Board of Directors
Report to Congress

July 2009

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Banco de la República
Central Bank of Colombia
Bogotá. D. C.. Colombia

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José Darío Uribe Escobar

Bogotá, July 30, 2009

Honorable Chairmen and Members
Third Standing Constitutional Committees of the
Senate and the House of Representatives

Dear Sirs,

In accordance with Law 31/1992, Article 5, the Board of Directors of the Central Bank of Colombia hereby submits to the Congress of the Republic of Colombia, for its consideration, a report on the country's macroeconomic performance during the first half of 2009, the targets adopted by the Board of Directors for the current year, and the outlook for the various macroeconomic variables. The last two chapters of this report deal with the composition of the country's international reserves and projections on the financial situation of the Central Bank of Colombia in 2009.

Yours truly,

José Darío Uribe Escobar
Governor

Introduction

The adverse world economic situation has affected the performance of the economy in Colombia and in many other emerging countries. Nevertheless, the performance of the gross domestic product during the first quarter of 2009 shows the Colombian economy has managed to resist the harsh effects of that the crisis better than many other emerging countries with a similar level of development.

The world economy continued to feel the consequences of the crisis during the first half of 2009, with ups and downs in its intensity and in the way different groups of countries have been affected.

During the first quarter of 2009, after the financial crisis in the United States and in other developed countries accentuated due to the failure of Lehman Brothers in September 2008, the world economy continued to face the consequences of the crisis, with ups and downs in its intensity and in the way different groups of countries have been affected. The growth figures for the first quarter of 2009 showed a contraction in the industrialized countries; in most cases, it was greater than the downturn observed during the last part of 2008. The Euro Zone and Japan, in particular, posted quarterly annualized reductions in economic activity of 9.7% and 14.2%, respectively, a situation without precedents in recent history. The U.S. economy contracted 5.5%, which is similar to the slump witnessed in the final quarter of 2008.

The crisis in the developed world had serious repercussions on productive activity in the emerging economies, which declined 4% as a whole during the first quarter compared to the same period in 2008.

The crisis in the developed world had serious repercussions on productive activity in emerging economies, which declined 4% as a whole during the first quarter compared to the same period in 2008. In this case, the Eastern European countries experienced the sharpest drop, nearly 15% in annual terms, due to pronounced capital outflows generated by major macroeconomic imbalances and the absence of exchange flexibility. Likewise, a number of emerging economies in Asia, such as South Korea, Hong Kong and Taiwan, posted dramatic slowdowns, as they depend heavily on international trade. However, relatively good performance by China and India, thanks to macroeconomic incentives and the size of their internal markets, managed to offset to some of the contraction in the region. Finally, *For the second half of 2009, the leading indicators of industrial production and international trade suggest that the contraction in the world economy will begin to ease.*

in the case of Latin America, the Mexican economy slumped sharply (8.2%), given its close commercial and financial ties with the United States. Brazil, Chile and Colombia also experienced setbacks, but not as pronounced. Peru grew 1.8%, much less than the year before. The situation in Venezuela and Ecuador was similar, with 0.3% and 1.2% respective growth during the first quarter.

For the second half of 2009, the leading indicators of industrial production and international trade suggest that the contraction in the world economy will begin to ease and the global economy could begin to stabilize, supported by the strong counter-cyclical measures adopted by governments and central banks around the world. The improvement in U.S. and European business and consumer expectations for six months and one year out confirm this perception. In fact, the International Monetary Fund (IMF) announced on June 8 that it had raised its forecasts for world economic growth, which is now expected to reach 2.5% in 2010. This surpasses the 1.9% forecast in April. However, the IMF warns that economic recovery will be slow and highly uneven. After a 3.8% contraction anticipated for 2009, the advanced economies would see no recovery in economic activity until the second half of 2010, when annual growth is expected to reach 0.6%. However, this is better than the estimate of 0% forecast in April. The emerging economies are expected to be back on a positive track in the second half of 2009, although with notable regional differences, and are expected to grow 4.7% in 2010. The forecast in April was 4%.

The emerging economies are expected to be back on a positive track in the second half of 2009, although with notable regional differences.

These types of forecasts are surrounded by considerable uncertainty. As indicated by the IMF, world economic recovery will depend on a complex balance of forces. The negative impact on growth as a result of the financial shock, the plunge in global trade, heightened uncertainty and the collapse of confidence are diminishing gradually. Nevertheless, the housing markets are still in the process of adjusting, the financial markets remain fragile and financial institutions still need to clean up their balance sheets and many also need to restructure. Although policy interest rate cuts and broad liquidity provision have provided support for intermediation and reduced the possibility of systemic failure, the improvements are not the same in all markets and countries, and credit remains tight.

This context of world economic contraction, confidence losses, cutbacks in foreign trade and weak financial markets has affected economic performance in Colombia.

This context of world economic contraction, confidence losses, cutbacks in foreign trade and weak financial markets has affected economic performance in Colombia and in many other emerging market economies. Even so, the information on gross domestic product (GDP) in the first quarter of 2009, released recently by the National Statistics Office (DANE, in spanish), shows Colombian economy has managed to resist the harsh effects of the crisis, better than many other emerging countries. A 0.6% reduction in Colombia's economic activity during the first quarter, compared to the same period in 2008, is less than the contraction of the economies of Brazil (-1.8%), Chile (-2.1%) and Mexico (-8.2%). By the same token, the moderate downturn in the Colombian

The moderate downturn in the Colombian economy during the first quarter compares favorably to the drop in output in Brazil, Chile and Mexico, and in several emerging countries in Eastern Europe and Asia.

economy also compares favorably to the decline in output experienced by the emerging countries in Eastern Europe and some in Asia.

Another aspect that reflects the resilience of the Colombian economy to the effects of the crisis is that, despite a difficult external context, Colombian GDP did not continue to fall during the first quarter of 2009, beyond the 1% annual drop registered during the fourth quarter of 2008. Specifically, compared to the final quarter of 2008, the Colombian economy grew 0.2%. Although it may be premature to talk about a recovery, this outcome suggests the Colombian economy would have managed to stabilize and the worst of the crisis may be over. As discussed in this report, the channels through which the international financial crisis has affected the Colombian economy are associated largely with the deterioration in consumer and business confidence, and with the cutback in disposable income to the economy as a result of lower prices for most export goods and the decline in remittances. This helps to explain the 0.5% reduction in household consumption and the 6.3% cut in private investment during the first quarter. In contrast, the financial contagion channels have not operated forcefully for Colombia, since the international crisis has not blocked the country's access to international lending markets, and it has not resulted in capital flights. In this respect, it is important to remember that the national government had no trouble placing US$2 billion (b) in external debt bonds during the first half of the year, while an important amount of foreign direct investment continues to flow into the country, helping to finance the current account and to support the momentum in mining production, as illustrated by the GDP figures for the first quarter of 2009.

The channels through which the international financial crisis has affected the Colombian economy are associated largely with the deterioration in consumer and business confidence, and with the cutback in the disposable income of the economy.

The effects of the external crisis can be identified from another standpoint through an analysis of GDP by economic activity. The productive activities linked more closely to world trade, which are classified in the so-called tradable sector of the economy, were down 1.8% in annual terms during the first quarter. This is three times more than the contraction in the economy as a whole. Particularly prominent within this group is the 7.9% decline in the manufacturing industry, owing to fewer exports from sector of the industry such as vehicles, clothing and tailored goods, milling and starches, iron and steel, and chemical substances. The agricultural sector, which falls into the tradable category, also experienced a larger decline than the rest of the economy, but slightly less (-0.8%). There was a good performance in mining, and quarrying, which are another important tradable activities, with a 10.6% increase in the first quarter, which prevented that this sector of the economy contracted even more.

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In contrast, the non-tradable sector of the economy, which is oriented fundamentally towards serving the internal market, exhibited a mild expansion (0.1%) during the first quarter. This sector is apparently no stranger to the crisis; however, in this case, it had an indirect impact exerted through the loss of confidence, which undermines household consumption and investment. There was good performance of the financial system, which posted 4.1% annual growth in the first quarter.

The increase in unemployment is a reflection of the slowdown in economic growth. Given its social repercussions, this is clearly one of the more troubling effects of the world crisis.

However, the notable performance witnessed in civil works construction (21.2%) was undoubtedly the fundamental factor that prevented the non-tradable sector from contracting, thereby avoiding an even sharper drop in the economy. Because civil works partly reflect the pattern of public investment (some mining investments are private), their considerable growth during the first quarter is evidence of the effort of the fiscal policy to create a counter-cyclical demand that helps to keep the economy moving.

The increase in unemployment is a reflection of the slowdown in economic growth. Given its social repercussions, this is clearly one of the more troubling effects of the world crisis. The latest available figures indicate that total unemployment in the March-May quarter was 11.9% nationwide and 12.9% in the thirteen major metropolitan areas. This implies respective increases of 0.9 and 1.3 percentage points (pp) compared to the same period in 2008. As discussed in this report, the rise in unemployment is due to a labor-supply increase that outpaced the rise in demand. In other words, employment in the economy has not stopped growing. In fact, during the period in question, the employment rate went from 52.9% to 54%. Nevertheless, the entry of additional workers into the labor force, in order to offset the drop in family income or to compensate for the fact that the head of the household is without work, surpassed the economy's current capacity for job creation, thereby adding to the unemployment rate. As economic growth recovers, both of these phenomena should turn around, since many additional workers would return to their usual endeavors, either at home or in school, and the economy would be in a better position to generate more jobs.

The entry of additional workers into the labor force, in order to offset the drop in family income or to compensate for the fact that the head of the household is without work, surpassed the economy's current capacity for job creation, thereby adding to the unemployment rate.

The Board of Directors of Banco de la República (BDBR) responded in a timely fashion and with flexibility in terms of the monetary policy required to buffer the negative effects of the global crisis. Moreover, it did so without departing from its constitutional mandate to preserve the buying power of domestic currency. In October 2008, a few weeks after the international financial crisis accentuated, the BDBR decided to lower the bank reserve requirement on ordinary deposits. This measure reduced the cost of financial intermediation and reduced the fears of tight liquidity. During that same period, the Board of Directors also lowered the required deposit on external borrowing to zero, so as to facilitate access to external financing at a time when it would have been more expensive because of the global crisis.

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Later, in December 2008, ahead of the other central banks in Latin America, the BDBR launched an initiative to rapidly reduce the policy interest rate. By the end of June 2009, the cumulative reduction in that rate came to 550 basis points (bp). As a result, the central repo rate to supply liquidity to the banking system went from 10% to 4.5%.

The monetary stimulus policy applied in recent months is part of the inflation targeting strategy, which is intended to keep economic activity on a long-term path that is sustainable. This implies adjusting interest rates and other

The first half of 2009 witnessed a pronounced slowdown in annual consumer inflation from 7.7% at the end of 2008 to 3.8% at the end of June

monetary policy instruments in a counter-cyclical way to avoid sharp fluctuations in output and to guarantee low stable inflation. As in the high phase of the economic cycle, when interest rates were raised to curb the growth in spending and the credit bubble that brought inflationary pressures to bear, now, when the economy is growing below its potential capacity, and there is less pressure on prices and inflation expectations, monetary policy becomes less expansive, without endangering control over inflation. In fact, the first half of 2009 witnessed a pronounced slowdown in annual consumer inflation from 7.7% at the end of 2008 to 3.8% at the end of June, the lowest level on record since June 1962. Likewise, core inflation - which isolates temporary supply shocks such as those that occur in food or fuel prices - registered a sharp downturn from 6.1% in December to 4.9% in June, according to the average of the three indicators monitored by Banco de la República. This drop in inflation was accompanied by a plunge in inflation expectations. According to the Banco de la República's monthly survey, those expectations are around 3.5% for the end of 2009 and 4.6% for a 12-month horizon. These levels are compatible with the inflation targets.

The policy rate cut passed through quickly to interest rates on loans from the financial system.

The policy rate cut passed through quickly to interest rates on loans from the financial system. So far this year, up to mid-June, the weighted lending rate was down 595 bp. This compares favorably to the 550 bp policy rate cut mentioned earlier. The rates on almost all types of lending have responded to a looser monetary policy, particularly the interest rate on commercial loans, with a 638 bp reduction during the same period. The consumer lending rate was the only one to show some resistance to decline, with a 221 bp reduction during the period. The relative inflexibility of this rate is due to the fact that consumer loans are the riskiest for financial institutions, as they usually have no collateral. This is a common phenomenon found in many other economies, as discussed in one of the special sections of this report.

The reduction in the interest rate on lending and the soundness of the financial system have helped to sustain a certain amount of momentum in the total loan portfolio.

The reduction in the interest rate on lending and the soundness of the financial system have helped to sustain a certain amount of momentum in the total loan portfolio, which was up 14% in annual terms by the end of the first half of 2009. Considering the slowdown in the economy and the loss of consumer and investor confidence, this is a satisfactory increase in lending. The commercial loan portfolio, in particular, is more dynamic, having grown at an annual rate of 20% during the first half of the year. This clearly reflects a greater of a response to the policy rate of the interest rate for this type of lending. Commercial lending is focused on the corporate sector of the economy and helps to maintain the momentum in productive investment. Consumer lending, on the other hand, has remained almost at a standstill, registering 2.8% annual growth during the first half of the year. This should come as no surprise, considering its sharp growth in the past, the drop in household consumption during the first six months of the year, less consumer confidence, and the slow response of consumer credit rates to Banco de la República's policy rate cuts.

The current year will go down in history as an exceptionally difficult one for the world economy, hit by an international financial crisis not seen since the Great Depression in the Thirties. In this adverse economic environment, the Colombian economy is holding up better than many other emerging countries with a similar level of development.

The current year will go down in history as an exceptionally difficult one for the world economy, hit by an international financial crisis not seen since the Great Depression in the Thirties. As a result of economic globalization, its contagion is quick and intense. In this adverse economic environment, the Colombian economy is holding up better than many other emerging countries with a similar level of development. This is not by chance. It is a reflection of the country's good economic fundamentals and the prudent economic policy that preceded the crisis. A number of indicators reflect the increased strength of the Colombian economy in contrast to the past. The level of international reserves, the financial system's capital soundness and limited exposure to risk, less external borrowing (public and private) as a share of GDP and its profile of long-term maturity, a sustainable current account deficit, financed largely with foreign direct investment, the highest saving and investment rates in the economy, and increased capacity for potential growth in a context of low, stable inflation are some of the factors that worth mentioning in this respect. Moreover, the country has access to a US$10.4 b flexible credit line from the IMF, which is extended to countries with good economic performance, prudent policies and a solid economic policy framework.

It is the duty of the country's economic authorities to capitalize those strengths through prudent and effective management of the crisis, using all available tools without increasing the imbalances. The fundamental objective is to temper the effects of the external shock and to prepare the Colombian economy for recovery, once international conditions improve. Economic policy management in a context of exchange flexibility, together with a prudent counter-cyclical fiscal policy in a framework of government debt sustainability, as outlined by the government in the medium-term fiscal framework, will help to accomplish that desirable objective.

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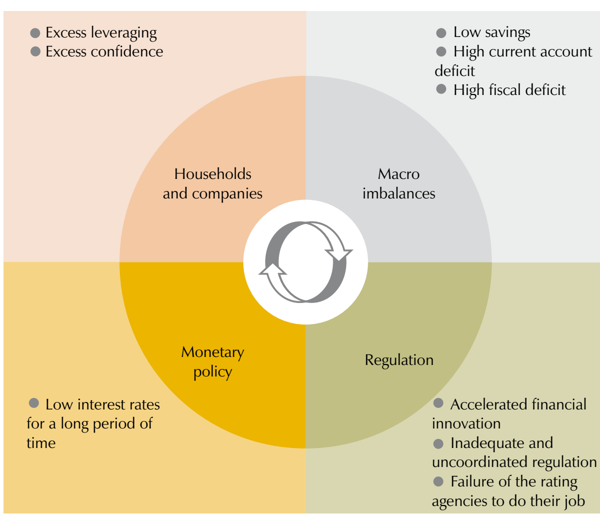
There are four chapters in this report. The first offers a description of how the world crisis evolved, its impact on economies and outlook. The second chapter delves into the performance of the Colombian economy and how it has been affected by the international crisis. The third focuses on the way international reserves are managed, their composition, the measures adopted and the status of claims filed with respect to credit events. The last chapter discusses the financial situation of Banco de la República. The report also includes several special, in-depth sections on technical matters to complement the economic analysis presented in the chapters.

I. The World Crisis, Policy Lessons and Outlook

Indicators of consumer and business sentiment in the developed countries suggest the international crisis is close to bottoming out and the economy could begin to recover during the second half of the year, although very slowly.
Together with the good performance by the large emerging Asian economies in terms of foreign trade and economic activity, this could create a more favorable panorama for the developing countries.

Unlike other episodes of international economic crisis, the current recession originated in the world's largest economy and spread in a synchronized way to the other industrialized countries. The co-existence of large macroeconomic imbalances and a lax monetary policy in the United States for a prolonged period of time, amidst an environment of precarious bank regulation and accelerated innovation in the financial market set the stage for the formation of asset price bubbles (mortgage and financial assets). Excess confidence and leveraging by agents in the market accentuated the situation (Diagram 1). Given this macroeconomic situation, the drop in housing prices later on sparked the worst recession in U.S. history since the postwar.

Diagram 1
Principal Factors that Influenced the Crisis in the United States



Source: Banco de la República.

The crisis in the United States was passed on to the other developed countries largely through financial channels, with an adverse shock that began in mid-2007. It intensified after the failure of Lehman Brothers and with the uncertainty surrounding the resources from the Troubled Asset Relief Program

The crisis in the United States was passed on to the other developed countries largely through financial channels, with an adverse shock that began in mid-2007. It intensified after the failure of Lehman Brothers and with the uncertainty surrounding the resources from the Troubled Asset Relief Program (TARP).

(TARP).[1] Most of the industrialized countries whose financial systems had U.S. subprime mortgage securities suffered a deep financial crisis in the second half of 2008;[2] that is, illiquidity in the interbank payment system, loss of solvency on the part of major financial institutions, paralysis in credit markets and devaluation in capital markets, all of which seriously affected household wealth and business cash flow. The situation also was aggravated by the fact that several developed economies such as England, Spain, France, Ireland, Australia and New Zealand also had mortgage bubbles of their own that began to burst.

The decline in world demand and the plunge in external financing also affected foreign trade, which had been a driving force of growth. All of these events seriously undermined confidence and provoked enormous losses in output and jobs, unleashing the worst combined recession in the industrialized countries in the postwar era.[3]

Many of the emerging countries have not been exposed directly to the financial crisis, and have not experienced a sharp devaluation in asset prices (including mortgage assets).[4] Most of the impact of the world crisis has been in the form of less volume and lower prices for exports, fewer worker remittances, a slowdown in foreign direct investment, and a loss of confidence (with implications for consumption and investment).

The decline in world demand and the plunge in external financing also affected foreign trade, which had been a driving force of growth.

