices could have considerable impact on growth of the world's economies and on inflation. However, given the information available at March, this is not likely to happen.

As to the macroeconomic imbalances in the United States, the slowdown in domestic demand in that economy and a weaker dollar should help to correct the current deficit, although gradually. At present, the deficit is nearly 6% of GDP (annualized). However, any such impact might be neutralized if not accompanied by less of a shortfall in tax revenue. Congress is now considering a series of initiatives proposed by the government to reduce certain spending items. Some analysts believe a measure of this sort is necessary to lower the deficit in a sustained way. Yet, new reductions in tax rates for the upper income brackets have been proposed as well.

Although the steady increase in the current account deficit and the extent of the shortfall in tax revenue suggest the possibility of a sudden adjustment, which could be traumatic for the world economy, the central scenario in this report (considered by most likely) indicates these imbalances will be adjusted gradually and the dollar will continue to weaken, but moderately so.

*The main sources of uncertainty in the international context are the trend in oil prices, how fast the Fed will raise interest rates, and what happens with the U.S. deficits.*

TABLE 4

INTERNATIONAL PRICES

	Averages			Current projection 1/ 2005	Earlier projection 2/ 2005
	2002	2003	2004		
Coffee (ex-dock) (dollars/pound)	0.7	0.7	0.9	1.2	0.8
Oil (dollars/barrel)	24.2	29.0	37.3	40.6	36.3
Coal (dollars/ton)	30.8	28.2	36.1	36.1	36.5
Nickel (dollars/pound)	1.1	1.4	2.3	2.3	1.9
Gold (dollars/troy ounce)	310.2	362.5	409.3	484.5	410.0

1/ Balance of payments estimated at March 2005.  
 2/ Balance of payments estimated at January 2005.  
 Source: Banco de la República.

The Fed is expected to increase reference rates gradually, in the direction of a neutral monetary policy for the United States. Although analysts more or less agree on the extent of the required adjustment in interest rates, there is uncertainty about how fast it will be. With the central scenario, the increase is expected to total 125 bp during the remainder of the year. This would place rates at 4%, which is still below their equilibrium level.

TABLE 5

CURRENT ACCOUNT BALANCE  
(PERCENTAGE OF GDP)

	1994	2004
Argentina	(3.7)	2.2
Brazil	(0.3)	1.9
Chile	(3.0)	2.5
<b>Colombia</b>	<b>(4.7)</b>	<b>(1.1)</b>
Mexico	(7.0)	(1.1)
Peru	(5.3)	(0.1)
Indonesia	(1.7)	2.8
Korea	(1.2)	4.0
Malaysia	(6.3)	13.5
Philippines	(4.6)	4.6
Thailand	(5.6)	4.4

Source: Work Economic Outlook. Projected Balance of Payments, Banco de la Republica; De Gregorio (1998).

In a scenario of gradual rate hikes by the Fed, with no abrupt adjustment in the U.S. deficits, the main tendencies are likely to continue. These include capital flows to the emerging economies, characterized by broad liquidity on international markets and with no major surge in country-risk premiums. Better fundamental factors in most of the emerging economies also will contribute to this. For example, many emerging economies that had a current account deficit in the mid-nineties now have a surplus or a much smaller deficit (Table 5).

However, it is important to point out that any unexpected change in external interest rates would have a negative effect on the emerging economies, including the ones in Latin America. If this were to happen, investors might opt for safer investments, which would mean higher country-risk premiums for the emerging economies. The most vulnerable countries are probably those that have a higher relative level of indebtedness and failed to use the favorable conditions to reduce their external borrowing, and/or those with less of a history of growth and fewer prospects for future growth.

## B. INTERNAL PROSPECTS AND DEMAND

The forecast for growth in the first half of 2005 is 3.7% (Table 6). The number of working days affects the way this rate is distributed among the quarters. The first quarter of 2005 has three less working days than the first quarter of 2004, while the second quarter has two more. The number of working days could affect a number of production sectors (including transportation and commerce), but particularly industrial production. In fact, growth in manufacturing production during the first quarter of 2005 might even be negative.

Much of this can be attributed to irregular factors such as the one already mentioned (which would be overcome in part during the second quarter).

**SECTORAL GDP  
(PERCENTAGE)**

	2004	2005 First Half
Agriculture, livestock, hunting and fishing	2.1	2.8
Mining and quarries	2.8	5.2
Electricity, gas and water	2.9	1.4
Industrial manufacturing	4.8	2.5
Construction	10.7	16.5
Buildings	30.6	7.5
Civil works	(17.2)	38.4
Commerce, repair, restaurants and hotels	5.6	3.4
Transportation, storage and communication	5.0	5.5
Financial, insurance, real estate and company service establishments	4.3	3.7
Social, community and personal services	2.8	1.9
Financial brokerage services, measured indirectly	12.2	6.1
Added value subtotal	3.8	3.7
<b>GDP</b>	<b>4.0</b>	<b>3.7</b>

Source: DANE. Banco de la República calculations.

However, there is no discounting the possibility of less momentum in the industrial sector during the current year. This would spell slowdown in growth from 4.5% in the second half of 2004, once the figures are seasonally adjusted and corrected for noise, to annual variations of around 4.0% in the first half of 2005.

Agriculture and livestock should increase by 2.8% during the first six months of the year. One of contributing factors would be the rise in coffee production. In February, it registered an important comeback compared with 2004 (more than 10%). Continuation of the cattle slaughtering cycle and normal weather should help as well.