In terms of the magnitude of its impact, the world crisis has affected each developing country differently. Nevertheless there are economic policy lesson to be learned on how to face negative external shocks:

- The adoption of macro-prudential policies that shield economies against adverse shocks is necessary.
- Excess spending in an economy for prolonged periods of time creates large current account deficits that may be impossible to sustain in the face of a sudden reduction in external financing.
- An accelerated and excessive increase in lending, apart from what might be considered a natural trend in loan growth, usually will

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1 TARP is a program of the United States government designed to purchase assets and equity from financial institutions to strengthen the country's financial sector.

2 Countries with a financial system that was highly integrated with the U.S. financial system or highly exposed to toxic assets.

3 An IMF study (WEO, 2009) comparing the current recession to various recessions in the last century shows that those associated with financial crises have been more severe and lasting than those related to other shocks. The same is true of highly synchronized recessions among countries.

4 The majority do not have a financial system that is as integrated with the U.S. financial system, as do various industrialized economies, nor are their financial systems highly exposed to toxic assets.

generate asset price bubbles that are unsustainable. Any reversal of those prices in the future may produce an economic crisis.

- Major differences between terms for deposits and loans, as well as serious exchange mismatches between banks and companies,[5] amplify the risks to the financial system. If this situation occurs in the presence of a drop in external financing, the financial system may face serious liquidity problems and interest rates could remain on an upward course.

- A healthy financial system, with adequate provisions and capital requirements, works better to buffer the adverse effects caused by a reduction in external financing.

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- Having a floating exchange rate is important. In economies with sharp rigidities, the exchange rate adjusts in response to different shocks and makes it possible to achieve a better macroeconomic balance. With a flexible exchange rate, the adverse effects on GDP generated by a real external shock, such as falling terms of trade, are tempered by the depreciation that occurs, since the latter means more income for exporters and increases their competitiveness in the short term. Exchange flexibility also allows the central bank to have more control over the internal interest rate. In contrast, with a fixed exchange rate, given the loss of control over the interest rate, the adjustment falls more heavily on the fiscal policy, by increasing the risk that the country becomes insolvent.

Accordingly, the developing countries most affected by the crisis have been those with some of the aforementioned structural problems. The Eastern European countries are a a clear example. The real increase in lending during the last five years averaged more than 40% in a number of countries within the region and generated unsustainable growth in internal demand that was well above output. Accordingly, they were hit by the international crisis with a historically high current account deficit[6] financed largely through external borrowing. Moreover, a number of those countries had a commitment to exchange rate parity against the euro and their financial institutions showed large mismatches in currency and terms.[7] Since most of the banks are foreign and a large portion of their deposits originate outside the country, lending to internal agents was

Accordingly, the developing countries most affected by the crisis have been those with some of the aforementioned structural problems. The Eastern European countries are a clear example.

5 An example of exchange mismatch is a bank that requests a loan in dollars to extend credit in pesos, with no backing of any sort.

6 In a number of economies, it reached two digits as a percentage of GDP.

7 The loan portfolio/deposit indicator for the private sector in the region is more than 2, which is much higher than the indicator for the other developing economies.

In a number of Latin American countries, the story is different. In spite of being seriously affected by the international situation, via the channels associated with the balance of payments and confidence, the impact of the crisis in many of them is expected to be mild.

sharply reduced when international flows dried up.[8] The sale of reserves to defend the exchange rate caused a monetary contraction that aggravated the financial system's liquidity and increased the constraints on lending. All of these macroeconomic vulnerabilities, together with a sharp drop in external funding, unleashed an unprecedented recession in Eastern Europe.

In a number of Latin American countries, the story is different. In spite of being seriously affected by the international situation, via the channels associated with the balance of payments and confidence, the impact of the crisis in many of them is expected to be mild, even less than in the developed economies. The reason, primarily, is the variety of macro-prudential measures developed since the crisis at the end of the nineties. Indeed, several Latin American economies that have maintained a responsible monetary and fiscal policy still have a healthy financial system and a sustainable current account deficit financed largely through foreign direct investment. In a number of them, foreign trade accounts for a reduced share of their economic activity and exports are focused mainly on commodities, which have devaluated sharply as a result of the crisis, but remain at high levels compared to the average for past years. Therefore, for the first time, countries such as Peru, Chile, Colombia and Brazil are able to take counter-cyclical action on the fiscal and monetary front, which has tempered the negative impact of the international crisis and generated relatively early momentum towards recovery.

As described below, several indicators of consumer and business perception in the developed countries suggest that the international crisis would be close to bottoming out and recovery could begin in the second half of the year, although very slowly.[9] Together with several signs of improved performance in foreign trade and economic activity in the large emerging Asian economies, this could generate a more favorable outlook for the countries of the region for the rest of the year. However, for 2010, most analysts expect to see historically low growth in most countries.

Therefore, for the first time, countries such as Peru, Chile, Colombia and Brazil are able to take counter-cyclical action on the fiscal and monetary front, which has tempered the negative impact of the international crisis and generated relatively early momentum towards recovery.

8 From the Western European countries.

9 The recovery forecast for the industrialized countries may be slow because of a number of factors. On the one hand, there is the severe crisis facing their financial systems, which are crucial to a quick and sustained recovery in long-term output. On the other, household wealth was seriously affected by the drop in financial asset and housing prices. This can jeopardize the momentum in future consumption. Moreover, unemployment continues to rise and it may take time for the job market to recover. This also would damper consumption and affect confidence.

In the last quarter, fiscal and monetary-policy efforts in amounts without precedent in recent history have allowed for some improvement that could restore the conditions required to begin the stabilization of the economy during the second half of this year.

A. INDUSTRIALIZED COUNTRIES: WHAT IS NEW AND WHAT TO EXPECT FOR THE REST OF 2009

As noted, the combined action of several events in the financial environment of the developed countries during the third and fourth quarters of 2008 triggered the sum of macroeconomic imbalances faced by those countries, which led to a plunge in household wealth, a paralysis of credit and a loss of business and household confidence that triggered a sharp decline the global productive activity. However, during the last quarter, fiscal and monetary-policy efforts[10] in amounts without precedent in recent history have allowed for some improvement that could restore the conditions required to begin the stabilization of the economy during the second half of this year. As for household wealth, the stock market recovery in recent months has helped to compensate for a large percentage of the huge losses incurred in 2008. Similarly, although credit remains tight, there has been some relief, especially for large companies, in an environment of increased interbank liquidity and improvements in the capital adequacy ratio of large financial institutions. Also, numerous indicators of confidence with respect to the economic situation, business sentiment and medium-term prospects have improved slightly. Although very different from one region to another, they do indicate a better outlook. Finally, the drop in manufacturing activity, which has inflicted a drastic impact on the labor market, could begin to recover during the coming quarters, to the extent that new orders are starting to pick up in the presence of what can be considered historically low inventories. The following are some of the signs of economic stabilization observed during the last quarter.

The response of capital markets in developed countries was quite positive during March, April and May of this year and they have recently stabilized.

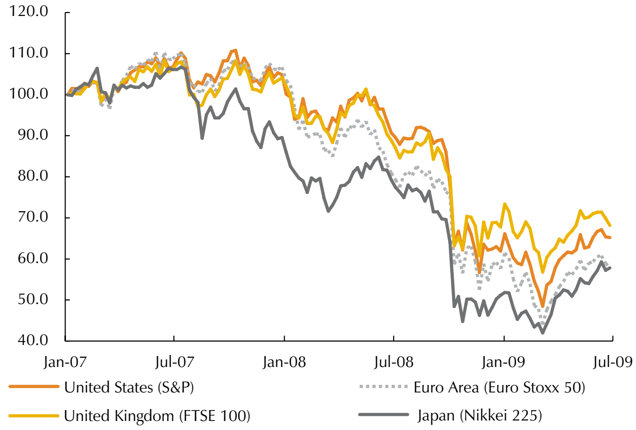
- *Stock Markets*. The capital markets are an essential component of expectations about how the economy will perform.[11] The response of those markets in the developed countries was quite positive during March, April and May of this year and they have recently stabilized (Graph 1). Investors have benefited from the low levels to which most indexes had sunk at the end of last year. The stock markets also have been fowored by the decline in pessimism reflected in surveys of household and business sentiment.

- *Financial System.* The focus of action taken by the central banks and treasury departments of the major industrialized countries has been on restoring the operation of financial systems by supplying ample

10 The *Report by the Board of Directors to the Congress of the Republic of Colombia*, submitted in April 2009, details the principal fiscal and monetary policies implemented by the developed countries during the second half of 2008 and early 2009. Although that description remains valid, there is still a great deal of uncertainty as to how quickly and effectively fiscal policies will be implemented during the second half of 2009, particularly in the case of the United States.

11 Several academic exercises have been done for the Japanese case in particular, showing the predictive power stock prices can have on future alterations in the economy (see Yamada and Honda, 2005). However, it should be noted that this relationship is maintained under particular market conditions and has not been tested for all countries.

Gráfico 1
Stock Market Indexes in the Developed Economies



Sources: Bloomberg; calculations by Banco de la República.

liquidity to offset the lack of confidence in the interbank markets. The United States and the United Kingdom are a prime example, where policies to expand and restructure central bank balance sheets have managed, in most cases, to re-establish the performance of the highly liquid markets.

As for the capital needed to respond to the turbulence in financial systems, stress tests have been done in the United States and Europe to analyze how the capital adequacy ratios of financial institutions are expected to behave in response to the changes in macroeconomic conditions.[12] The overall results are favorable to the extent that the capital requirements show by those stress tests are lower than the market expected.[13] However, in the European case, analysts are extremely concerned about the possible consequences that the deterioration in macroeconomic conditions in Eastern Europe could have for Western European banks. As mentioned, much of the financing for projects and portfolio investment in those developing economies comes from major Western banks.

Although the liquidity and balance sheets of financial institutions are under less stress, it is important to bear in mind that credit remains very tight for most sectors.

Although the liquidity and balance sheets of financial institutions are under less stress, it is important to bear in mind that credit remains very tight for most sectors. Despite the reduction in interest rates in the commercial paper market, issues have declined steadily.[14] In addition, the commercial bank surveys conducted by the central banks show lending is still down, as a result of both supply and demand (Graph 2).

- *Indicators of business sentiment and confidence*. Various indicators of economic sentiment and expectations can give signs of changes in the economic cycle. Their relationship depends on when they are published, their coincidence with the business cycle (coincident indicators), or the ability they have shown to predict the future of the economy (leading indicators). The indicators published by the Institute for Supply

12 The amount of capital needed to maintain a healthy capital adequacy ratio, even if economic conditions become considerably worse in the next two years, was determined for the 19 largest banks in the United States. The results of the exercise showed that, in the worst-case scenario, the capital needs of those 19 institutions would come to US$$ 600 billion (b) between 2009 and 2010. After analyzing the projected profits of those firms, the expectation is that ten of them, in total, would need to collet US$ 75 b in private capital.

13 Nevertheless, there is talk of repeating the stress tests using more deteriorated macroeconomic scenarios.

14 The real question is whether interest rates are good indicators at times like these. It is quite possible that financial institutions may make an adjustment in terms of the quantity and selection of their customers, excluding many from the market and leaving only the preferred customers with moderate interest rates. There might even be price competition to attract good customers.

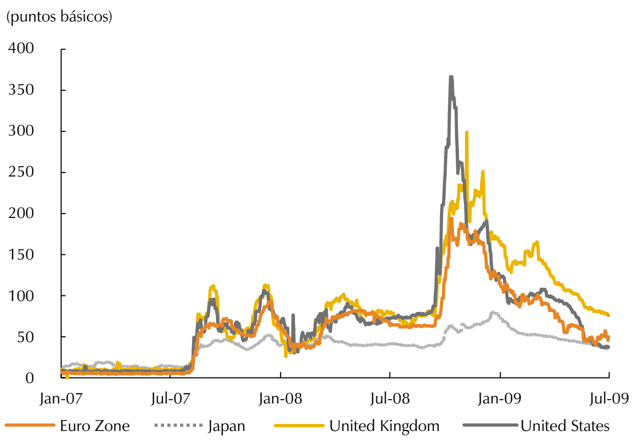
Various indicators of economic sentiment and expectations can give signs of changes in the economic cycle.

Management (ISM) in the United States and by Markit for the other developed economies involve businessmen's perception of their current and future situation in the industry. In the United States and Europe, despite recent increases in these aggregate indexes, their level still is consistent with a contraction in industry. However, the questions that relate to industry's expectations at six months or a year out have recently rebounded. The situation in the service sector is very similar (Graph 3).

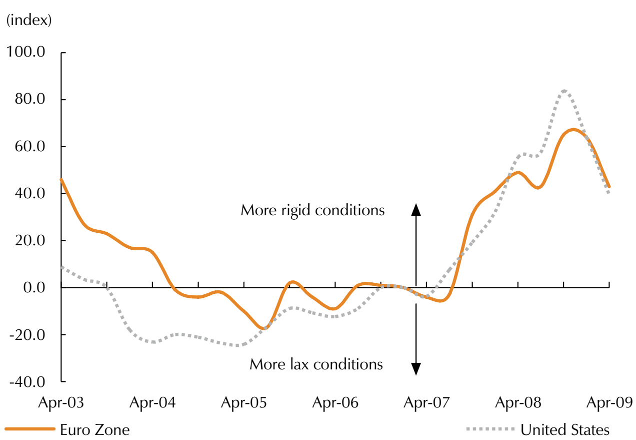
Household expectations also have improved slightly. Indicators of consumer confidence have rebounded in the U.S. and in the U.K., but recovery for the rest of Europe has been less clear. The counter-cyclical fiscal policy measures announced in late 2008 and early 2009, whose effects have yet to be seen, could begin to boost the economy during the second half of the current year. This should support the optimism that has

Graph 2
Financial System in the Industrialized Economies

A. Interbank Market Rate Spreads: Libor vs. OIS Spread at Three Months



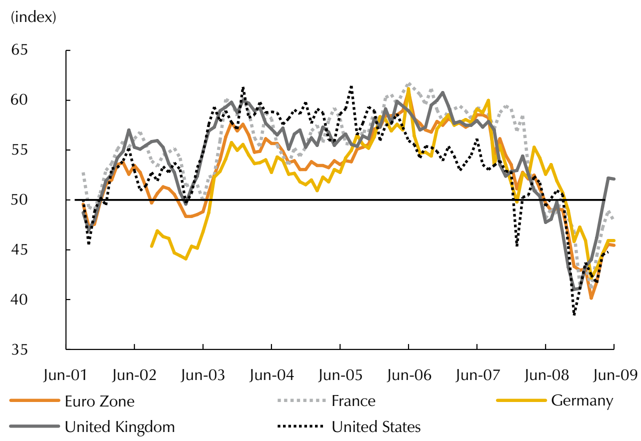
B. Standards for Lending to Large Companies



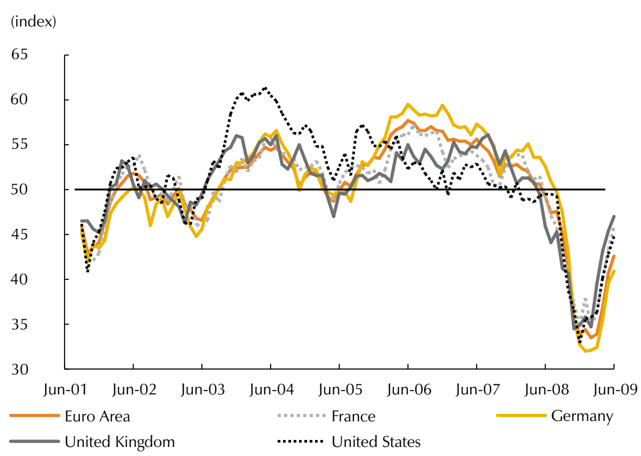
Sources: Bloomberg; calculations by Banco de la República.

Graph 3
Business Sentiment Indexes in the United States and Europe[a/]

A. Service Sector

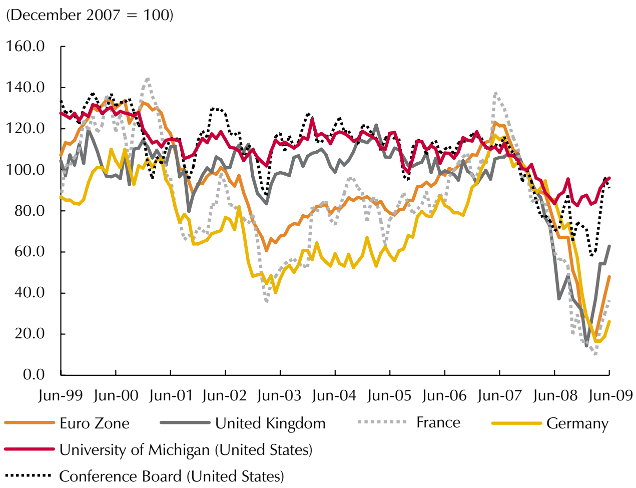


B. Industrial Manufacturing Sector



a/ The information for the United States is from the Institute for Supply Management (ISM); for the other countries, it is from the Markit Purchasing Managers' Index (PMI).
Source: Bloomberg.

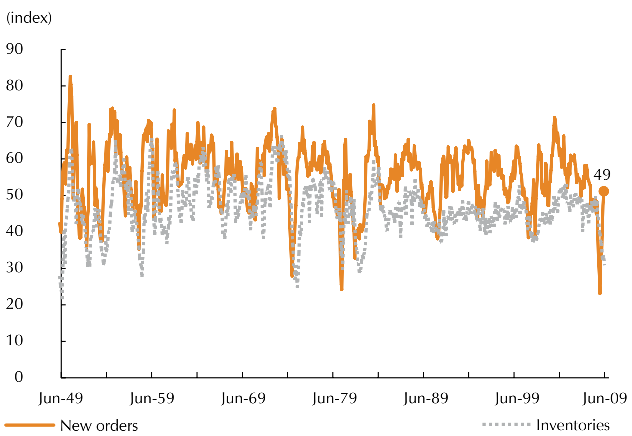
Graph 4
Consumer Confidence Indexes in Europe and the United States



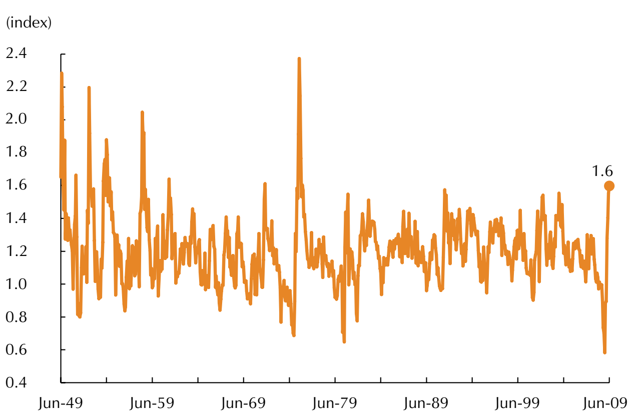
Source: Bloomberg; calculations by Banco de la República.