Mining is expected to see major increases during the year, particularly for coal (balance of payment projections indicate 12.0% additional export volume). Oil production will continue to decline, inasmuch as the country's reserves are being depleted, while the annual increase in gold and nickel mining should be 0% and 1%, respectively.

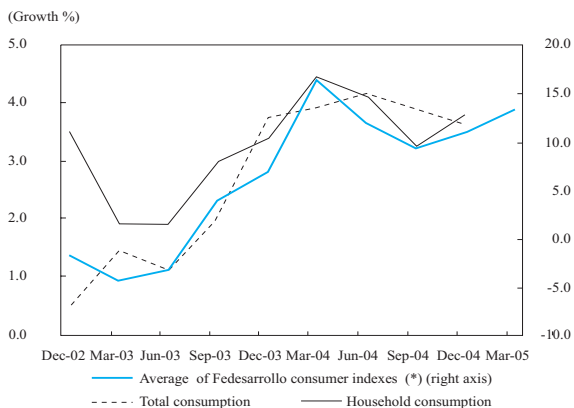
On the other hand, there is expected to be an important surge in civil works associated with the delay in carrying out investment plans in 2004, especially on the part of regional and local administrations. Home construction will slow throughout the year, finishing out the expansion cycle and beginning a moderate decline.

*There is expected to be an important surge in civil works associated with the delay in carrying out investment plans in 2004, especially on the part of regional and local administrations.*



GRAPH 47

**TOTAL HOUSEHOLD CONSUMPTION AND THE FEDESARROLLO CONSUMER SURVEY**



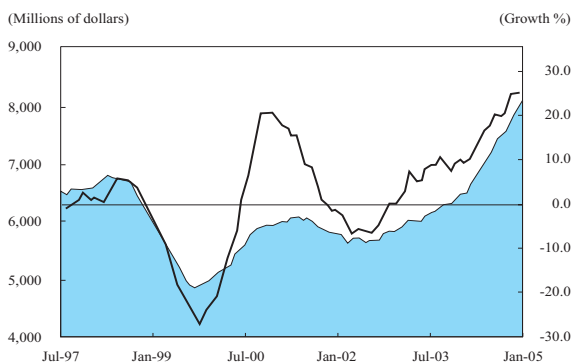
(\*) Average of the indexes on consumer confidence, consumption expectation and economic conditions, respectively.  
Source: Fedesarrollo. Banco de la República calculations.

From the standpoint of demand, 2005 will continue to see a build-up in household consumption, as noted for the first quarter by indicators such as the Fedesarrollo consumer survey (Graph 47). In fact, a recent exercise showed a close connection between the extent of the indicators mentioned in that survey and the annual variation in household and total consumption measured by the National Bureau of Statistics (DANE). Although more samples are needed to determine the significance of this connection, available information showed correlations above 90% between the growth in household consumption and the average of the Fedesarrollo indexes. These include indexes of consumer confidence, economic conditions and consumer expectations.

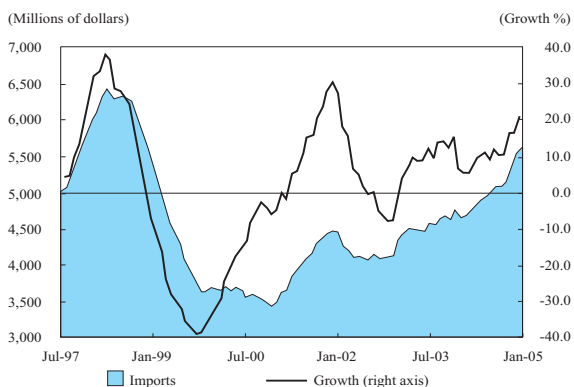
GRAPH 48

**TOTAL IMPORTS (12 MONTH ACCUMULATION)**

**INTERMEDIATE GOODS**



**CAPITAL GOODS**



Source: DANE. Banco de la República calculations.

Judging by imports of capital goods for industry, which rose 41% in dollar value during the first two months of the year, investment in machinery and equipment is still dynamic. This fact and the rise in other imports add credence to the idea that the pace of economic activity could continue to expand and will retain its momentum in the coming quarters. By February, imports of raw material had increased by 12% in dollars and consumer durables by 42.6%. (Graph 48).

The multisector general equilibrium model (MGEM) was used for an overall assessment of how growth in 2005 might be affected by a number of factors, such as better terms of trade, the recovery in civil works, growth in real government consumption (projected according to the figures in the financial plan) and larger volumes of traditional exports. The preliminary MGE series indicates that growth could exceed 4.0% in 2005, depending on how non-traditional exports perform. The momentum seen in recent months and the latest projections on growth of our major trading partners suggest non-traditional exports could increase by around 6.0% during 2005 (in real terms).

In keeping with the anticipated increase in economic activity, employment growth is expected

to exceed that of 2004, and the quality of jobs should continue to improve as a result of more formal employment.

Another reduction in the global participation rate is also possible, as has been the case since last year. This means an additional drop in unemployment is expected nationwide and in 13 cities.

Preliminary calculations point to an increase of 4.5% in disposable income during 2005, or perhaps more if GDP growth is above 4% (Graph 49)<sup>5</sup>. Graph 50 shows the trend in some of the main items used to calculate disposable income, such as remittances from abroad and tax revenue.

### C. INFLATION FORECASTS

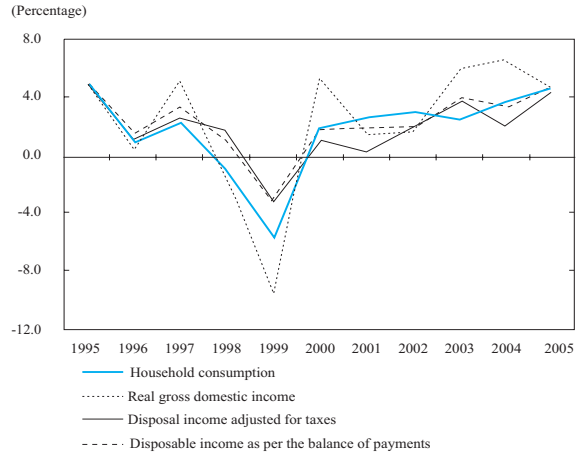
The base scenario of the inflation forecast in the December report contemplated less appreciation in the exchange rate than during the year to date. It also assumed the fourth-quarter recovery in growth would be more moderate than what was reported by DANE. Moreover, as mentioned earlier, DANE made an important correction in the growth figures for the third quarter of 2004 and for previous quarters (since 2003).

As is customary, our inflation reports outline the base scenario of the most probable external and internal context in the coming quarters. The assumptions for the exogenous variables used for the central estimation model (TMM) to predict mid-term and long-term inflation are derived from this scenario.

<sup>5</sup> Three different methods are used to calculate disposable income. The first, derived from the balance of payments (disposable income as per the balance of payments), includes GDP, net factor income and net transfers. The second (disposable income adjusted by taxes) considers changes in the tax burden, additional growth in GDP and the external accounts (net remittance of profits, net interest on the external debt, net remuneration from employees outside the country, external government transfers, remittances and other transfers). The third is real gross domestic income, which is derived from the GDP accounts on the demand side, plus the purchasing power of exports.

GRAPH 49

#### REAL DISPOSABLE INCOME

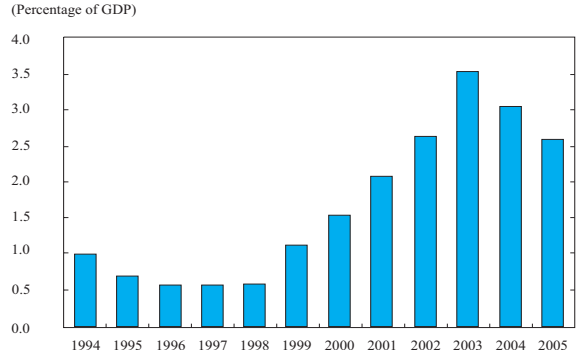


Source: DANE. Banco de la República calculations.

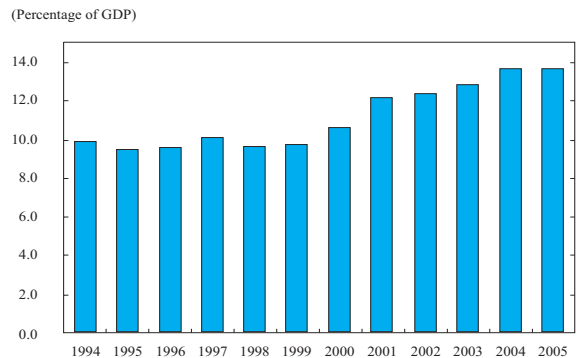
GRAPH 50

#### PRINCIPAL VARIABLES IN MEASURING REAL DISPOSABLE INCOME

##### REMITTANCES



##### TAX REVENUE



Source: DANE. Banco de la República calculations.

*This implies an additional 125 bp in the Fed's for the remainder of 2005 (25 bp per meeting), ending the year at 4%.*

The central path of the inflation forecast is coupled with a risk balance that tries to determine the uncertainty surrounding the base scenario.

## **1. External Context**

We believe the volatility in international financial indicators during the first quarter - because of higher oil prices and the possibility of a tighter monetary policy in the United States - does not change, in essence, any of the relevant external conditions for the Colombian economy that were outlined in the December report. Therefore, in terms of international liquidity, we agree with the analysts who expect monetary authorities in the United States to continue to raise interest rates gradually. This implies an additional 125 bp in the Fed's rates for the remainder of 2005 (25 bp per meeting), ending the year at 4%. Compared with the prediction in the last report (3.75%), this increase is marginal and below the historic average weighed by the Bank's models (5%).

As to growth, a slowdown is expected in the U.S. economy due to higher interest rates and high oil prices. However, compared with the December report, there is no substantial change in the forecasts for Colombia's trading partners as a whole. In fact, the forecast for growth in Venezuela and Ecuador has increased due to the positive impact of high oil prices on these economies. Because no cool off in the Chinese economy and those of other Asian countries is expected, strong world demand would appear to be certain.

The foregoing seems to bode good prices for raw material exports from the region, including those from Colombia. In fact, the forecasts have been raised for the rest of the year, especially in the case of coffee and oil prices. As such, despite more international uncertainty and the slowdown in the U.S. economy, the international context with respect to export growth seems now to be more favorable for Colombia than it was three months ago. This is primarily the result of the demand originating with Colombia's oil-producing trading partners (Venezuela and Ecuador) and the fact that we also benefit from high prices for oil and other commodities.

Accordingly, the new forecasts assume a lower current account deficit and, therefore, less pressure for exchange rate depreciation in 2005 than anticipated in the December report. However, 2006 is expected to see a larger current account deficit and more pressure for peso devaluation.

This scenario assumes no substantial change in capital flows during 2005, barring any abrupt adjustment in U.S. interest rates. This also would keep inflationary pressures in check. Nevertheless, the exchange forecasts are

*The forecast for growth in Venezuela and Ecuador has increased due to the positive impact of high oil prices on these economies.*

more uncertain now than at the beginning of the year. For example, more of a rate adjustment at a time of growing trade and fiscal deficits in the United States could prompt a sudden withdrawal of capital from Colombia and other emerging economies, which would raise pressure on the exchange rate.