Graph 5
Inventory Accumulation in the United States

A. U.S. Manufacturing Industry[a/]



B. New Orders /Inventories in the United States



a/ Based on the ISM business sentiment index.
Sources: Bloomberg and the Institute for Supply Management (ISM); calculations by Banco de la República.

been perceived in some household and business surveys (Graph 4). The following highlighted section contains an analysis of the combined behavior of the main U.S. confidence and expectations series (see page 25).

- *Inventories.* The behavior of private inventories is another leading indicator related to the economic cycle. When an unexpected recession is triggered, companies tend to accumulate inventories. Later, the company lowers its production for the dual purpose of adjusting to less demand for its output and to offset the undesired accumulation of inventory that occurred at the start of the recession.[15]

During the second half of 2008, firms in the developed countries accumulated large amounts of inventories. Only since this year, they have begun to get rid of those inventories, generating a substantial contraction in GDP during the first quarter. In the case of the United States, Graph 5 shows that, since new orders have increased, currently low inventories could encourage firms to boost their production during the second half of the year. With very few exceptions, the recovery phase in previous recessions has been marked by situations like these.

Despite the aforementioned improvements in several of the leading indicators and the conditions for economic stabilization generated by the re-establishment of financial markets during the rest of the year, the momentum in output will continue to be weak, and uncertainty about the start of the recovery phase of the cycle will remain very high until the structural macroeconomic imbalances in these economies are adjusted.

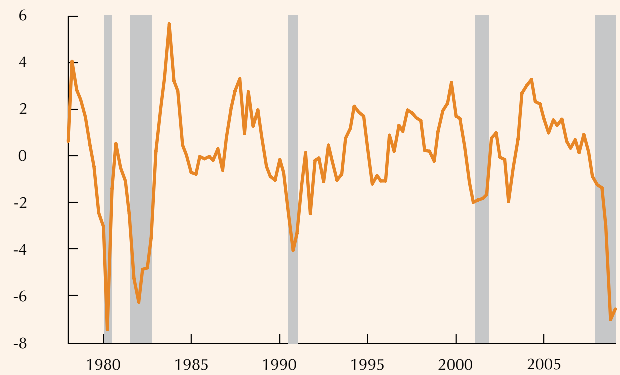
15 "An unexpected contraction in demand is absorbed with a drop in output and an increase in inventory. Because companies usually want to maintain a certain level of inventory in relation to output, they will adjust their output after an unexpected shock in response to unwanted increases or decreases in inventories [...]" (Metzler, 1941).

EXPECTATIONS, CONFIDENCE AND OUTPUT MOMENTUM IN THE UNITED STATES

In a recent paper, Bernal and Romero (2009)[1] analyzed the behavior of the main eleven confidence and expectation series used in the United States to determine if their combined behavior is a leading indicator of GDP growth that country. A principal component analysis was the statistical method used to summarize the data, and a high correlation was found between the indicators, as a whole, and observed GDP and the economic cycles reported by the National Bureau of Economic Research (NBER).[2] It should be noted that these indicators are published up to three months before them release of the figure for economic growth, thereby providing a forecast of how it might perform.

Graph A shows the principal-component indicator[3] calculated by the authors with respect to the economic cycles reported by the NBER (shaded areas). Using that same method, the authors argue that, on average, current levels of expectations and confidence in the U.S. economy would be similar to what they were during the recession in the early 1980s. With this analysis, it was found that indicators of manufacturing employment, the business climate and the Purchasing Managers' Index (PMI) are those that have a higher weight in the construction of the principal-component indicator. The same study also poses the hypothesis that the combined behavior of the confidence and expectation indicators may show changes in the present growth paths (which are reported with a lag) that would lead growth of the United States economy in the second quarter to fall less than in previous quarters and to cease to stop declining the second half of the year.

Graph A
Combined Behavior of Confidence and Expectation Indicators in the United States, Using the Principal Components Method



Note: The shaded areas represent the periods of economic recession in the United States, as determined by the NBER.
Source: NBER; calculations by Bernal and Romero (2009).

1 Bernal, Ricardo and José V. Romero, "Down is the New Up: Confidence and Expectation Indicators of the US Business Cycle," (mimeograph) Banco de la República, 2009.

2 An independent economic research agency that identifies the productive cycles in the United States.

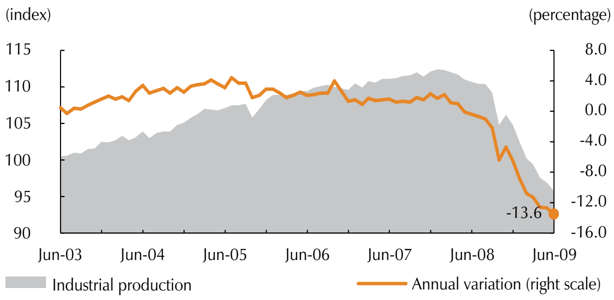
3 The principal-component analysis is a statistical technique that makes it possible to model the variance structure of a broad set of variables and, therefore, to summarize the common movement of different series in a few combinations or components.

This is confirmed by the figures on real activity at April and May in the developed countries, which remain negative and have yet to show clear signs of a change in pattern. One of the most relevant cases is industrial production, which continued to register historically high reductions for June in the United States and for May in the Europe case (Graph 6).

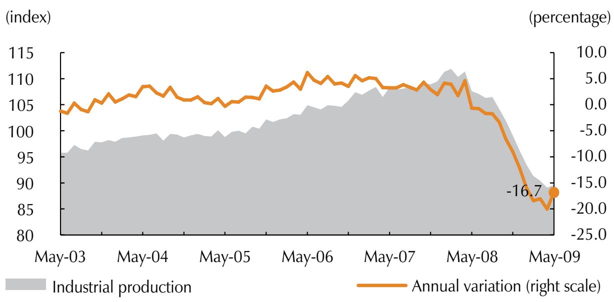
The contraction in the industrial sector, together with the decline in several branches of the service sector, especially the financial services, continues to destroy jobs on a massive scale in the industrialized countries. In the case of the United States, the cumulative effect of the huge setback in the demand for labor

Graph 6
Industrial Production in the Developed Economies

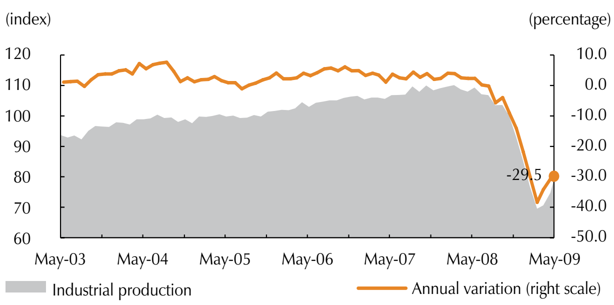
A. United States



B. Euro zone



C. Japan



Sources: Bloomberg; calculations by Banco de la República.

quickly raised unemployment rates to levels not seen since the 1982 recession (Graph 7).[16]

The export sector, which is the driving force of economic activity in several European countries and Japan, still shows no signs of recovery (Graph 8). According to the latest IMF report (WEO, 2009), world trade has fallen in recent quarters to levels unprecedented since the post-war era, with most of the impairment in trade evidenced by the industrialized economies.

All these factors associated with weakening aggregate demand and lower prices for energy and agricultural goods continue to allow inflation to decline, particularly in the case of the United States (Graph 9). As a result, it has been possible to maintain a very loose monetary policy, without generating inflationary pressure in the short term.

B. THE EMERGING ECONOMIES AND THE EFFECTS OF THE INTERNATIONAL CRISIS

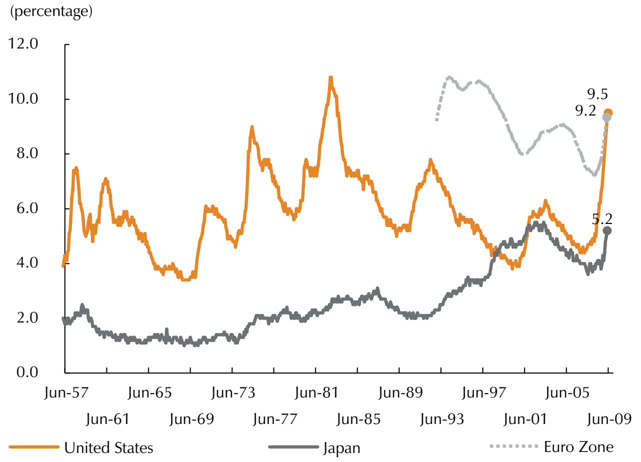
The crisis in the developed countries seriously jeopardized productive activity in emerging market economies (see the highlighted section on page 28). After several years of economic boom, the GDP in most of those economies contracted during the last quarter of 2008 and the first of 2009 (Graph 10). The strongest impact was felt in the Eastern European region where, as mentioned, the economic imbalances were particularly sensitive to the retraction of external flows. In the Asian region and in Latin America, the effects of the crisis have been more indirect, given the macro-prudential policies that were implemented after the crisis of the late nineties and due to the health of their financial systems. In the emerging Asian countries, the main pass-through channels are related to the deep exposure of their economies to international trade.

The crisis in the developed countries seriously jeopardized productive activity in emerging market economies. After several years of economic boom, the GDP in most of those economies contracted during the last quarter of 2008 and the first of 2009.

Most Latin American countries have been affected by lower international commodity prices, fewer worker remittances and less external demand for

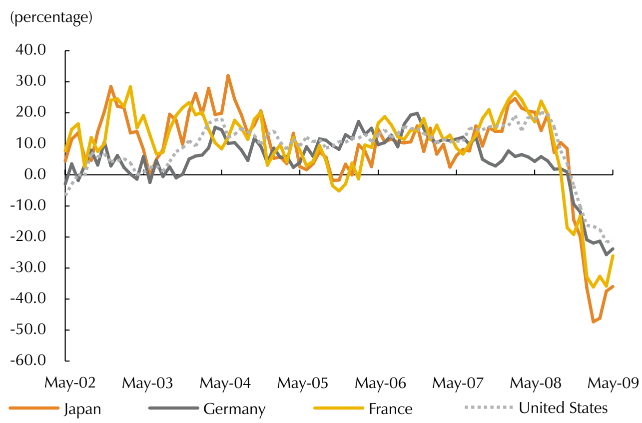
16 In the European case, the increase has been more modest, possibly because its labor market is less flexible than the labor market in the United States.

Graph 7
Unemployment Rate in the Developed Economies



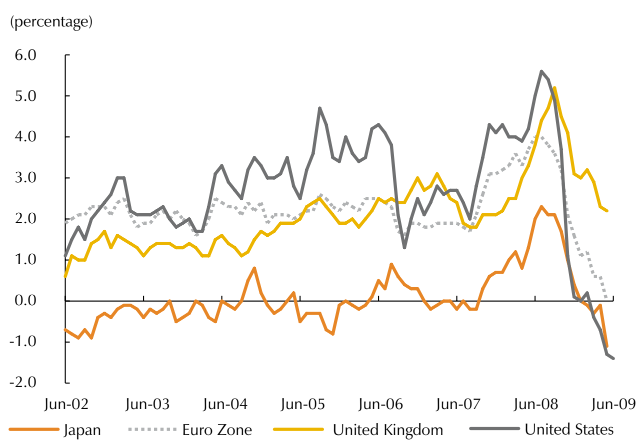
Source: Bloomberg.

Graph 8
Exports from the Developed Economies [a/]
(annual variation)



a/ Export figures in dollars
Source: Bloomberg; calculations by Banco de la República.

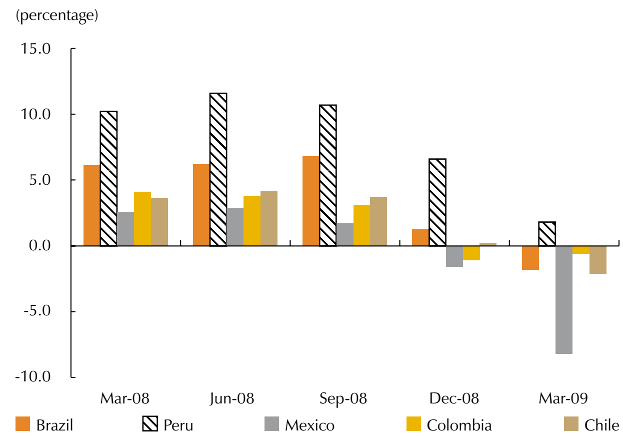
Graph 9
Total Inflation in the Developed Economies
(annual variation)



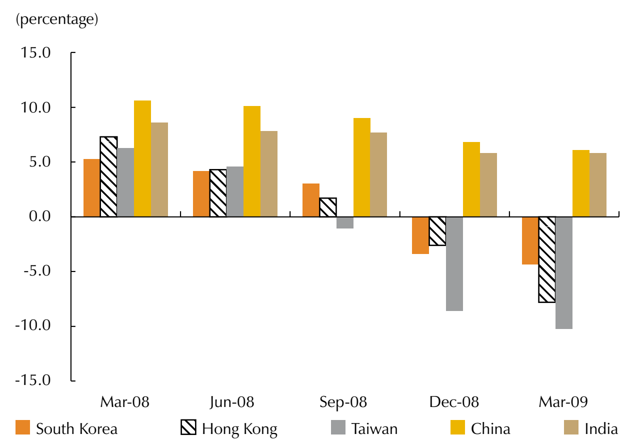
Source: Bloomberg.

Graph 10
GDP of the Emerging Economies
(annual variation)

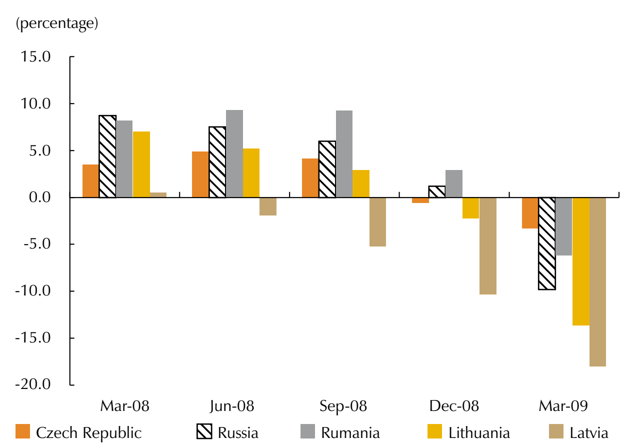
A. Latin America



B. Emerging Asian Economies



C. Emerging Eastern European Economies



Sources: Bloomberg y DANE; calculations by Banco de la República.

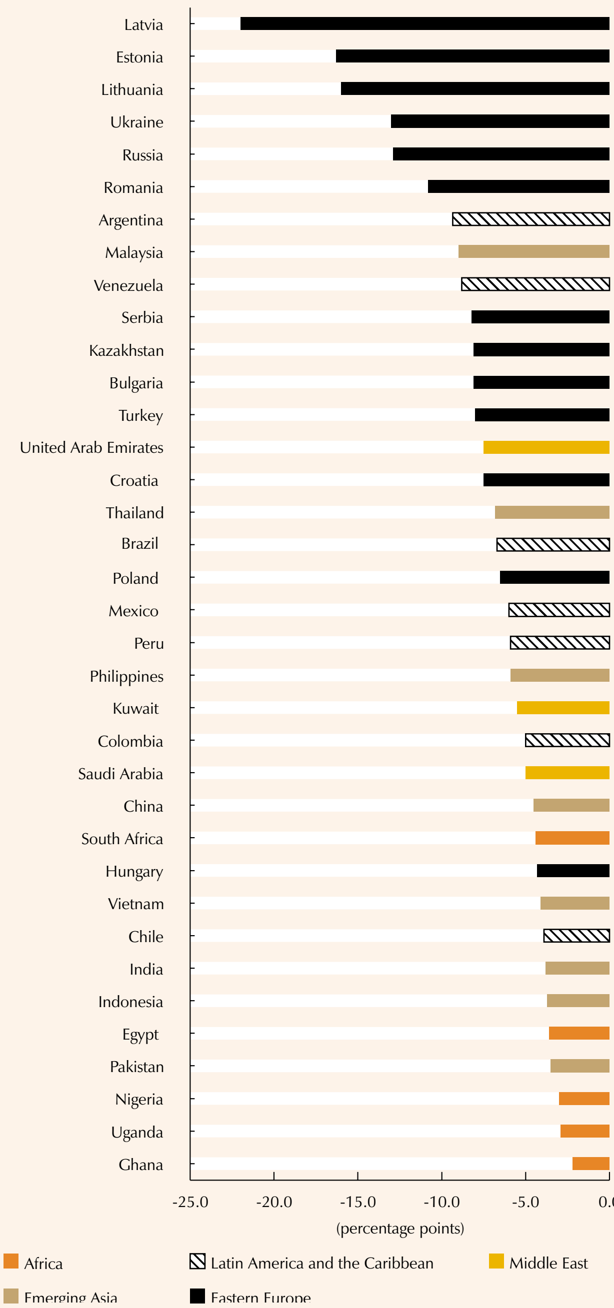
Although some effects of the crisis are common to the emerging countries, it is difficult to determine the economic impact on each of them.[1] Graph A shows the difference between growth projected for 2009 by the IMF and the average observed between 2007-2008, as an estimate of the extent of the slowdown expected in the emerging economies. In the case of the African countries with less international financial and commercial integration, less of a slowdown in their economic growth is expected, followed by the Latin American and Asian countries.[2] The largest drop in GDP is expected to occur in Eastern Europe.

Likewise, Graph B, Panel 1 shows that countries with more net deficit in their external position (as a percentage of GDP) may experience a sharper slowdown in 2009 (according to IMF estimates). Something similar, though less pronounced, occurs with countries that have more open economies (measured as exports/ GDP, Graph B, Panel 4).

Graph A, and panels 2 and 3 of Graph B show that the strongest impact of this crisis could be determined by the particular characteristics of each economy, which are related primarily to macroeconomic imbalances. The slowdown in international financial flows has revealed many of the macro vulnerabilities of various developed and emerging countries, as reflected in large trade and fiscal deficits.

Accordingly, the countries that have been most affected by the international crisis are those with major macroeconomic vulnerabilities: on the one hand, the countries that spawned the crisis, whose imbalances were primarily responsible for the bubbles that emerged in the financial and real estate markets; on the other, the countries that did not participate in generating the crisis but whose economic imbalances made them particularly vulnerable to the reduction in international flows. The other developing economies that had made an effort to consolidate the fiscal position, the current account and the financial system have been hit hard by the crisis, but the effects are not comparable to other times of international stress, particularly those associated with the crisis during the late nineties. Also, these are economies were able to recover more rapidly, since they have room for counter-cyclical policies, even though their currencies are not strong in the international context.

Graph A
Difference between Growth Forecast for 2009 by the IMF and Average Growth in 2007 and 2008



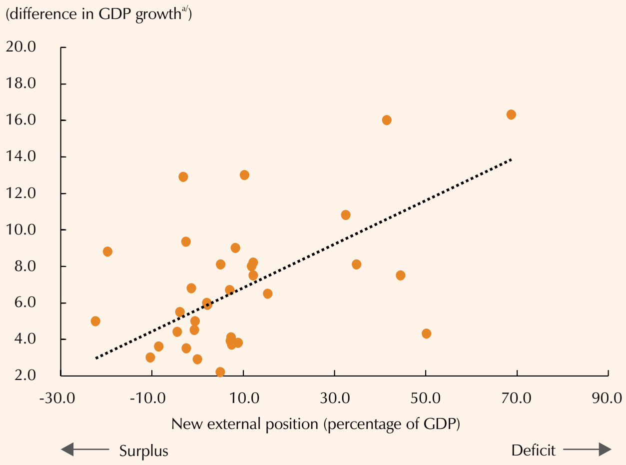
Source: FMI and calculations by Banco de la República.