*The international context now seems more favorable for Colombia than it was three months ago.*

## **2. Domestic Context**

Good economic growth in the fourth quarter and the continuation of favorable external conditions allow us to predict around 4% growth for this year, which is slightly more than the estimate in the December report. For the first two quarters, the short-term models anticipate an annual increase in GDP of nearly 3.7%, on average. Since the first quarter has fewer working days (because of Holy Week in March), growth is expected to be less than in the second quarter.

In comparison with the December report, the role of external demand has become more important, thanks to higher forecasts for export prices and to growth in Ecuador and Venezuela. Once again, private investment will be a source of expansion, although building construction is not expected to be as vigorous as it was in 2004 and perhaps less than what was forecast in the last report. Part of this slowdown will be offset by more public investment, which will reverse the sharp reduction observed in civil works during 2004. On the other hand, we expect more of an increase in government consumption during 2005 than in 2004.

Growth in household consumption should remain moderate, as it has for the last two years. A certain amount of agitation associated with supply shocks cannot be ruled out. Yet, in general, no slowdown is expected this year.

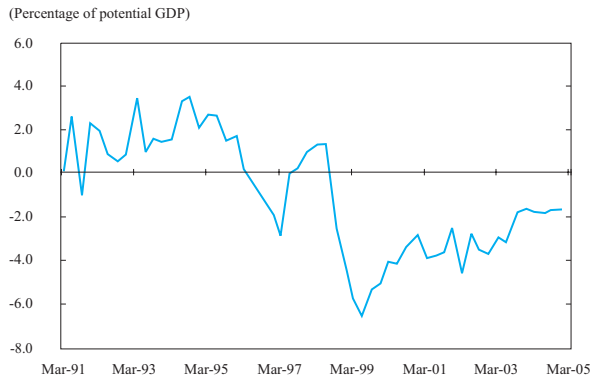
Broad liquidity and interest rates below historic averages will continue to boost household consumption and private investment. Consumer confidence is a factor as well. So far this year, it has been at an acceptable level, similar to what it was in 2004. The index of business confidence and the climate for industrialists remains high and should favor private investment.

*Broad liquidity and interest rates below historic averages will continue to boost household consumption and private investment.*

Given these considerations and the increase in growth during 2004 (especially in the fourth quarter), the present report assumes a narrower gap at the end of the year (-1.5%) compared with the figure in the last report (-1.8%) (Graph 51).

GRAPH 51

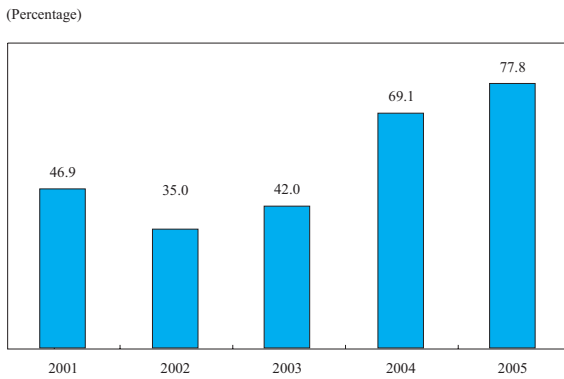
THE OUTPUT GAP



Source: Banco de la República.

GRAPH 52

CREDIBILITY OF INFLATION TARGETS FROM 2001 TO 2005



Source: Banco de la República.

*Various satellite models used by the Bank anticipate an increase in food inflation during the second half of the year.*

3. Other Determinants of Inflation

The trend in inflationary expectations is a factor that favors lower inflation and has been particularly important since the end of last year. The drop to 5% inflation in the early part of 2005 led to price changes that are more consistent with the target set by Banco de la República. Inflationary expectations have an adaptive component. Consequently, with the lower than anticipated decline in inflation by March, an additional drop in inflationary expectations is forecast. The fact that the 2004 target was met lent credibility to the country's monetary policy, as evidenced by the higher percentage of people who, at the beginning of the year, felt the 5% target for inflation in 2005 was credible (Graph 52).

With respect to inflation, the economy could enter a virtuous cycle in 2005, in which case the increased credibility of monetary policy and fewer expectations of inflation would allow for less actual inflation. This, in turn, reinforces the drop in expectations during the months ahead and discourages future price hikes.

The pace of wage adjustments is another favorable element. As mentioned in previous sections of this report, wage increases have been below 6%, at least in the case of industry. If we also consider the fact that labor productivity could be increasing at historic average rates (between 1.5% and 3.0%), wages are probably exerting less pressure on costs. This situation could continue

for the rest of the year, given the ample conditions still existing on the job market.

There are two circumstances mentioned in the December 2004 report that would operate to the contrary. The first is the possibility of higher food inflation in the second half of the year. Although less likely, El Niño weather is not out of the question, and various satellite models used by the Bank anticipate an increase in food inflation during the second half of the year.

Although the results do not exceed 6.5%, the margin of error associated with these forecasts is usually high, meaning that further increases cannot be ruled out. The other negative factor is the price of fuel and how it affects transportation rates. The unexpected rise in international oil prices at the start of the year could spell higher domestic fuel prices than anticipated in the December report. Nevertheless, it is important to remember that appreciation of the exchange rate in the first quarter, coupled with the increased stability expected during the rest of the year, could have the opposite effect. In view of these tendencies, the present report reiterates the shocks estimated in the December report.