1 According to several recent studies, the more profound and commercially integrated a financial system is, the greater the impact of the current crisis in each country, because pass-through occurs through close commercial and financial ties between developed and developing economies.

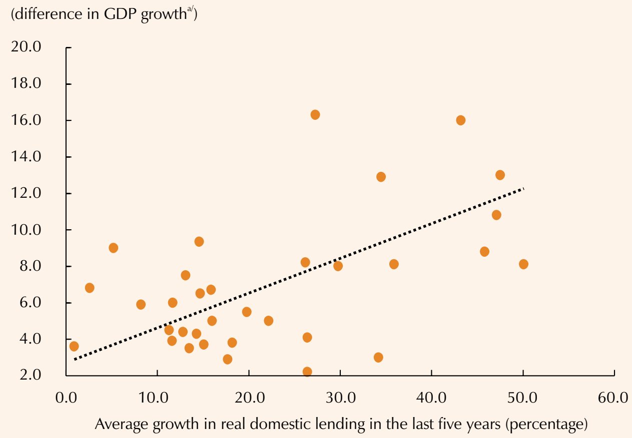
2 Venezuela and Argentina are the Latin American countries that have been affected the most. Their policies, in recent years, have been different from those of the rest of the region.

Graph B
Difference between Growth Forecast for 2009 by the IMF and Average Growth in 2007 and 2008 Compared to Different Macroeconomic Indicators

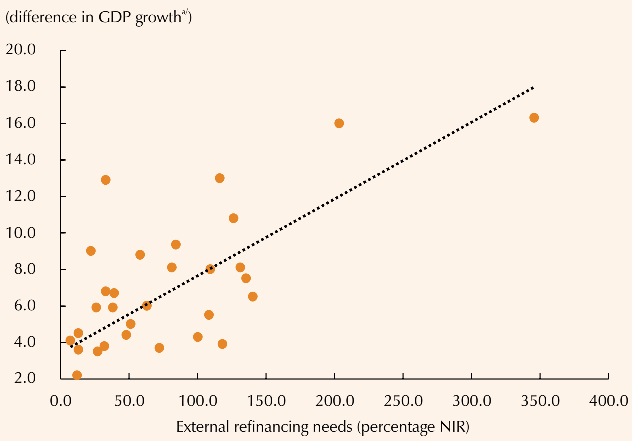
1. Net External Position reported by BIS



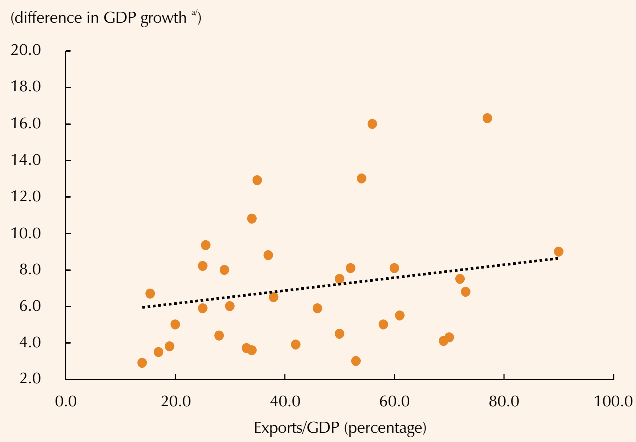
2. Real Growth in Domestic Lending in Recent Years



3. External Debt Refinancing Needs



4. Degree of Economic Openness



a/ Forecast by the IMF.
Source: IMF; calculations by Banco de la República.

Since December 2008, the Latin American central banks have cut their intervention rates in response to a scenario of marked economic slowdown with less inflationary pressure. The pass-through to lending rates[1] has been mixed, depending on the type of lending and the country.[2]

The effect on commercial lending rates has been the most notable and has responded more strongly to the monetary stimulus in most countries, with Peru being the only exception.[3] The pass-through to interest rates on consumer loans, including credit card lending, has been mixed (Table A). For example, in Colombia and Mexico[4] it has been slow, especially in Mexico (where the risks are greater due to the sharp drop in employment and household purchasing power). In Peru and Chile, the response has been more pronounced. In those countries, consumer lending rates (in nominal terms) have been higher than in Colombia (Table B).

Table A
Percentage of Lending Rate Response to the Repo Rate

	Consumer	Commercial	Mortgage
Colombia	57,49	114,06	75,77
Peru	63,39	30,57	(5,93)
Chile	179,34	84,25	15,84
Mexico	19,63	102,21	0,75

Sources: Central Banks and Bloomberg.

Mortgage interest rates are more resilient to monetary easing, particularly in Mexico and Peru. In Colombia, the mortgage rate is more responsive to the policy rate compared to other Latin American countries. The effects of indexing (UVR in Colombia and UF in Chile) and the added influence of long-term interest rates compared to the intervention rate are some of the factors that may explain the diverse performance within the region (Graph A).

Table B
Current Rate Response to the Repo Rate [a/]

	Date of maximum rate before beginning to fall and date of the last period analyzed	Repo rate	Consummer	Commercial	Mortgage
Colombia	19-Dec-2008	10,00	26,57	16,64	16,85
	03-Jul-2009	4,50	23,41	10,37	12,68
Peru	Jan-2009	6,50	32,68	10,77	9,88
	07-Jul-2009	3,00	30,46	9,70	10,09
Chile	07-Jan-2009	8,25	36,77	16,43	5,78
	07-Jul-2009	0,88	23,55	10,21	4,61
Mexico	01-Dec-2008	8,25	43,87	12,13	12,80
	May-09 (commercial at June)	5,59	43,35	9,41	12,78

a/ Calculated as the change in the lending rate over the change in the repo rate. It takes into account the maximum repo rate prior to declining up until the last period analyzed.
Notes: The mortgage rate in Chile is real; that is, percentage points added to the UF (development unit).
The figure for Colombia is based on the rate of non-low-income housing construction. For purchase, the result was 44.01%.
The results for Chile are obtained from loans at more than one year.
In Colombia and Chile, the lending rates are weekly; therefore, the repo rate is the average of the daily rates during the week. For Chile, the four-week moving average was used.
The lending rates used in Peru and Mexico are monthly; accordingly, the repo rate is the average of the daily rates during the month.
Sources: Central banks and Bloomberg.

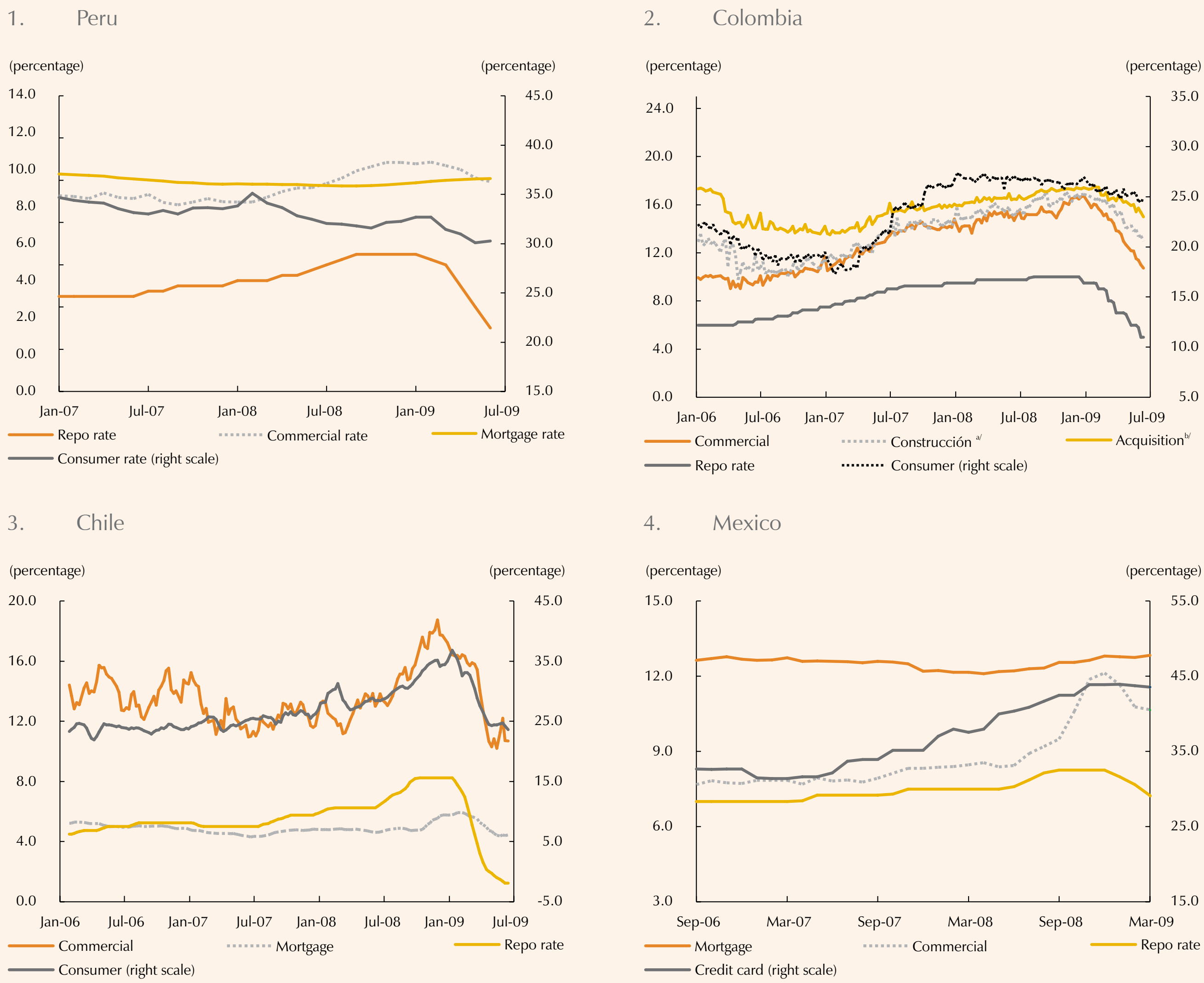
1 The benchmark rates of all the countries are expressed in an effective annual rate, 360 day base and 365 days for Colombia.

2 In this regard, see Jeanneau and Tovar, "Los mercados de títulos locales y la política monetaria en América Latina: implicaciones,"BIS Working Paper No. 36.

3 Even so, Peru has the most dynamic commercial loan portfolio in the region. See the highlighted section entitled "The Dynamics of Lending in Latin America," Inflation Report, March 2009, Central Bank of Colombia, pg. 46.

4 In December 2004, the Bank of Mexico began to publish interest rates on mortgage loans and the average interest rate on credit card lending, which was used in this exercise. Since the rate charged to companies is not published, the short-term interest rate on the corporate securities market was used as an estimate.

Graph A
Nominal Interest Rates [a/]



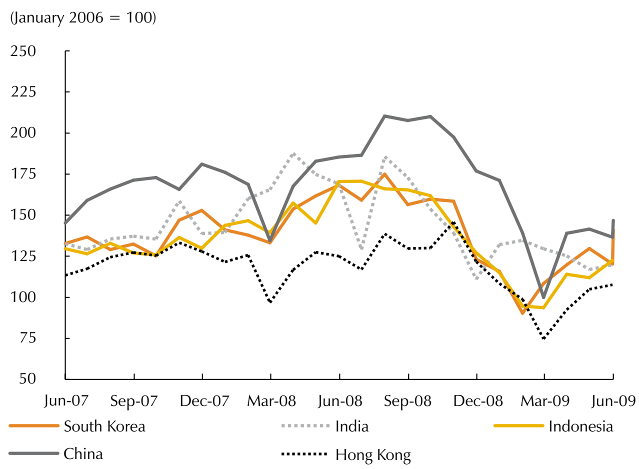
a/ In the case of Chile, the mortgage rates are real.
b/ Other than social housing.
Sources: Central banks and Bloomberg.

exports. As for the latter, the strongest aftermath of the crisis has been felt in Mexico, given its close commercial and financial ties with the United States.

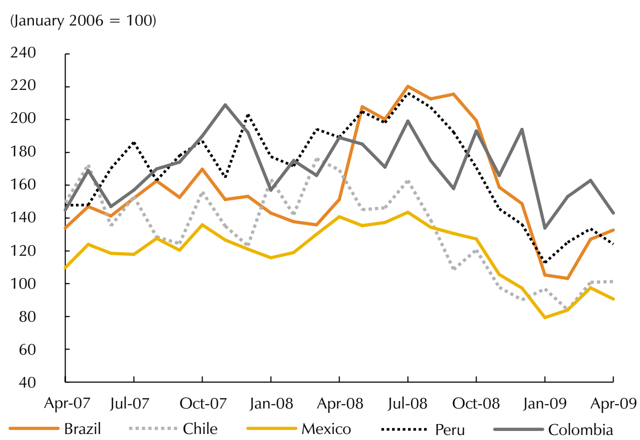
In general, the economic crisis in the developed countries has been passed strongly to the emerging countries through three channels: production, confidence and finance. In terms of production, the economic downturn in the developed countries affected exports from emerging markets via prices, particularly for commodities, and via quantity, given less demand for exports. Moreover, the worldwide decline in credit, which had become a fundamental

Graph 11
Dollar Exports of Developing Countries

A. Index of Total Asian Exports

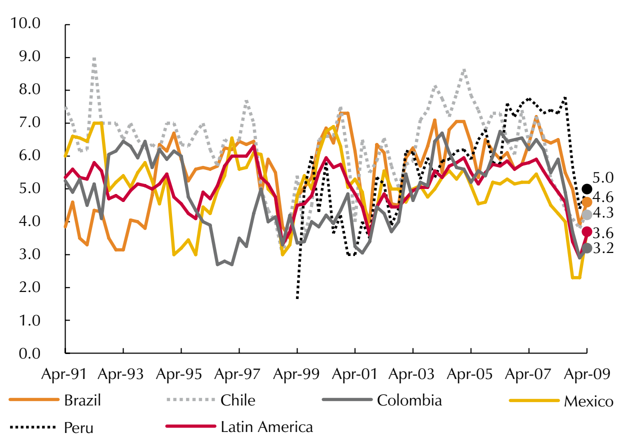


B. Index of Total Latin American Exports



Sources: Bloomberg y DANE; calculations by Banco de la República.

Graph 12
Economic Climate Index



Sources: IFO, Database.

pillar of international transactions, accentuated the reduction in world commerce to record levels not seen since the postwar (Graph 11).

International trade of industrial origin was seriously affected by the crisis and by the external credit crunch (Escaith and Gonguet, 2009). In the case of Latin America, Mexico's manufacturing exports have been hit hard, particularly the automotive sector, which has close ties with U.S. industry. As for the region's other economies, manufactured goods are not as important as a share of total exports as in other emerging market economies (Asia and Eastern Europe) and the momentum in the export sector responds primarily to the trend in international commodity prices.

Lost confidence and uncertainty among households and businesses is another important channel that influences productive activity and financial conditions in emerging economies, as it has reduced investment (external and internal) and consumption. For the Latin American economies, the largest blow to confidence has been in Mexico, although the dynamics in the other countries have been very similar (Graph 12). Remittances and tourism have slowed dramatically as well; they are important components of demand for a number of countries in the region.

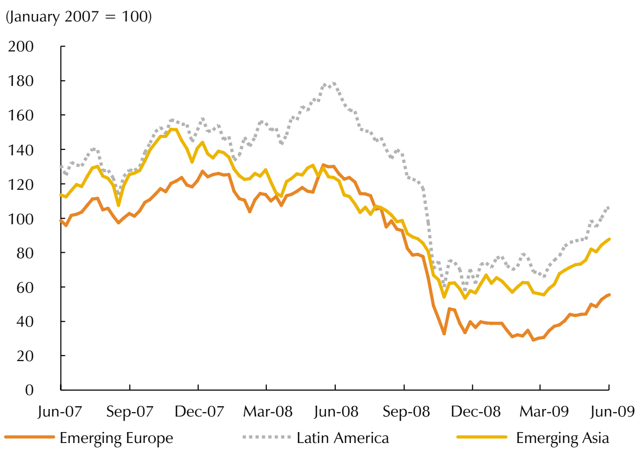
The third channel through which the financial crisis is passed on is financing, especially the reduction in external financing. This has led to tighter credit conditions for emerging countries, where the corporate sector has been particularly affected.[17] Foreign direct investment in the region's economies has also declined.

Although the financial sector in most emerging economies was not exposed to toxic assets, the

17 Unlike other crises, according to the Economic Commission for Latin America and the Caribbean (ECLAC), on this occasion, the private sector in many countries seems to have been more exposed to exchange rate volatility and has experienced the most problems with external funding.

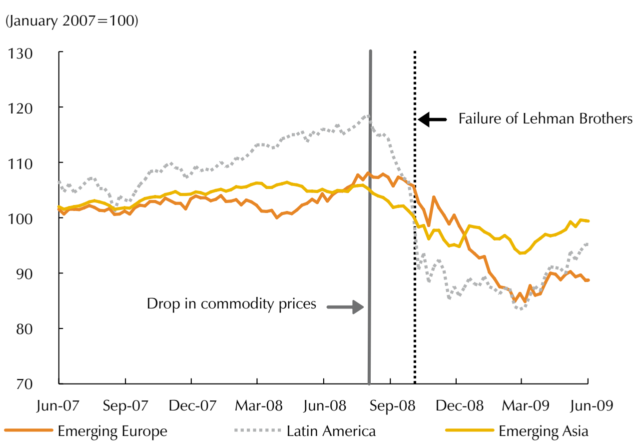
Graph 13

A. Emerging Market Stocks in Dollars (MSCI) a/

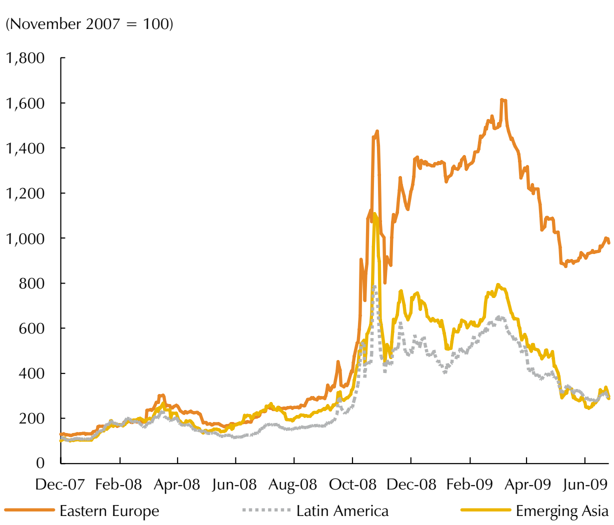


a/ MSCI: Morgan Stanley Capital International
The index pertains to data in dollars.

B. Emerging market currencies against the dollar



C. Credit Default Swaps (CDS) in Emerging Economies



Sources: MSCI, JP Morgan and Bloomberg; calculations by Banco de la República.

stress and problems of the international interbank markets generated greater global risk aversion, increasing risk premiums and affecting exchange rates[18] and the fixed and variable equity income markets in each economy. In the case of several Latin American countries, including Colombia, this situation was reversed in the second quarter when stocks rose again, risk premiums declined and currencies appreciated once more (Graph 13).[19]

Despite the higher risk premiums and strong constraints on lending, the governments in the region have been able to meet their financing needs.[20] In some cases, external issues have been replaced by local bond issues, as well as loans from foreign banks and multilateral institutions.[21]

C. OUTLOOK FOR 2010

From the mid-twentieth century, the industrialized countries have witnessed two types of economic recovery. Between the 1950s and the 1980s, the recoveries were charaterized by high growth in output, which rapidly reached pre-crisis GDP levels. During those periods, fiscal and monetary

18 Together with exchange rate pressures and the deterioration in stocks, the volatility of the region's main assets has been affected by the development of the international crisis. Compared to the other emerging countries, it is noteworthy that the exchange rates in Latin America have been more volatile.

19 Stock markets tumbled during the fourth quarter of 2008, with the Eastern European region being affected the most by macroeconomic vulnerabilities. Latin America had the sharpest devaluations in the exchange market, partly because of less intervention compared to the other countries.

20 A few Latin American countries with good credit ratings floated external bond issues during the early part of 2009. Brazil, Colombia, Mexico and Peru are a clear example as they obtained financing on international markets at convenient interest rates.

21 According to a regional report by the Bank for International Settlements (BIS, *Quarterly Review*, June 2009), although the corporate sector in emerging economies has faced funding problems, bond issues have been floated successfully in economies such as those in Chile and Colombia.

Factors such as the tendency towards household saving and the private sector's response to the fiscal injections will determine the extent to which these policies affect output in the coming quarters.

policies played a major role. Since the 1980s, economic recessions have been slower to recover and their causes have been associated with structural factors in the economies, as might have been the weakness of the financial structure in the nineties, among other reasons (Kohn, 2009).

As for the current recovery, there are serious macroeconomic imbalances that could hinder the resurgence of the industrialized economies. By the same token, some of the main factors that generated the crisis have not gone away: weakness in the mortgage sector and lack of confidence about the financial soundness of the developed economies. In this last respect, risk premiums remain high compared to pre-crisis levels, and lack of investor confidence in important financial institutions could mean credit conditions will continue to be tight, thereby affecting the momentum in spending and investment.

Moreover, the export sector has been one of the driving forces of economic recovery in the wake of recessions in industrialized and emerging countries alike. It has contributed significantly to economic growth in the United State, Europe and Japan in recent years. However, the global nature of the current economic crisis could prevent the export sector from playing an important role during the for recovery in these economies.

Accordingly, the prospects of economic recovery for the G7 would depend largely on the role governments can play through counter-cyclical monetary and fiscal policies. In its last *report to Congress, the Board of Directors* listed the most important public projects scheduled to be undertaken in 2009 and 2010 in the developed countries. So far, there is no evidence of their implementation, but the market expects it to happen in the second half of 2009 and the first half of 2010. In addition to the effectiveness of these practices, factors such as the tendency towards household saving and the private sector's response to the fiscal injections will determine the extent to which these policies affect output in the coming quarters.

There are a variety of possible scenarios for GDP in the years ahead (Table 1). Paul Krugman, winner of the 2008 Nobel Prize in Economics, said recently that the markets expect a V-shaped economic recovery, with the economy falling for a short period of time, to then quickly recover the pre-crisis levels. However, most economists believed the recovery would be U-shaped, with the economy declining for a longer period of time and

Table 1
U.S. Economic Growth Forecasts
(percentage)

Analysts	Forecasts for: 2009 (July 2009)	Forecasts for: 2010 (July 2010)
SwissRe	(2,8)	1,8
Merrill Lynch	(2,1)	2,6
JP Morgan	(2,4)	2,8
UBS	(2,5)	2,2
HSBC	(1,9)	1,9
Goldman Sachs	(2,9)	1,2
Crédit Suisse	(2,5)	2,5
BBVA	(2,0)	1,1
Barclays	(2,4)	2,8
Morgan Stanley	(2,6)	2,2
RGE	(3,5)	1,0
Average	**(2,5)**	**2,0**
Bloomberg average	(2,5)	2,0
IMF	(2,6)	0,8
DPI	(2,5)	1,2

Source: Bloomberg, IMF and Banco de la República.

Most economists believed the recovery would be U-shaped, with the economy declining for a longer period of time and recovering more slowly.

recovering more slowly (Banco Santander, 2009). And, finally, there are those who speak of a L-shaped recovery, with recuperation taking much longer. [22], [23].

For the emerging countries, the analysts are more optimistic about their chances for economic stabilization and recovery in the mid-term, notwithstanding it will depend on the evolution of developed economies. The forecast in the latest IMF World Economic Outlook Report (WEO Update, July 8, 2009) indicates the emerging area will regain growth in the second half of the year, with differences among countries. Economies with larger local markets, healthier financial systems and more possibilities for pursuing counter-cyclical policies will be the quickest to recover from this unprecedented episode in recent history.

The economic growth forecasts for Latin America in 2009 have declined in the last few months. However, the region still exhibits one of the best responses to the crisis, and prospects for 2010 are positive.

The emerging Asian countries would benefit from the recovery witnessed in recent months in China and India, which was associated with the large amount of macroeconomic stimulus provided by the government and a return to normal in terms of capital flows into the area. The economic growth forecasts for Latin America in 2009 have declined in the last few months. However, the region still exhibits one of the best responses to the crisis, and prospects for 2010 are positive, which is consistent with the recovery of commodity prices at the international level. Finally, for the Eastern European region, the prospects vary considerably from one country to another, but the projections show substantial reductions in output during 2009 and slow growth in 2010.

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22 This is the case of Professor Roubini and his team at RGE.

23 One of the leading current debates is about the long-term fiscal sustainability of the industrialized economies. The key question asked by the market is how to pay for the huge fiscal injections made by these economies. There are several alternatives. One is to adopt counter-measures that trigger virtuous cycles, stimulate economic activity, and clear the fiscal gap, through tax revenue. Another is to maintain "indefinite" financing until the markets recovers and can lead the economy to long-term growth on its own. A further alternative is to reduce the value of the debt through added inflation. To the extent this last aspect is anticipated by the market, it would generate strong sales of government bonds that could end up offsetting all or part of the gain through prices. And, finally, there is the option of debt default, which would have unimaginable repercussions on the markets.

II. The Colombian Economy: Performance, Impact of the International Crisis and Prospects

The world economic crisis has accentuated the slowdown observed in the Colombian economy since 2008 and has been felt through a reduction in terms of trade and in confidence, but has not seriously affected the health of the financial system or capital flows. For that reason, a recovery is anticipated during the second half of the year. Inflation has dropped sharply so far this year, reversing the shocks of past years. During the next year and a half, it should stay close to the target set by the BDBR.

A. ECONOMIC ACTIVITY

The global economic crisis hit the Colombian economy at a time when it already was slowing after four years of rapid growth. That slowdown was due to the effects of a restrictive monetary policy, the impact of high commodity prices on business costs and household income, and the restrictions imposed by some of the country's trading partners.

The international economic crisis has accentuated the downturn in Colombia's economic activity, mainly through loss of consumer and business confidence, and a decline in export prices.

As a result, the international economic crisis has accentuated the downturn in Colombia's economic activity, mainly through loss of consumer and business confidence, and a decline in export prices. The effect of less confidence was reflected in a slowdown in consumption and private sector investment. The decline in the value of exports, together with fewer worker remittances, reduced the amount of disposable income in the economy, and consequently affected local demand.

The impact of the external crisis on financial flows has been moderate.

Contrary to these real channels, the impact of the external crisis on financial flows has been moderate. Foreign direct investment declined compared to its historic maximum in 2008, but is still high, especially foreign direct investment in the mining and oil sector. Moreover, the large flows of external resources received by the national government and Ecopetrol have been enough to offset the decline in flows to the private sector. Accordingly, on the whole, the current account in 2009 is expected to remain stable at around 3% of GDP.

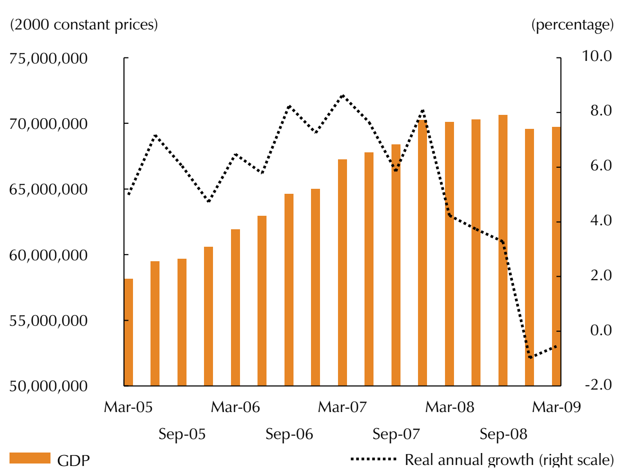
Unlike previous crisis episodes, the current one has not caused a significant cutback in external financing. The macro-prudential measures taken between 2006 and 2008 curbed excessive growth in lending and avoided currency and term mismatches on bank, corporate and household balance sheets. This has allowed the financial system and the credit channel to keep operating, even amid the severe global recession. Both loans and deposits in the financial system have maintained growth rates above the increase in nominal GDP, with a bit more of a pronounced adjustment in the case of consumer lending.

Given the significant, rapid change in the stance of monetary policy, coupled with the moderately counter-cyclical fiscal policy announced by the government, in a context of access to external financing and operation of the local credit channel, growth in the Colombian economy is expected to be near 0% in 2009 and 2.5% in 2010. Of course, this is subject to a gradual improvement in international conditions as of the second half of 2009, as is now expected by most economic analysts.

1. Economic Activity in 2009

GDP in the first quarter of 2009 fell 0.6% compared to the same period in 2008, according to DANE (Graph 14). Despite two straight quarters with negative annual variations, GDP in the first quarter of 2009 was slightly higher (0.2%) than the quarter before. Annual GDP growth in Colombia during the first quarter was better than it was in several other Latin American countries, such as Mexico, where the annual decline was 8.2%, or in Chile and Brazil which fell 2.1% and 1.8%, respectly.

Graph 14
Gross Domestic Product



Source: DANE.

A breakdown by type of expenditure (Table 2) shows the contraction in GDP during the first quarter of this year centered on domestic demand, which was down 0.5%, thus contributing to the total variation in GDP. Net external demand, defined as the difference between exports and imports (in constant dollars), fell 0.4%; however, given its limited magnitude,

Table 2
Real Annual GDP Growth by Type of Expenditure

	2008				2009	
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	I Qtr.	Contribution
Private Demand	7.0	6.3	4.3	2.8	(2.0)	(1.7)
Household Consumption	4.3	2.8	1.5	0.5	(0.5)	(0.3)
Private GCF	9.1	16.1	7.7	(1.1)	(6.3)	(1.1)
Inventories	63.6	32.1	43.3	114.6	(8.3)	(0.3)
Public Demand	(2.8)	(2.4)	5.3	(5.0)	5.0	1.1
Government Consumption	1.4	2.4	1.6	(0.0)	0.2	0.0
Public GCF (civil works)	(14.9)	(14.8)	18.0	(17.8)	21.2	1.1
End Internal Demand	4.8	4.3	4.5	1.0	(0.5)	(0.6)
Net External Demand	10.6	10.0	16.3	21.9	(0.4)	0.0
Exports	14.6	8.8	3.1	2.4	(0.5)	(0.1)
Imports	13.1	9.3	8.0	9.0	(0.5)	0.1
GDP	4.2	3.7	3.3	(1.0)	(0.6)	(0.6)

Source: Banco de la República.

new external demand did not contribute significantly to the change in GDP. As will be explained, this decline was the result of a drop in exports that was offset, in accounting terms, by an equivalent drop in imports. This being the case, the effects of the external crisis have not been limited to external demand; and has also affected domestic demand through the channels mentioned earlier (e.g. confidence).

Public demand made a positive contribution to GDP growth during the first quarter of 2009.

Although DANE does not provide quarterly figures on total public or government demand, it is possible to have at a rough estimate by adding public consumption and investment in civil works. The resulting estimate shows that public demand made a positive contribution to GDP growth during the first quarter of 2009, thanks to an annual increase of 5%. The momentum in this expenditure is associated primarily with investment in civil works (21.2%) and was possible thanks to higher costs in terms of river, reservoir and coastal dredging and mining construction.[24] Public consumption posted a slight

24 It should be noted that some investments in mining could have originated in the private sector.

The effects of the external crisis have been felt more in terms of private domestic demand than in exports.

annual growth (0.2%) during the first quarter of 2009, but the level reflected a decline compared to the previous quarter.

Domestic demand generated by the private sector declined 2.0% during the first quarter of 2009, in annual terms. Together with exports, this is the aggregate that most forcefully felt the effects of external crisis. The biggest blow has been to private investment (gross fixed capital formation minus investment in civil works), which dropped 6.7% during the first quarter, in annual terms, if changes in inventory are included. This performance contrasts sharply with the more than 10% increase registered in this aggregate for all the quarters in 2008. However, excluding inventories, DANE's figures show private investment had suffered since the fourth quarter of last year.

The setback in private investment is largely due to significantly less investment in transport equipment (22.4% in annual terms) and in construction and buildings (14.8% annually). This may be related, in part, to the deterioration in business confidence and expectations as a result of the international crisis, as well as the drop in profitability for some sectors and less demand for tradables. However, there are also statistical factors posed by an extremely high base of comparison during the same period last year. It is important to point out that the level of investment in building construction was not lower than the register of to the previous quarter, despite its sharp drop in annual terms.

Weaker household consumption is associated with the plunge in consumer confidence.

Household consumption declined 0.5%, which is less than the reduction in investment. Its contribution is important with respect to the GDP slowdown, as it accounts for 66% of spending. Household demand has moderated gradually since 2008, but without posting negative growth. Like private investment, weaker household consumption is associated with the plunge in consumer confidence since the fourth quarter of last year. This is a phenomenon evidenced in most economies throughout the world, both industrialized and developing. In Colombia and in other developing countries, worsening labor market conditions and the decline in worker remittances also have some incidence, as their contribution to disposable household income would have declined.

Although there has not been an annual drop in household consumption since the crisis in the late nineties, the extent of the current setback is much different from the reductions witnessed during that period.[25] It also is important to point out that monthly consumer confidence indicators showed a rebound towards the end of the second quarter and a sharp recovery in mid-term expectations. This might imply more dynamic consumption during the second half of the year.

25 In 1999, household consumption declined at an annual rate of 5.5%.

The sales that were most affected by the crisis so far this year were still those to the United States.

With respect to net external demand, the figures for the first quarter of 2009 show an annual reduction of 0.5% in real exports. DANE recently revised the export records for the fourth quarter of 2008, lowering annual growth from 6.3% to 2.4%. This confirms the slowdown in this item since the second half of last year, and partly corrects the divergence shown by the data on Colombian foreign trade with respect to the figures for most countries over the world.

Consequently, the effects of the external crisis had a greater impact on Colombia and its trading partners since the fourth quarter of 2008. The sales that were most affected by the crisis so far this year were those to the United States, mainly industrial products,[26] since the volume of mining exports continued to increase.

Colombian exports in real pesos during the first half of the year continued to be affected by restrictions on foreign trade imposed by Venezuela (as of the second half of 2008) and Ecuador (from the beginning of this year). The most affected products by those constraints are of manufacturing origin, particularly automobiles. In fact, automobile exports declined in the first half of 2009 from the already low levels observed during the same period in 2008. In the case of Ecuador, the restrictions would have been more extensive, affecting the agricultural and textile sectors as well.

According to the National Accounts, the annual decline in total real imports during the first quarter of the year was similar to the drop in exports. However, unlike exports, the slump in imports has not been gradual. In the second half of 2008, they still showed a significant momentum and were up 8.5% with respect to the same period the year before. The figures for import volume confirm this trend. In fact, the downturn in imports of intermediate goods intensified, while imports of capital and consumer goods saw less growth.

A breakdown of the GDP figures for the first quarter of 2009, by economic activity (Table 3), shows the sectors that contributed the most to this slump were industry, commerce, and building construction, in that order. As a whole, these economic activities account for approximately 30% of GDP. As for industry, which was down 7.9% compared to the same period last year, the international crisis has manifested itself in the form of a large reduction in exports by certain sub-sectors that produce tradables. A good portion of this performance is explained by just five sub-sectors: vehicles, wearing apparel and tailored goods, milling and starches, iron and steel, and chemicals.

GDP in commerce fell 2.7% during the first quarter of 2009, rounding out two straight quarters of negative figures. The setback in retail sales and the downturn in the restaurant and hotel sector reflect the slump in commerce. As for GDP in building construction, the annual contraction was around 14.1%. However,

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26 As suggested by the figures for the balance of payments in dollars.

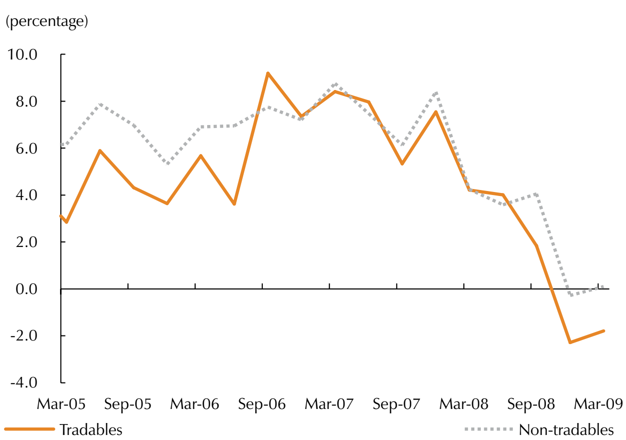
Table 3
Real Annual GDP Growth by Branch of Economic Activity

	2007	I Qtr. 2008	II Qtr. 2008	III Qtr. 2008	IV Qtr. 2008	I Qtr. 2009
Agriculture, forestry, hunting and fishing	4,0	4,0	5,5	2,1	(0,6)	(0,8)
Mining and quarrying	2,9	4,6	7,9	10,4	6,4	10,6
Manufacturing industry	9,6	2,1	1,2	(2,5)	(7,9)	(7,9)
Electricity, gas and water	3,7	0,7	1,7	1,2	1,0	1,9
Construction	11,7	0,4	(0,2)	21,1	(11,3)	4,1
Buildings	2,2	24,9	25,9	25,2	(0,9)	(14,1)
Civil works	19,3	(15,1)	(14,8)	18,1	(17,7)	21,2
Commerce, repairs, restaurants and hotels	8,8	2,2	4,0	1,1	(0,6)	(2,7)
Transport, storage and communication	11,0	9,0	4,6	2,3	0,4	(2,0)
Financial companies, insurance, real estate and corporate service corporate services	7,3	7,0	4,9	6,5	3,9	4,7
Social, community and personal services	4,7	3,4	2,9	1,7	0,3	(0,2)
Subtotal: added value	7,2	4,0	3,6	3,3	(0,9)	(0,2)
Taxes minus subsidies	11,5	6,9	5,4	2,6	(1,8)	(4,2)
GDP	7,5	4,2	3,7	3,3	(1,0)	(0,6)

Source: DANE; calculations by Banco de la República.

as mentioned with respect to investment, its level in the first quarter of 2009 showed no additional decline compared to the previous quarter.