*With respect to inflation, the economy could enter a virtuous cycle in 2005, in which case the increased credibility of monetary policy and fewer expectations of inflation would allow for less actual inflation.*

#### 4. Inflation Forecasts

Based on the foregoing assumptions and considerations, the forecast system used by Banco de la República (the central model or TMM and satellite models)<sup>6</sup> lowered the short and medium-term inflation forecasts in comparison with the previous report. At this point, the downturn in core or non-food inflation is expected to continue for the next three quarters, settling in the lower portion of the target range (4.5% - 5.5%) by the end of the year. The central forecast for December is 4.2%, as opposed to 4.8% in the last report. The downward trend in non-food inflation could reverse temporarily at the start of 2006, but would reappear later to finish the year at 4.1% (Table 7).

TABLE 7

##### CENTRAL MODEL FORECASTS (TMM)

	Total inflation	Non-food inflation	Food inflation	Output Gap
Mar-05	5.1	4.8	5.6	(1.7)
Jun-05	4.8	4.6	5.3	(1.6)
Sep-05	4.8	4.5	5.5	(1.5)
Dec-05	4.7	4.2	6.0	(1.3)
Mar-06	4.9	4.7	5.4	(1.1)
Jun-06	4.7	4.5	5.1	(0.8)
Sep-06	4.3	4.3	4.1	(0.5)
Dec-06	4.1	4.1	4.0	(0.3)

Source: Banco de la República.

<sup>6</sup> As explained in previous reports, Banco de la República develops inflation forecasts in two stages. Short-term forecasts for two months (STF) are developed in the first stage, using satellite models of inflation, growth, output gap, etc., which are more reliable for short horizons. Mid-term and long-term forecasts are developed in the second stage, using the STF and the central model (TMM).

*Capital inflows or prices for Colombia's principal exports above those contemplated in the central scenario ...*

The mid-term and long-term forecasts for core inflation have been reduced substantially. These are the reasons why.

- ✦ The first quarter witnessed a substantial drop in non-food inflation, even more than what most of the satellite models had predicted. This lowered the STF and the central path of the TMM, given the historically high inertia of inflation in Colombia. As a result, straggling data weigh heavily on the inflation forecasts produced by the models, including the TMM. Technically speaking, the models are highly self-regressive.
- ✦ Exchange rate appreciation in the first quarter was more than expected, and the present report anticipates less pressure for depreciation in 2005 than what was forecast three months ago. The result is a lower forecast for tradable inflation. However, the beginning of 2006 is expected to see an increase in tradable inflation that will be transferred to core inflation. This would be linked to the pressure for peso depreciation anticipated at mid-term.
- ✦ Expectations of inflation are now closer to the Bank's target for 2005 than they were three months ago, a factor that has eased pressures on this front.

The forecasts for total inflation have not changed substantially: 4.7% for December 2005 and 4.1% for December 2006. The respective figures in the last report were 5.0% and 4.0%. In contrast to this stability between the forecasts in both reports, the increase in food inflation anticipated for the end of 2005 is 6.0%, as opposed to 5.5% in the December report.

## **5. Risk Balance**

The risk balance associated with the central forecast is based on the following considerations:

- ✦ For the first forecast year, private consumption and investment could grow more than foreseen in the central scenario. As a result, the output gap would close faster than expected. The gap is just as likely to be over or underestimated in the second year, which indicates a neutral risk balance.
- ✦ The food inflation forecast for the first year shows an upward bias, given its traditional volatility and current upward tendency. The bias is modified as neutral for the second forecast year.
- ✦ Capital inflows or prices for Colombia's principal exports above those contemplated in the central scenario could create less pressure for exchange rate depreciation than contemplated in the central scenario.

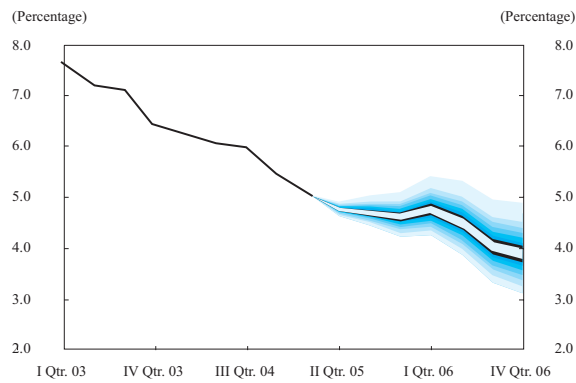
*... could create less pressure for exchange rate depreciation than contemplated in the central scenario.*

The fan chart probability distribution table (Graph 53) shows the risk balance. There is an 80.7% chance that total inflation at December 2005 will be less than 5%; this probability is 92.5% for December 2006. For 2005, the range with the highest probability is between 4.5% and 5.0%, while the most likely range for 2006 is below 4%. The fan chart shows a balanced confidence interval related to the central path of the inflation forecast.

*There is an 80.7% chance that total inflation in December 2005 will be less than 5%; this probability is 92.5% for December 2006.*

GRAPH 53

**INFLATION PROBABILITY DISTRIBUTION  
(FAN CHART)**



Source: DANE. Banco de la República calculations.

**ACCUMULATED PROBABILITY  
OF CONSUMER INFLATION BENEATH  
THE INDICATED RANGE**

Inflation Ranges (%)	2005			2006			
	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
[>6.5]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
[<6.5]	100.0	100.0	100.0	100.0	100.0	100.0	100.0
[<6.0]	100.0	100.0	100.0	99.7	99.6	99.9	99.9
[<5.5]	100.0	100.0	99.5	93.0	94.7	98.8	98.8
[<5.0]	97.4	84.9	80.7	58.3	72.7	91.1	92.5
[<4.5]	0.1	7.2	21.2	15.1	34.5	67.2	73.6
[<4.0]	0.0	0.0	0.7	1.2	8.3	32.4	42.7



**PROJECTIONS ON THE MAIN MACROECONOMIC VARIABLES  
BY DOMESTIC AND EXTERNAL ANALYSTS**

The following are the latest projections on the country's main economic variables for 2005 and 2006 by domestic and external analysts. They were developed with information available at March 2005.

### I. Projections for 2005

Both domestic and external analysts maintained their forecast for growth (developed last quarter), which is 3.7% (Table A1). Two of the twelve lowered theirs, only one increased it, and the other nine made no change in their predictions. This suggests the forecasts were not affected by DANE's upward correction of the growth series, due to the change in the way civil works were measured.

**TABLE A1  
PROJECTIONS FOR 2005**

	Real GDP growth %	CPI inflation %	Nominal Exchange Rate (End of)	Nominal TDR %	Deficit (GDP %)		Unemployment Rate (13 cities) %
					Fiscal (CPS)	Current Account	
<b>Domestic Analysts</b>							
Revista <i>Dinero</i>	3.4	5.2	2,509	7.7	2.5	n.d.	13.5
BBVA Ganadero	3.8	5.2	2,550	7.5	2.5	2.0	12.0
Citibank Colombia	3.8	5.2	2,509	7.7	2.7	1.3	14.2
Suvalor-Corfinura	3.5	5.2	2,543	8.2	2.6	n.d.	n.d.
Corfivalle	4.0	5.5	2,514	7.9	2.7	n.d.	13.0
ANIF	3.8	5.2	2,500	7.5	2.5	n.d.	12.5
Fedesarrollo	3.9	5.0	n.d.	8.7	2.5	2.6	15.5
<b>Average</b>	<b>3.7</b>	<b>5.2</b>	<b>2,521</b>	<b>7.9</b>	<b>2.6</b>	<b>2.0</b>	<b>13.5</b>
<b>Foreign Analysts</b>							
Goldman Sachs	3.5	5.5	2,420	7.4	2.4	2.0	14.8
CS First Boston	3.5	5.0	2,375	n.d.	2.5	0.9	12.8
IDEA Global	4.3	5.0	2,400	7.5	2.1	0.8	12.5
J. P. Morgan Chase	3.5	5.5	2,450	7.5	2.4	0.3	13.5
Deutsche Bank	3.6	4.9	2,500	7.6	2.6	2.1	11.7
<b>Average</b>	<b>3.7</b>	<b>5.2</b>	<b>2,429</b>	<b>7.5</b>	<b>2.4</b>	<b>1.2</b>	<b>13.1</b>

SPC: Consolidated public sector.

N.D.: Not available.

1/ Yearly average.

Source: *Dinero* and *Consensus Forecast*, January 2005.

The domestic analysts lowered their inflation forecast by 10 bp to 5.2%, which is equal to that of the external analysts (with a 10-point increase). Since annual inflation was 5% at March, these forecasts assume an increase in inflation, on average, during the remainder of the year. While all the analysts believe the target will be met, as they did last quarter, their forecasts are in the upper half of the range set by the BDBR for this year (between 4.5% and 5.5%).

In terms of the exchange rate, there is a difference of Col\$92 between what the domestic and external analysts have forecast (it was Col\$8 a quarter ago). Five of the 12 analysts lowered their forecasts, one raised it, and the other six made no changes. The domestic analysts lowered their forecasts by Col\$12, on average, and the external analysts, by Col\$96. In general, they all expect foreign exchange to devalue by 3.4% in relation to the price at the end of 2004 (the inflation forecast a quarter ago was 5.6%). The maximum forecast for devaluation is 6.1%; the minimum is -1% (11% and 1% last quarter). Only one analyst anticipates exchange appreciation at end of 2005; a quarter ago, no one thought this was possible.

As to the TDR, the average domestic forecast is 7.9% as opposed to 7.5% by foreign analysts (8% and 8.1% last quarter and 8.3% and 8.4% two quarters ago). In other words, on average, the analysts expect the TDR to be where it was at the end of 2004. Nine of the 12 analysts lowered their forecasts, one raised it and two made no change. The shortfall in tax revenue is expected to be around 2.5% of GDP, which is similar to what was forecast for the last six months. As to the current account deficit, the domestic analysts predict 2% (1.8% last quarter) and the external analysts, 1.2% (1.8% last quarter). The agents expect 13.3% unemployment in 13 cities (the domestic analysts raised their forecasts by 0.2% compared with last quarter and the external analysts lowered theirs by 0.2%). Five analysts lowered their forecasts, three raised theirs, and four made no changes.

## **II. Projections for 2006**

Table A2 shows several forecasts for the end of 2006. The domestic analysts anticipate 3.8% growth and the foreign analysts, 3.6% (the same as last quarter). In terms of inflation, the domestic analysts predict 4.8% and the foreign analysts, 5.2% (4.9% and 5.3%, respectively, a quarter ago). On average, the domestic analysts expect the representative market rate (TRM) to be about Col\$121 above what the foreign analysts predict (Col\$50 last quarter). Annual devaluation in 2006 is expected to average 10% compared with the forecasts for the end of 2005 (6% last quarter). Therefore, on average, the analysts expect the TRM to be Col\$2,643 per dollar by the end of 2006 (Col\$2,685 last quarter). This is similar to the TRM in July 2002.