Graph 15
Annual Tradable and Non-tradable GDP Growth



Source: DANE, calculations by Banco de la República.

The most positive contribution to GDP performance in the first quarter of 2009 came from the financial sector, with 4.7% annual growth, followed by mining and civil construction, which posted respective annual increases of 10.6% and 21.2%. Performance in the mining sector was associated with increased production of oil and natural gas.

This being the case, during the first quarter of the year, tradable GDP, which was the most exposed to the external crisis and within which industry is the sector with the greatest weight, fell 1.8% compared with the same period last year. Non-tradable GDP was up slightly (0.1%) thanks to the performance of the financial sector and civil works construction (Graph 15).

In the case of the Colombian economy, recovery would begin to be evident as of the third quarter.

2. Outlook for Economic Activity

As suggested by several indicators for the second quarter in the developed and emerging economies, the global economy is expected to begin to show signs of recovery during the remainder of 2009. In the case of the Colombian economy, recovery would begin to be evident as of the third quarter (during the second quarter, the economy will continue to be hit partly by the international crisis, and partly by the Easter holiday[27]). Annual GDP growth for the year as a whole will be between -1.0% and 1.0%. Accordingly, the level of GDP would be similar to what it was in 2008 and its annual variation would be close to 0% (the midpoint of the forecast range). 2009 would mark the second straight year of a slowdown in the GDP growth rate.

From a historical perspective, growth in 2009 (midpoint of the forecast range) would be among the lowest on record, second only to the rates posted for 1930, 1931 and 1999. However, despite low growth, the result for the entire year would not be so bad when compared to the forecasts for the developed economies and some emerging economies that are much closer to the Colombian economy.

The Colombian economy is expected to perform better in 2009 than the developed economies and many emerging countries.

As noted already, foreign trade is one of the channels through which the external shock would pass through to the Colombian economy. Given the weak demand exhibited by Colombia's primary trading partners and the trade restrictions imposed by Venezuela and Ecuador, exports are expected to decline in 2009. However, the net effect of foreign demand on growth would be positive, because imports, which account for a larger share of GDP, would be down as well.

Imports would be responding to weak household consumption, which would continue to slow compared to 2008, and to the record contraction in investment, mainly due to private investment. The expected effects on private consumption and investment could be associated with weak consumer, investor and business confidence and with wide uncertainty about the duration and depth of the global crisis and its impact on the Colombian economy.

The first half of the year witnessed a reversal of the supply shocks that affected consumer price inflation in 2007 and 2008.

B. INFLATION

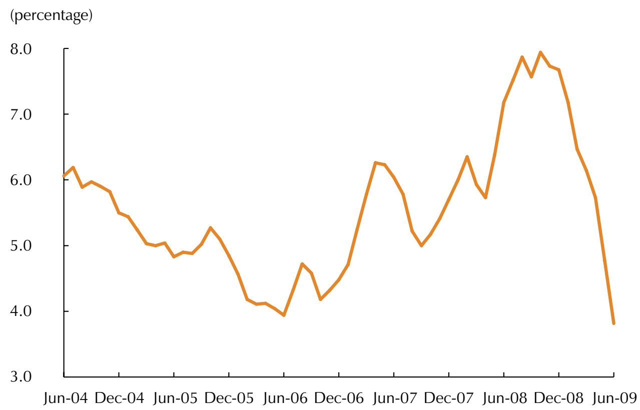
1. Inflation during the First Half of 2009

The first half of the year witnessed a reversal of the supply shocks that affected consumer inflation in 2007 and 2008, particularly on food prices and, to a lesser extent, on those of regulated goods and services. Annual consumer

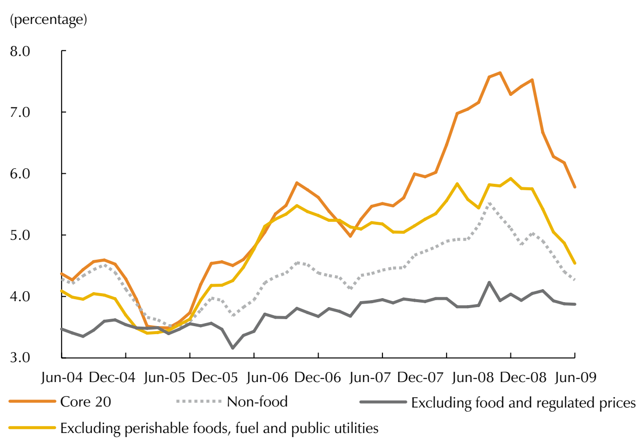
27 In 2008, Easter week was in the first quarter; in 2009, it was in the second quarter.

Graph 16

A. Annual Consumer Inflation



B. Annual Core Inflation Indicators



Source: DANE; calculations by Banco de la República.

inflation plunged from 7.7% in December to 3.8% in June (Graph 16, Panel A). This last figure was below forecast and under the target range set by the BDBR for this year (between 4.5% and 5.5%). It also is the lowest on record since July 1962.

Core inflation has fallen simultaneously with total inflation, although not as much. Core inflation discounts temporary supply shocks, such as those originating with sudden changes in food or fuel prices. The average of the four indicators tracked by Banco de la República went from 5.6% in December to 4.6% in June, which is within the target range. In the case of non-food inflation, the figure for June was 4.3%, which is slightly lower than predicted by Banco de la República's technical staff in its inflation reports. The indicator that excludes the two main sources of exogenous shocks – food and regulated goods and services (which include fuel and transportation) - also declined, but much less than in the other three cases (Graph 16, Panel B).

The performance of inflation in Colombia during the first half of the year was also the seen in many other developed and emerging economies, largely due to the sharp drop in prices for oil and other commodities from levels that were extremely high up until the third quarter of last year. As in 2007 and 2008, the rise in oil and commodityprices led to higher inflation over the world; by the same token, their decline has significantly reduced inflation pressures.

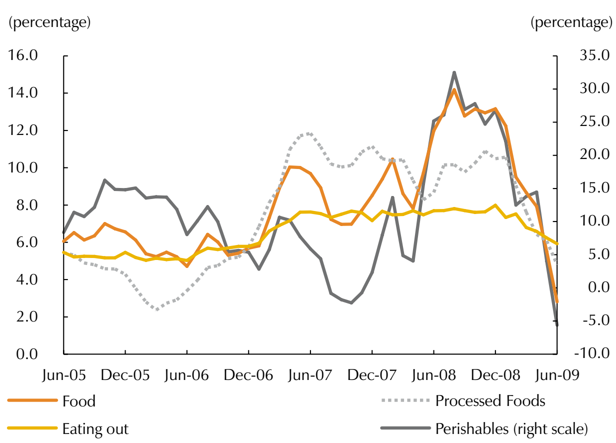
In Colombia, the downturn in international commodity prices has had a direct impact on food, fuel and transportation prices. Moreover, this reduction has relieved some of the pressure on production costs, as suggested by the slowdown in annual producer price inflation (PPI) (from 9.0% in December to 2.7% in June).

As a result of the slowdown in demand, price hikes for a number of non-tradable items in the consumer market basket were moderate, especially in services. Also, the weather during the first half of the year favored the supply of highly perishable foods, thereby heightening the drop in inflation. These circumstances all helped to offset some of the upward pressure caused by the depreciation of the peso until March-April and the high inflation expectations observed at the end of last year, which resulted in relatively high additions to the minimum wage and the price of some indexed utilities. However, as shown later, expectations dropped sharply during the first half of the year. This should help to keep inflation low for the remainder of 2009 and in 2010.

The bulk of the decline in annual inflation between January and June is due to the fall in the annual change in the consumer price index (CPI) for food, which went from 13.2% in December to 2.8% in June. The decline in perishable food prices (vegetables, tubers and fruits) was substantial compared to the sharp increase witnessed during the same period in 2008 (Graph 17). This is possibly due to a relatively abundant supply brought on by good weather and high prices last year. Although the more moderate adjustments in production and transportation costs may have had an effect as well.

The other food CPI components – processed foods and meals eating out - also posted contractions in annual inflation, but not as large (Graph 17). Processed food, in particular, responded to the decline in international commodity prices, especially prices for grains, oilseeds and edible oils. However, their rebound in the second quarter and the depreciation witnessed during the first quarter may have pushed up local prices by the end of the first half of the year.

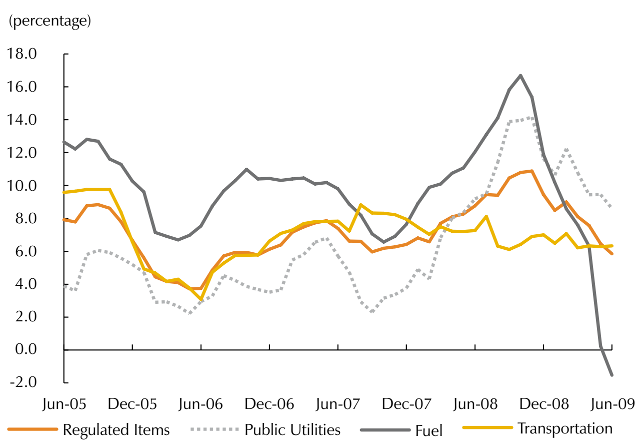
Graph 17
Annual Food Inflation



Source: DANE; calculations by Banco de la República.

Annual inflation in regulated goods and services also declined substantially, largely because of fuel prices. In fact, fuel prices dropped by slightly over 6% during the first half of the year, leaving the annual variation at -1.5%, which contrasts sharply with the increase recorded last year. The public-utilities component also included major reductions in natural gas for residential use; this was associated with the tendency in foreign prices and, to a lesser extent, water and electricity rates. However, in this case, the annual change remained above 15%. In all, the annual variation in regulated CPI was 5.9% in June, down from 9.5% in December (Graph 18).

Graph 18
Annual Inflation in Regulated Items and their Components

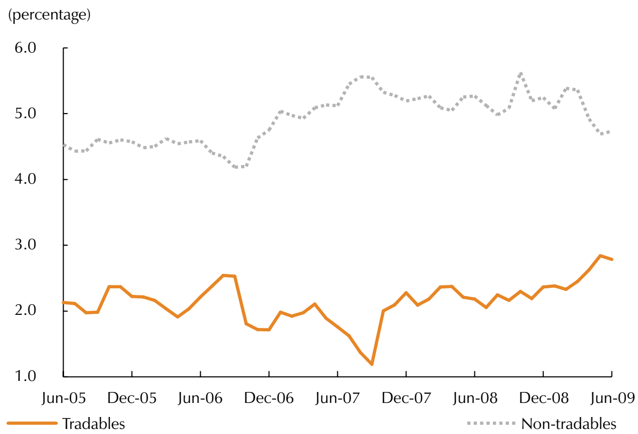


Fuente: DANE; cálculos del Banco de la República.

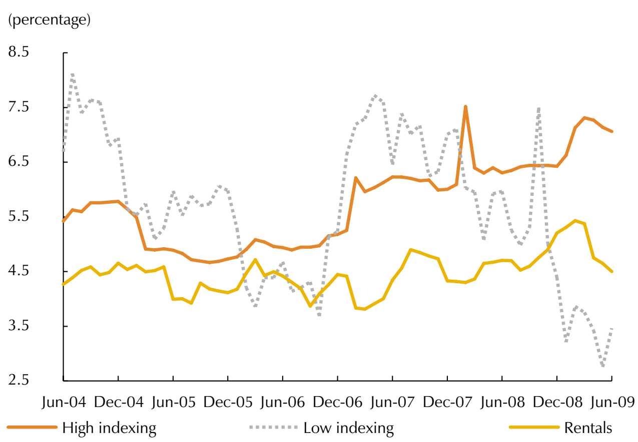
Besides the two sub-baskets analyzed (food and regulated goods and services), downward pressure on inflation also was also generated by the non-tradable CPI, excluding food and regulated prices, particularly during the second quarter. By June, the annual variation in this index was below the midpoint of the target range and had reached 4.7%, a level not seen since late 2006 when demand-side pressures and inflation expectations were still low (Graph 19, Panel A).

Graph 19

A. Annual tradable and non-tradable inflation excluding food and regulated prices



B. Breakdown of annual non-tradable inflation excluding food and regulated prices



Source: DANE; calculations by Banco de la República.

Within the non-tradables, excluding food and regulated prices, several low-indexed but labor-intensive utilities appear to have responded more quickly to weak demand (Graph 19, Panel B). On the contrary, annual inflation in services such as education and health care, which are covered by indexing regulations, remains high annual at around 7%. The momentum that produced the rise in inflation last year and the effect of high expectations up to the start of this year are most evident in these prices. Rentals have behaved somewhat in between, registering a moderate slowdown. Even so, their impact is significant, because rentals are an important item in the consumer market basket (accounting for about 19%) (Graph 19, Panel B).

Tradables excluding food and regulated prices were the only sub-basket that has not contributed to the reduction in inflation so far this year. The annual variation in its index went from 2.4% in December 2008 to 2.8% in June of this year (Graph 19, Panel A). The devaluation in the exchange rate during the first quarter and the early part of the second would have contributed to this increase, which was evident in a wide range of items, , including automotive vehicles, medicine, home cleaning supplies and goods related to entertainment, culture and recreation, among others.

2. Outlook for Consumer Inflation

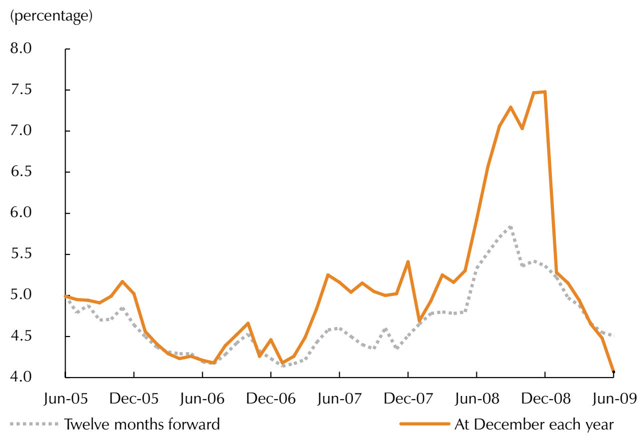
According to the forecasts, inflation in Colombia is likely to close out 2009 below the target range set by the BDBR (4.5% -5.5%). Although the economy is expected to resume growth during the second half year, demand-side pressures will continue to be contained given the excess productive capacity in the economy.

Moreover, the last few months have seen a sharp drop in inflation expectations, as evidenced by Banco de la República's quarterly and monthly surveys, which indicate those surveyed expect inflation to be between 3.8% and 4.5% by December of this year (Graph 20). Also, for a twelve-month horizon, the monthly survey shows 4.8% expected inflation.

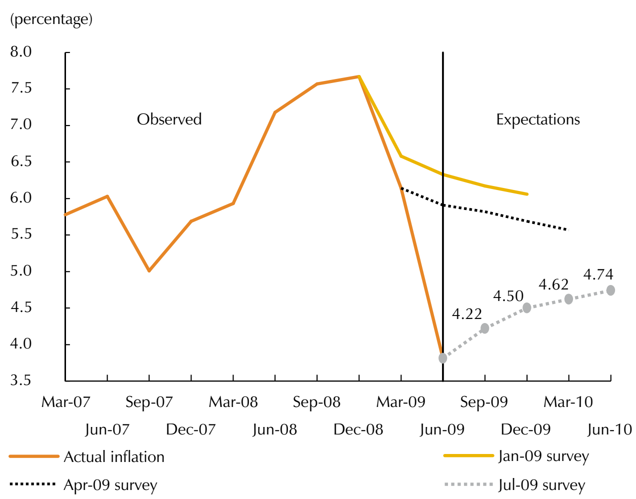
On the other hand, the labor market is expected to remain loose, given higher unemployment and the increase in labor supply, which should minimize wage hikes. However, we do not expect relief in international food and fuel prices,

Graph 20

A. Inflation Expectations, Monthly Survey [a/]



B. Inflation Expectations, Quarterly Survey [b/]



a/Inflation expectations based on the bank and brokerage firm survey conducted monthly by Banco de la República.
b/ Inflation expectations based on the survey of companies, unions and analysts conducted quarterly by Banco de la República.
Sources: DANE and Banco de la República; calculations by Banco de la República.

which could rise during the remainder of the year and in 2010 as global demand recovers.

Accordingly, there should be no rebound in annual inflation in the price of goods and services that are most sensitive to demand or are adjusted according to regulations on indexation. Specifically, the annual variation in non-tradable CPI, excluding food and regulated prices, which are an important component of the CPI basket (accounting for 30.5%), is expected to remain within the target range for inflation. Its main component (rentals) is not expected to experience inflation above target, due to the increased supply of housing in recent years and the likely standstill in household income this year, among other reasons.

Depreciation in the exchange rate should not pose a serious problem, although increases in certain tradables, excluding food and regulated prices, cannot be ruled out if the exchange rate remains above the levels witnessed in late May and early June. However, it is likely that weak demand, the added competition companies face, and low inflation expectations might play an important role with respect to some goods and services, curbing price hikes or leading to price reductions. This behaviour would have already begun to occur in certain areas, such as domestic air fares.

Although the last three months saw an increase in the international price of oil, it is not expected to push up the price of domestic of fuel and public transportation to a great degree, provided the upward trend is not prolonged and the price of West Texas Intermediate (WTI) does not go above US$70 a barrel. This forecast assumes the exchange rate will not depreciate significantly and will remain near the levels observed in late June (around Col$2,150 per dollar). Accordingly, no major changes in the price of gasoline are forecast for the rest of the year. This, in turn, would facilitate hikes in public transportation fares somewhere near the midpoint of the target range and below those registered last year.

There is the possibility of El Niño weather during the rest of the year and in early 2010.

The above-target increases in public utility rates are not expected to continue, since growth in demand has been more moderate in recent quarters. Price hikes for water and natural gas should be close to the target range as well.

This being the case, annual inflation in the regulated CPI will continue to decline and should be close to 5% by the end of 2009. Accordingly, non-food inflation during the second half of the year is expected to be what it was in June, or slightly lower, and below the target range for December.

The outlook for food prices during the remainder of the year is more uncertain. The models used by Banco de la República point to a moderate rebound in annual food inflation during the third quarter, but the year-end result would be at the bottom of the target range or below. Therefore, food would help to keep inflation low towards December.

However, there is the possibility of *El Niño* weather during remainder of the year and in early 2010, as announced by several international meteorological organizations. If so, it could result in higher prices for perishables by the end of 2009 and, especially, during the first half of 2010. International prices are another source of uncertainty with respect to food. The Central Bank's forecasts do not contemplate further increases in the price of cereals and edible oils during the rest of the year, given the global recession and the anticipated stability in oil prices.

The outlook for inflation in 2010 is favorable.

The outlook for inflation in 2010 is favorable as well. On the one hand, low inflation at the end of 2009 and controlled expectations should help to temper price hikes at the start of the year for highly indexed goods and services such as health care, education and rentals. On the other, although the economy should be growing, excess productive capacity accumulated during the past two years rules out the presence of demand-side pressures for much of the year.

Wages are not expected to increase significantly, given the real wage gains in 2009 and the reduced demand for labor. Moreover, costs will remain stable if external prices for commodities and fuel do not increase more than anticipated.

The primary upwards risks in this scenario currently come from food prices, because of the possible impact of *El Niño* weather. For the same reason, there might be several shocks to energy prices, if this phenomenon affects the generation of energy, as it has in the past.

All of this suggests that conditions are right for consumer inflation to remain low in 2010 and to continue to converge towards the long term target range defined by the BDBR several years back, which is between 2% and 4%.

C. RECENT TRENDS IN THE LABOR MARKET

According to available information on the labor market, employment declined during the first half of 2008 (particularly salaried employment), stabilized by the end of last year and recovered somewhat throughout most of the first half of 2009 (especially non-salaried employment). This trend, which contrasts with the slump in the country's output, is less clear in the sectors and cities more associated with foreign trade, showing the effect of the external crisis.

Employment has recovered somewhat throughout most of the first half of 2009. This trend is less clear in the sectors and cities that are more associated with foreign trade.

The rise in employment did not prevent the unemployment rate from increasing as a result of an increase in the labor supply, which began in early 2009 and has two possible explanations. The first is the additional worker effect, which implies that workers other than the head of the household have entered the job market to compensate for shortfalls in current income.[28] In some cities that receive remittances from workers outside the country, this effect would have been reinforced by the decline in those remittances. The second reason deals with an increase in labor supply, due to the return of Colombian emigrants.

However, the rise in employment did not prevent the unemployment rate from increasing due to an increase in the labor supply.

According to data from the Comprehensive Household Survey (GEIH),[29] the unemployment rate began to increase in July 2008. The deterioration grew worse during the final quarter of that year and coincided with the slump in economic activity during that period (Graph 21, Panel A). Compared to the same period last year, the figures for the first half of 2009 show higher unemployment in all territorial domains.[30] However, the acceleration in unemployment came to a halt in January of this year, and the stability of its growth throughout the year indicates the contraction in the labor market has not worsened (Graph 21, Panel B). Given the latest information, the unemployment rate for March-May was 11.9% nationwide and 12.9% for the thirteen major metropolitan areas. This implies respective increases of 0.9 and 1. 3 pp compared to 2008.

To characterize the momentum in unemployment, Table 4 contains a breakdown of the labor market according to its two main components: the demand for labor and the labor supply. The interaction between these components determines the extent of unemployment. While movement the demand for labor is evident in the employment and occupation indicators, the labor supply is reflected in the global participation rate. As noted, during the quarter ending in May, employment rates for the different domains increased less than the global participation rate, a trend that has been characteristic of the first five months of 2009. This is indicative of an expansion in labor supply that exceeds the

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28 Because the head of the household has lost his/her job or because other current household income has declined.

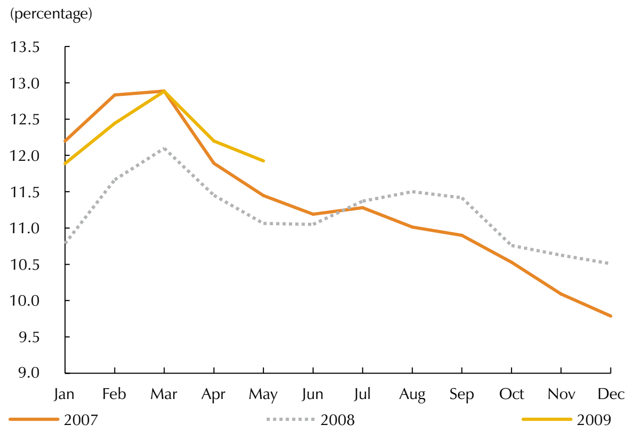
29 The GEIH provides information on the global participation rate (GPR), the employment rate (ER) and the unemployment rate (UR), among other job indicators. The GPR is the ratio of the economically active population (EAP) (all persons participating in the labor market, whether employed or unemployed) and the working age population (WAP) (the population age 12 and over in municipal areas and age 10 and over in rural areas). It is a rate that can be interpreted as a labor supply indicator. The UR is the proportion of the economically active population that is unemployed and the ER is the total number of persons in the economically active population who are employed. Both the GPR and the ER are rates that have the WAP as a common reference point, and their respective fluctuations are reflected in the unemployment rate:

$$UR = 1 - \frac{ER}{GPR} = 1 - \frac{employed / WAP}{EAP / WAP} = 1 - \frac{employed}{PEA} = \frac{unemployed}{EAP}$$

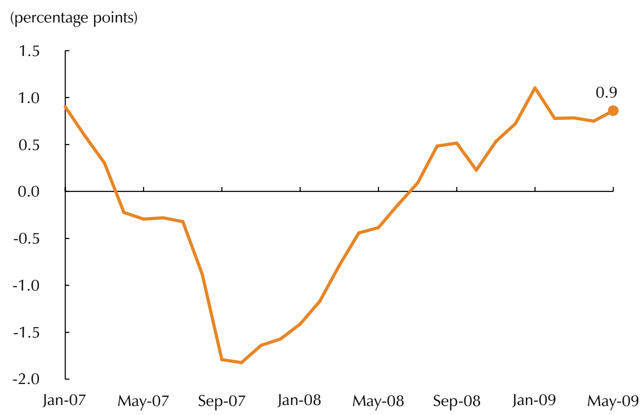
30 Territorial domains are the geographic divisions of the GEIH; namely, the nationwide total, the rural area (or rest), municipal centers and, among them, the thirteen major metropolitan areas in Colombia.

Graph 21

A. Total Unemployment Nationwide (moving quarter)



B. Annual Variation in Total Employment Nationwide (moving quarter)



Source: DANE-GEIH.

demand for labor, leading to the increases in the unemployment rate mentioned earlier.

1. The Demand for Labor

The trend in employment observed during late 2008 changed in 2009, when employment began to increase since the moving quarter ending February (Graph 22). Accordingly, between January and May, 860,932 jobs were created nationwide and 272,785 in the thirteen major cities.[31] These figures were higher than those observed during the same period in 2008, when 232,931 jobs were created, including 124,100 in the thirteen major metropolitan areas.

However, the rise in the number of employed is concentrated mainly in the intermediate cities and rural areas. In fact, the quarterly moving averages show the number of employed rose between January and May at an average annual rate of 3.6% in urban areas (other than the thirteen major areas) and 1.8% in the rural area (above the 1.5%, on average, witnessed in the thirteen metropolitan areas).

The employment figures for the different economic activities suggest the urban areas are less dynamic (Table 5). During the course of the year to May, the annual increase in employment in construction and commerce for the thirteen metropolitan areas averaged 4.2% and 4.7%, respectively, compared to 5.7% and 5.2% nationwide. According to the GEIH, industrial employment in the thirteen major cities during the same period declined at an annual rate of 1.3%. This contrasts with the 3.2% increase in employment in industrial manufacturing nationwide.

Employment in the three major cities (Bogota, Medellin and Cali), which gather 67% of the employed, is at a relative standstill. In Bogota, so far this year (up to May), the number of jobs is up 0.7%, on average. In this case, the recovery in employment in commerce offset the decline in employment in industry, services and transportation. As for Cali, the increase in employment during the same period was 0.8%, including more employment in industry and less in construction and commerce, respectively. Finally, in Medellin, employment grew 1.7%, bolstered by a recovery in commerce and services,

31 The margin of error with respect to the absolute figures for employment is high, since the sample was designed to obtain rates as opposed to levels.

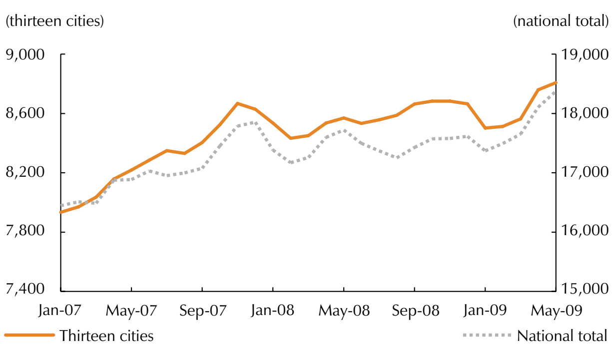
Table 4
Job Market Indicators

	Quarter (March-April-May) 2005	2006	2007	2008	2009	Absolute Difference: 2008 and 2009	Moving quarter previous month[a/] Absolute Difference: 2008 and 2009
National global participation rate	60.1	59.9	57.9	59.5	**61.3**	1.8	1.2
Rural area	57.2	56.9	51.3	53.5	**55.8**	2.3	0.9
Metropolitan areas	61.1	60.9	60.0	61.4	**63.0**	1.6	1.3
Thirteen cities	63.0	62.6	61.5	62.8	**64.3**	1.5	1.5
National employment rate	52.6	52.9	51.3	52.9	**54.0**	1.1	0.6
Rural area	52.7	52.5	47.4	49.7	**51.2**	1.5	0.8
Metropolitan areas	52.6	53.0	52.5	53.9	**54.8**	0.9	0.6
Thirteen cities	53.9	54.6	54.2	55.5	**56.0**	0.5	0.4
National unemployment rate	12.4	11.7	11.4	11.1	**11.9**	0.9	0.7
Rural area	7.7	7.8	7.6	7.0	**8.1**	1.0	0.2
Metropolitan areas	13.9	12.9	12.5	12.2	**13.0**	0.8	0.9
Thirteen cities	14.5	12.7	11.8	11.7	**12.9**	1.3	1.4

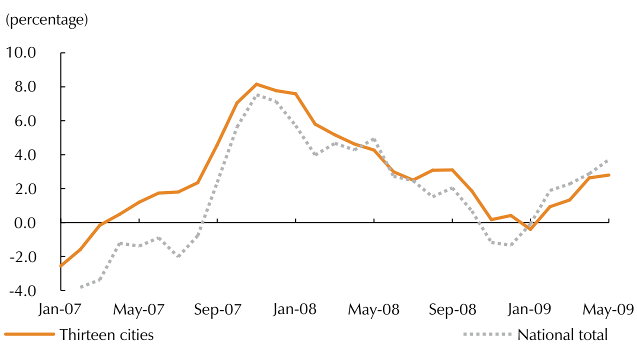
a/ Absolute annual variations pertaining to the quarter from February to April.
Source: DANE.

Graph 22

A. Number of Employed
(thousands employed, moving quarter)



B. Job Creation
(annual variation, moving quarter)



Source: DANE-GEIH.

which could be attributed to the events surrounding the assembly of the Inter-American Development Bank, which was held in April and May. However, industrial employment in Medellin has suffered the most, with an annual decline of 6.2%, on average.

The labor indicators suggest that the capacity for job creation has declined in the metropolitan areas where the industrial sector is concentrated (71.3% of industrial employment is in the country's three largest cities). This could be due to the fact that the sectors most dependent on foreign trade, such as industrial manufacturing, have been the most affected by the external crisis.

This hypothesis seems to be in line with the data extracted from sector surveys of industry and commerce. On the one hand, employment reported in the monthly manufacturing sample (MMS) showed an annual contraction of 6.9% in May, rounding out more than a year of decline (Graph 23, Panel A). These losses were concentrated among temporary workers for whom employment fell 11.8% during that same month. As for commerce, the monthly retail trade sample (MRTS) suggests that employment in

The labor indicators appear to suggest that job creation capacity has declined in the metropolitan areas where the sectors most dependent on foreign trade are concentrated.

Table 5
Average Annual Growth in Employment so far during 2009 a/
(percentage)

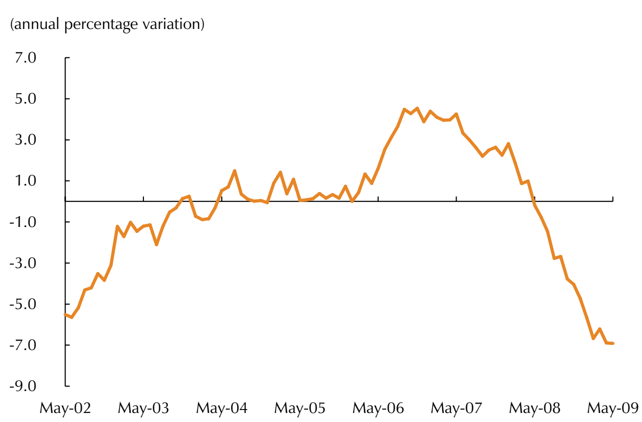
	National total	13 areas	Bogotá	Medellín	Cali
Total	2.1	1.5	0.7	1.7	0.8
Commerce	5.2	4.7	7.4	9.2	(1.1)
Services	(1.4)	(0.2)	(1.8)	5.1	(0.6)
Industry	3.2	(1.3)	(1.4)	(6.2)	8.9
Transportation	0.4	(2.5)	(9.6)	(5.2)	(1.2)
Construction	5.7	4.2	7.5	1.2	(13.4)

a/ Calculated as the average of the annual variations for the moving quarters.
Source: DANE-GEIH.

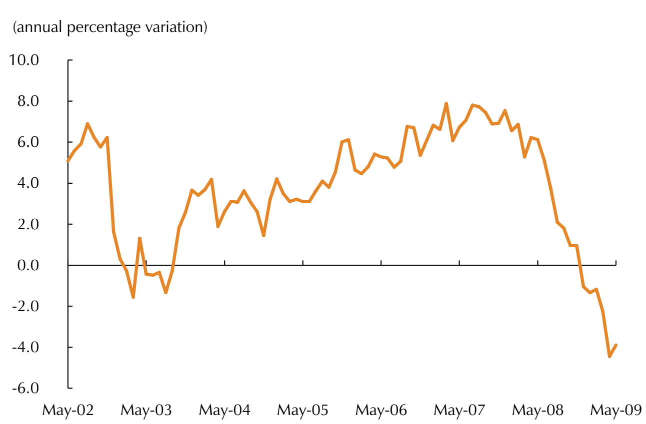
this sector fell 3.9% in May, continuing the slump witnessed since December 2008 (Graph 23, Panel B). In this case, the loss is equal for both temporary and permanent jobs: 3.1% and 1.8%, respectively, in May.

Graph 23

A. Industrial Employment



B. Employment in Commerce



Source: DANE- MMSM and MRTS.

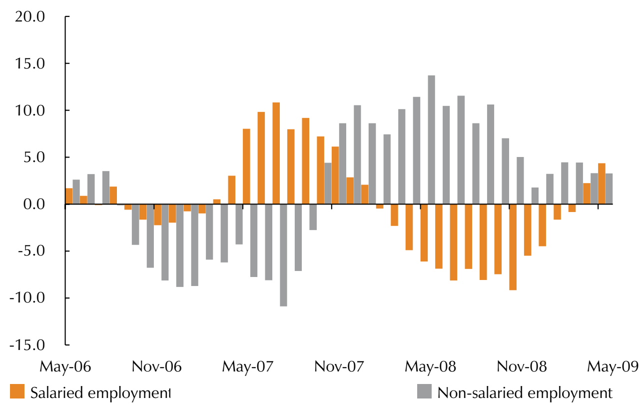
It is important to point out that the differences in the extent of change in sectoral employment between the aforementioned sectoral samples and the GEIH may be associated with the different methods estimate them. On the one hand, the GEIH is targeted on employees of medium-size and large firms, as well as employees of small companies (considered informal). The MMS includes only companies with more than ten employees, while the MRTS has information only on companies with more than twenty employees. For this reason, the increase in employment in industry and commerce nationwide, as noted in the GEIH, may be concentrated in small and informal businesses.

On the other hand, in terms of the quality of the jobs being generated, the GEIH figures show non-salaried employment increased throughout much of the first half of 2009 at a higher rate than salaried employment. So far this year, up to May, non-salaried employment nationwide rose at an average annual rate of 3.7%, while salaried employment declined 0.1%. In the thirteen major cities, the difference is even greater, since non-salaried employment rose 3.9% and salaried employment was down 0.7%. However, it is important to note that this trend in salaried employment was interrupted during April and May, when employment of this type began to grow (Graph 24). Finally, considering that non-salaried employment is the type that has

Graph 24
Job Creation: Salaried and Non-salaried

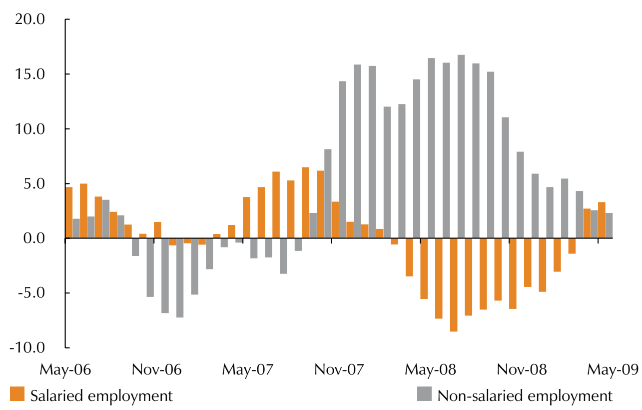
A. National Total

(annual percentage variation, moving quarter)



B. Thirteen Areas

(annual percentage variation, moving quarter)



Source: DANE, calculations by Banco de la República.

increased the most so far this year, the momentum in job creation suggests that informality in the labor market is growing.

2. Momentum in the Labor Supply

The contraction in the global participation rate (GPR) came to a halt in the final months of 2008 and the GPR has been on the rise since February 2009, with a buildup in March, April and May (Graph 25, Panel A). At the same time, the size of the economically active population (EAP) accelerated since January and expanded 4.7% nationwide and 4.3% in the thirteen metropolitan areas during the moving quarter ended in May.

The growth in the labor supply is related primarily to the additional worker effect, which occurs when the economy is in a downward cycle. A look at the job indicators for household heads shows evidence of that effect. To begin with, as illustrated in Graph 25, the variation in GPR was more for the total population that for household heads in all domains, which indicates that growth in the total supply of labor outpaced the rise explained solely by the increased participation of household heads. This suggests the entry of secondary or additional agents is behind the momentum in the GPR for the total population.