These forecasts imply 10% peso devaluation in 2006 (12% last quarter) compared with the end of 2004. There are, however, major differences in the way this devaluation is distributed. Two

**TABLE A2**  
**PROJECTIONS FOR 2006**

	Real GDP Growth %	CPI Inflation %	Nominal Exchange Rate (end of)
<b>Domestic Analysts</b>			
Revista <i>Dinero</i>	3.6	5.0	2,760
BBVA Ganadero	3.0	4.7	2,720
Citibank Colombia	3.6	4.8	2,734
Suvalor-Corfinsura	3.8	5.0	2,695
Corfivalle	4.5	5.0	2,607
ANIF	n.d.	n.d.	n.d.
Fedesarrollo	4.0	4.0	n.d.
<b>Average</b>	<b>3.8</b>	<b>4.8</b>	<b>2,703</b>
<b>Foreign Analysts</b>			
Goldman Sachs	3.3	5.0	2,550
CS First Boston	3.5	5.5	2,442
IDEA Global	4.0	4.5	2,520
J. P. Morgan Chase	3.3	5.2	2,600
Deutsche Bank	3.8	6.0	2,800
<b>Average</b>	<b>3.6</b>	<b>5.2</b>	<b>2,582</b>

n.d. Not available.

Source: *Dinero* and *Consensus Forecast*, January 2005.

analysts believe it will be distributed equally between both years, one sees a concentration primarily in 2005, while the other seven believe it will be concentrated mostly in 2006 (five, three and two, respectively, a quarter ago). Most of them postponed some of the devaluation they predicted a quarter ago for 2005 until 2006.

# MONETARY POLICY DECISIONS IN THE LAST THREE MONTHS

## **Background Information: *Inflation Report* - December 2004**

The fourth quarter of 2004 saw several important changes in the inflationary situation in Colombia. The 5.5% inflation target for the year was met and non-food inflation declined substantially. At the same time, inflationary expectations fell sharply, something not seen up until the third quarter. On the other hand, there was more appreciation in the exchange rate. The nominal exchange rate was down by an average of 6% in the last quarter, compared with the first nine months of 2004. Information released by DANE shows a slowdown in economic growth during the third quarter. This prompted uncertainty about the force of economic recovery, although part of the slowdown was the result of supply factors. Less growth, coupled with a likely expansion in potential GDP, due to the force of investment and productivity in recent years, indicate the output gap may have widened at the end of 2004, thereby reducing inflationary pressures.

The fourth-quarter acceleration in appreciation was basically the result of external capital inflows amidst an international scenario characterized by a weaker dollar against most other currencies and the movement of private capital towards emerging economies. The BDBR believed these factors were temporary and, for this reason, decided to curb appreciation in an effort to lessen the negative impact it could have on the sectors that produce tradable goods, while preventing any abrupt correction in the exchange rate that might jeopardize the inflation target. Accordingly, in the fourth quarter of 2004, Banco de la República acquired US\$1,325 m in foreign exchange through discretionary purchases and US\$180 m in volatility options. On the whole, this accounts for 52% of all international reserves purchased during 2004 (US\$2,905 m).

The outlook for the exchange rate in 2005 assumed an external scenario characterized by gradual hikes in short-term interest rates in the United States, a weaker dollar and moderate reductions in world growth and commodity prices. In these circumstances, no major surge in the exchange rate was expected, but a possible depreciation in terms of the values observed at the end of 2004 (Col\$2,390 per dollar) did seem likely.

More appreciation in 2004 and the way the exchange rate is expected to behave in 2005, coupled with a possibly wider output gap and fewer expectations of inflation set the stage for a looser monetary policy compared with the stance adopted in previous inflation reports. This being the case, the BDBR lowered the intervention rate by 25 bp on December 21, 2004, closed the contraction window, and ended the auctions. These measures were mirrored by a nearly 50 bp drop in the interbank rate since the end of the year. The BDBR also announced the Bank would continue to intervene in the exchange market, but on a discretionary basis with no definite amounts or terms.

## Monetary Policy Decisions in the First Quarter of 2005

### *The State of Inflation*

The most predominant aspect of first-quarter inflation was the reduction in non-tradable inflation and the drop in expectations of inflation. These factors contributed to the sharp decline in core and total inflation witnessed throughout the quarter. Part of this contraction was due to exchange rate appreciation and its effect on tradable inflation.

On the other hand, fourth-quarter growth and DANE's revision of the GDP figures as of 2003 confirmed the increased force of the economy in the last two years and the temporary nature of the slowdown in economic activity witnessed during the third quarter of 2004, which mostly was the result of supply factors.

Although new information suggested the output gap could be closing faster than anticipated in earlier reports, it also was considered likely that potential GDP was growing at a higher rate, given the buoyancy of investment and more growth in total factor productivity. An analysis of various indicators showed no conclusive evidence of changes in the output gap compared with the last inflation report. Some indicators pointed to a narrower gap, as discussed in Chapter I, particularly with respect to the use of installed capacity, answers to questions on the importance of demand problems in industry, and the percentage of companies with above historic average use of installed capacity. However, these indicators referred only to industry and may have ignored what was happening in other sectors of the economy.

Other events suggested the output gap might not be closing. One example was the decline in non-tradable inflation, particularly for different services. Moreover, the unemployment rate was estimated as still above levels that would indicate the emergence of inflationary pressures in the job market. Moreover, the difference between the actual unemployment rate and the non-accelerating inflation rate of unemployment exceeded what was estimated in the last report.

Given this information, no change was made in the assumption on the output gap for the first quarter of 2005, compared with the last inflation report. However, it is important to insist on the uncertainty that surrounds assumptions concerning the output gap, its change over the course of time, and how this uncertainty can affect any assessment of the stance of monetary policy. Hence, the importance of rigorously continuing to monitor prices, economic activity and the other fundamental economic variables.

### *Economic Perspectives*

Arriving at monetary policy decisions necessitates more than identifying the actual state of the economy (in terms of its position in the economic cycle, the size of the output gap, or the unemployment rate, among other factors). It also involves the situation the economy could be in a year or two down the road. This lapse pertains to the delay the impact monetary policy has on prices. Accordingly, a good portion of any inflation analysis consists of anticipating the main external and domestic trends in the economy.

In this respect, although the world economy and that of our major trading partners might increase less than in 2004, the forecasts indicate growth should remain vigorous throughout 2005. Furthermore, the forecasts for growth in Venezuela and Ecuador were increased in relation to the last report, as were the forecasts on terms of trade. Even projections for the prices of certain commodities exported by Colombia rose in comparison with the levels last year (especially for oil, coffee and gold).

As to external interest rates, the central scenario of gradual increases by the Fed towards a neutral monetary policy was ratified. However, in spite of a relative consensus among analysts as to the overall size of the adjustment required of the Fed, there is uncertainty about how quickly it could occur.

This being the case, there should be no change in the principal tendencies with respect to capital inflows to the emerging economies. These are characterized by broad liquidity on international markets and no major surge in country risk premiums. In this context, Colombia could receive more revenue from exports that anticipated in the last report, and there would be no definite tendency towards peso depreciation in 2005 (even so, pressure for devaluation would continue in 2006). However, if the Fed raises interest rates faster than expected, or if developments with respect to the deficits in the United States economy push interest rates up, the risk perception on international markets would increase. This would affect capital inflows to the emerging economies and, in these circumstances, the Colombian peso would tend to depreciate, even in 2005.

#### *Interest Rates and Monetary Policy*

After identifying the external and internal context of the base scenario, a short term interest rate that is compatible with the 2005 inflation target and with efforts to lower inflation towards the range announced for 2006 has to be determined. This is done by analyzing the Inflation Report and is summarized in the scenarios of the central forecast model (TMM). As outlined in Chapter II, the results of the model show the target for 2005 is likely to be met (between 4.5% and 5.5%) and inflation will decline towards the range announced for 2006 (between 3% and 5%). This would be the case, even with moderate peso devaluation, and would be consistent with a short-term interest rate path (for the interbank rate-TIB) that is equal to or slightly below the current level (6.3%).

However, in the event of an increase in economic growth that implies swifter closure of the output gap, there would be no margin for the TIB to fall below current levels. On the contrary, next year, Banco de la República would move its intervention interest rates in the direction of a more neutral monetary policy, as most central banks in both the developed and emerging economies are doing.

On the other hand, if increases in the stock of capital and productivity imply less of an initial output gap or slower closure of the gap, the monetary incentive with which the economy now operates could be maintained. However, given the uncertainty over the status and evolution of the gap, it was difficult to determine which of these scenarios was most likely.

Also taken into account was the fact that the forecast models did not anticipate some of the first-quarter decline in inflation. Consequently, it was not possible to determine if this was a permanent or temporary phenomenon.

Uncertainty about the size of the output gap, the future of the exchange rate and the soundness of the recent decline in inflation necessitate having more information before making any change in monetary policy.

Considering all of the above, the BCBR decided (at its meeting on April 22) to maintain the current stance of monetary policy. This has the following implications:

1. No change in the structure of the Bank's interest rates (Table A)
2. Continued closure of the contraction window and auctions
3. Continued discretionary intervention in the exchange market

Pursuant to this last policy, effective as of September 2004, US\$773.83 m in discretionary purchases were made on the exchange market during the first quarter of 2005 (Table B).

**TABLE A**  
**LATEST CHANGES IN BANCO DE LA REPUBLICA'S INTERVENTION RATES**  
**(PERCENTAGE)**

Date	Lombard		Auction	
	Contraction		Expansion	
<b>2001</b> Dec. 17	6.25	7.50	8.50	12.25
<b>2002</b> Jan. 21	6.00	7.00	8.00	11.75
Mar. 18	5.25	6.25	7.25	11.00
Apr. 15	4.25	5.25	6.25	10.00
May. 20	3.75	4.75	5.75	9.50
Jun. 17	3.25	4.25	5.25	9.00
<b>2003</b> Jan. 20	4.25	5.25	6.25	10.00
Apr. 29	5.25	6.25	7.25	11.00
<b>2004</b> Feb. 23	5.00	6.00	7.00	10.75
Mar. 23	4.75	5.75	6.75	10.50
Dec. 20	4.50	5.50	6.50	10.25
Dec. 22 (*)	n.a.(*)	n.a.(*)	6.50	10.25

(\*)Not applicable. Monetary contraction operations (auction and Lombard) were suspended as of 22 December 2004.  
Source: Banco de la República.

**TABLE B**  
**PURCHASE-SALE OPTIONS FOR FOREIGN EXCHANGE**  
**BANCO DE LA REPUBLICA**  
**(YEAR: 2004)**

	Amount (US Millions)
<b>Purchases</b>	773.8
<b>Put Options</b>	0.0
To accumulate international reserves	0.0
To control volatility	0.0
<b>Discretionary Intervention</b>	773.8
<b>Sales</b>	1,250.0
<b>National Government</b>	1,250.0
<b>Net Purchases</b>	-476.2

Source: Banco de la República.