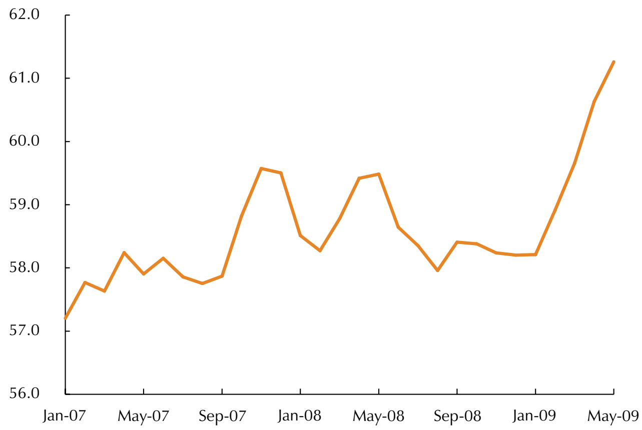
The Global Participation Rate started to increase in February 2009. The expansion of the labor supply is mainly related to the additional worker effect.

Secondly, the employment rate behaved just the opposite in the two demographic groups. Although employment among the population as a whole increased during the quarter ended in May, this was not the case for household heads. Their employment rates were down in all domains (Graph 26). This may be a sign that job creation was concentrated among those additional workers, while the increase in supply among household heads did not coincide with a rise in their employment. This is why one sees higher increases in unemployment rates for this demographic group than for the total population. In short, although employment has recovered so far during 2009, the capacity for job creation in the major cities and in the sectors more associated with foreign trade has been affected. Moreover, the rise in unemployment is explained by the increased labor supply (global participation rate), which rose faster than the employment rate (Graph 27).

Graph 25
Job Creation

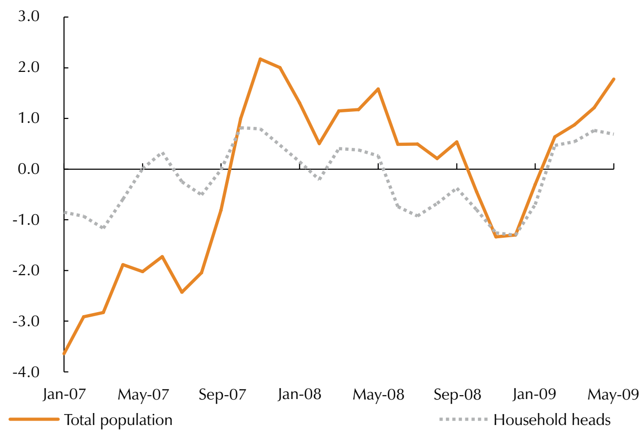
A. Global Participation Rate for the National Total

(percentage, moving quarter)



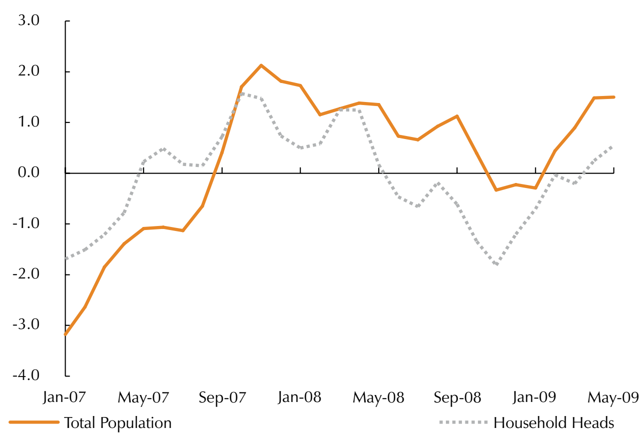
B. National Total (variation)

(percentage points, moving quarter)



C. Thirteen Metropolitan Areas

(percentage points, moving quarter)

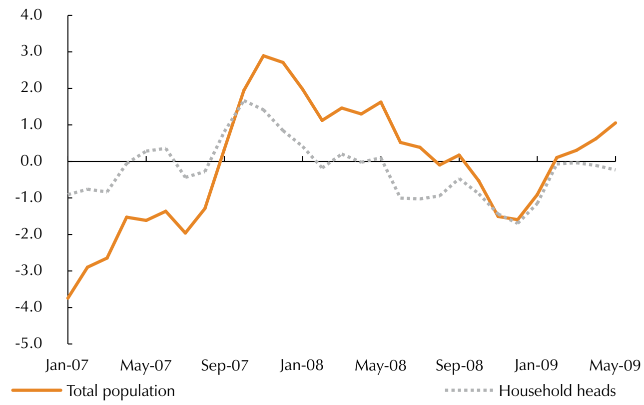


Source: DANE-GEIH.

Graph 26
Annual Variation in the Employment Rate

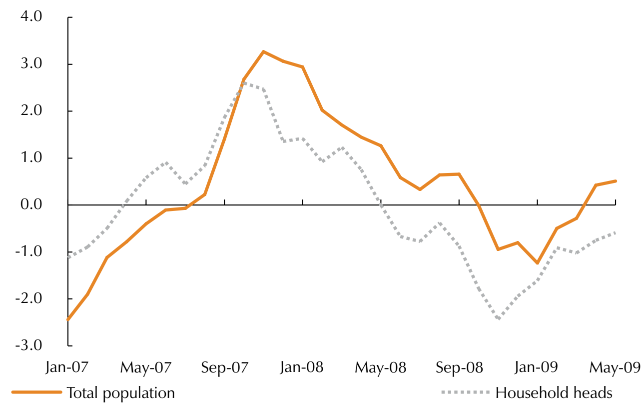
A. National Total

(percentage, moving quarter)



B. Thirteen Metropolitan Areas

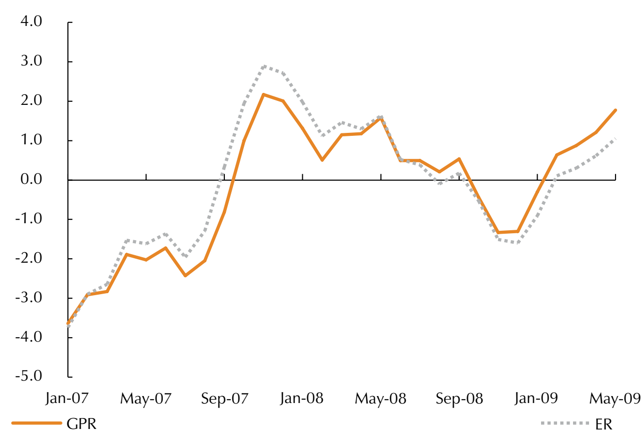
(percentage, moving quarter)



Source: DANE-GEIH.

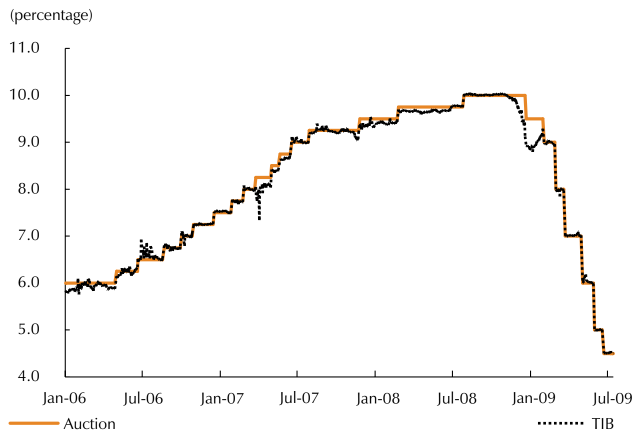
Graph 27
Annual Variation in the Global Participation Rate (GPR) and the Employment Rate (ER) for the National Total

(percentage points, moving quarter)



Source: DANE-GEIH.

Graph 28
Banco de la República Repo Auction Rate and Interbank Interest Rate (TIB), 2006-2009 [a/]



a/ The figures are for working days. The last figure pertains to June 15, 2009.
Source: Superintendencia Financiera de Colombia and the Banco de la República

D. MONETARY POLICY AND THE FINANCIAL SECTOR

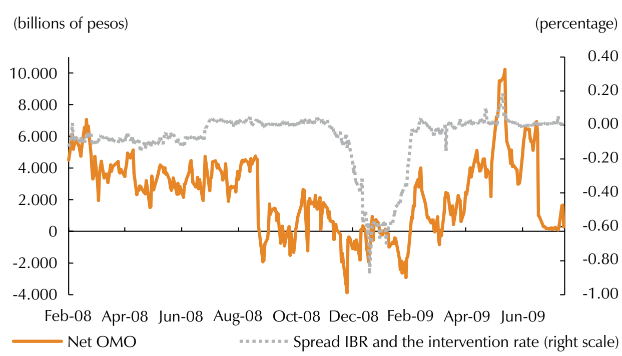
1. Monetary Policy Decisions and the Performance of Interest Rates so Far in 2009

a. Interest Rates: Banco de la República and the Market

The downward trend in inflation and growth was the scenario in which monetary policy decisions were adopted. Accordingly, the Banco de la República´s intervention interest rate, which was 10% in November 2008, was cut gradually by 550 basis points to 4.5% at end June 2009 (Graph 28). The reductions occurred as follows:

- In December 2008 and January 2009, a 50 basis point cut was adopted at each monthly meeting of the Board of Directors, placing the rate at 9%.
- Between February and May, it was lowered to 5% at a rate of 100 basis points per month. Moreover, the Board of Directors of Banco de la República announced in May that the information at hand meant any future interest rate cuts would be less than the recent ones.
- At its June meeting, the Board of Directors lowered the Banco de la República´s policy interest rate by 50 basis points to 4.5% and announced that it did not expect any additional intervention rate changes in the near future, give the data available at the time.

Graph 29
Spread between the Interbank Interest Rate and Banco de la República Intervention, and Banco de la República´s Net Creditor Position [a/]

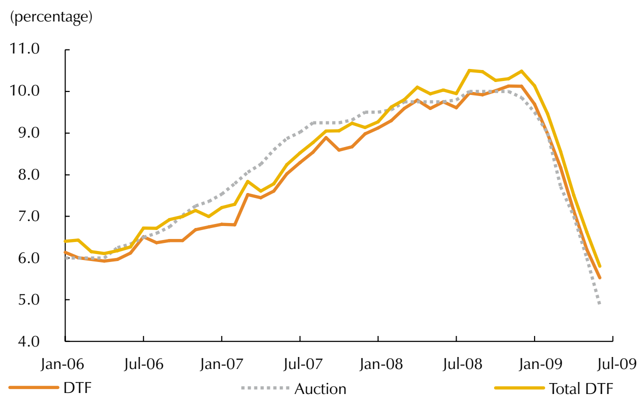


a/ The net creditor position of the Banco de la República is calculated as the different between expansion repos and contraction deposits with the Central Bank that are not subject to reserve requirements. If the difference is positive (negative), it means the Central Bank is a net creditor (debtor) of the financial system.
Sources: Banco de la República and Superintendencia Financiera de Colombia.

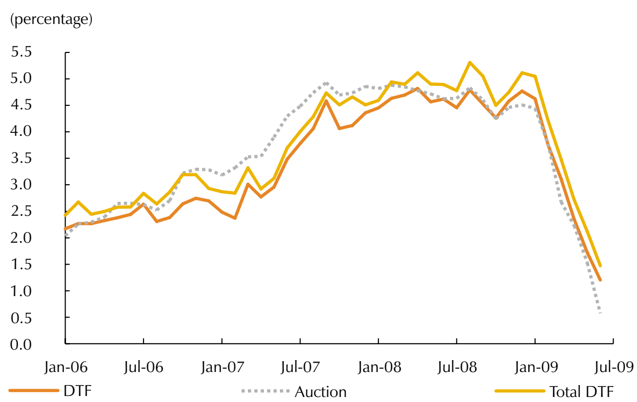
As of mid-February 2009, the interbank interest rate (IBR) has stayed close to the Banco de la República´s policy rate (Graph 28). However, this was not the case for the November - December 2008 period and January 2009, when the interbank rate deviated significantly and ended up below the intervention interest rate (Graph 29). One of the reasons for this turn of events was the temporary suspension of reverse repo auctions, which were reinstated in early 2009, guiding the IBR to levels near the policy rate by the end of that month, a pattern that has continued ever since. Accordingly, as of late January 2009, pass-through of Banco de la República´s intervention rate cut to the IBR occurred as expected and, by mid-July 2009, both of these rates were at similar levels.

Graph 30
Deposit Interest Rates a/ and Banco de la República Repo Auction Interest Rates

A. Nominal

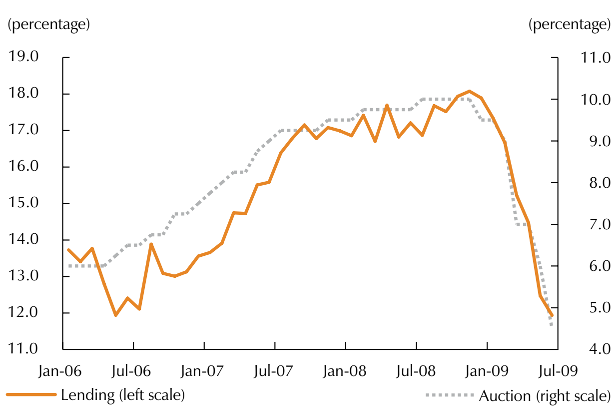


B. Real b/



a/ The weighted deposit interest rate measures the cost of new deposits with the financial system during the month, based primarily on deposits in savings accounts, certificates of deposit, bonds and repos with the productive sector. b/ The variation in the non-food CPI was used to calculate the real rates.
Source: Financial Superintendence of Colombia; calculations by Banco de la República.

Graph 31
Real Nominal Interest Rates: Banco de la República Auction and Lending Rate a/



a/ The interest rate on lending calculated by Banco de la República. The data in this graph are presented for the end of each month.
Source: Financial Superintendence of Colombia; calculations by Banco de la República.

Moreover, between December 2008 and June 2009, the policy interest rate cuts were passed through almost entirely to deposit rates in the market (Graph 30). So, while Banco de la República´s intervention interest rate had been cut 550 bp by the end of June (from 10% in November 2008), the DTF interest rate and the CD deposit rate have declined 463 bp and 458 bp, respectively, during the course of the year up to July 10. On that date, the DTF was 5.2% and the CD deposit rate was 5.6%.[32]

Lending rates also have declined in line with the policy rate. During the course of the year up to July 3, the lending rate calculated by the Banco de la República[33] has declined 595 bp, responding forcefully to the changes in the policy interest rate (Graph 31).

The pass-through has been varied, depending on the type of lending. Specifically, the interest rate on commercial lending was 10.4% during the week of July 3, 2009. This rounds out a reduction of 638 bp so far this year (Graph 32). With respect to this private loan portfolio, the largest decline was in the interest rate on preferential loans, which reached 9.3% (-699 bp so far this year), followed by treasury loans, with a 617 bp rate cut to 9.7% during the same period. The interest rate on ordinary lending declined 440 bp during the same period.

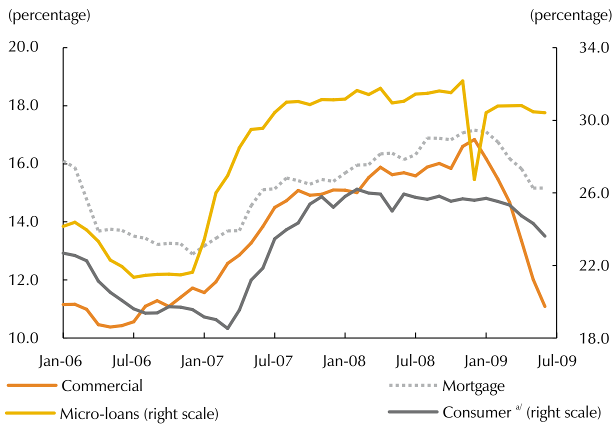
Consumer lending rates responded the least, having dropped by only 221 bp so far during 2009. The interest rate on consumer loans was 23.1% during the week of July 3, 2009. The interest rate on loans

32 The DTF is the weighted average monthly interest rate on 90-day certificates of deposit (CD), as reported to the Office of the Financial Superintendence of Colombia by banks, financial corporations and commercial finance companies throughout the country. The CD rate is the weighted average monthly interest rate for all maturities, as reported by all credit institutions to the Financial Superintendence of Colombia. The DTF information is weekly and the latest figure is the rate that is valid for the following week (July 13 to 19, 2009). The CD figure is weekly as well.

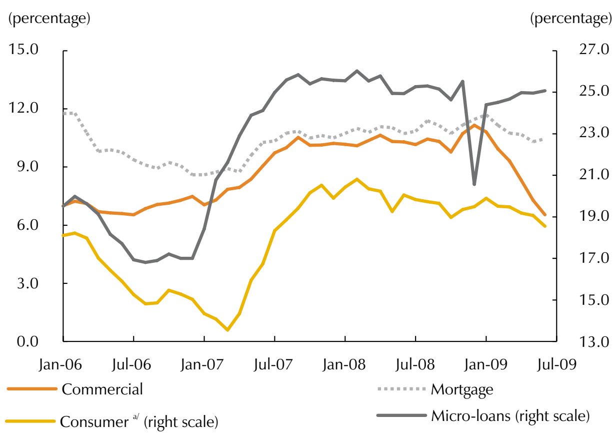
33 The figures for lending rates are weekly. The lending rate calculated by the Banco de la República is the weighted average interest rate on consumer, preferential, ordinary and treasury loans. Given the high rollover in treasury lending, its weight was determined as a fifth of the disbursements on loans of this type.

Graph 32
Lending Rates by Type of Loan

A. Nominal (monthly average)

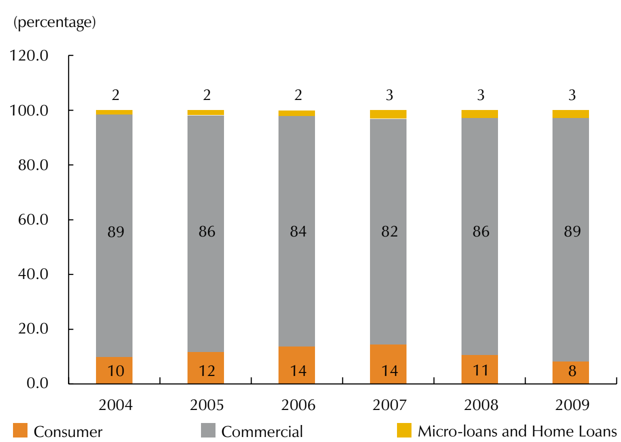


B. Real b/



a/ Does not include credit card lending.
Sources: Financial Superintendence of Colombia, DANE and Banco de la República.

Graph 33
Share of Disbursements by Type of Loan Portfolio
Compared to Total Disbursements (January-June 2009)



Source: Financial Superintendence of Colombia; calculations by Banco de la República.

for home purchase declined 252 bp to 14.9% during the same period.

According to the foregoing, policy interest rate pass-through was more pronounced for rates on commercial loans compared to other types of lending. Still, as noted, the reduction in the lending rate calculated by Banco de la República was proportionally greater than the policy rate cut. This reflects the change in the composition of expenditure. As shown in Graph 33, disbursements on commercial loans have grown as a share of total expenditure, having gone from 82%, on average, between January and June 2007 to 89% during the same period in 2009. This increase was accompanied by a reduction in disbursements on consumer loans as a share of total disbursements, which went from 14% to 8% between the same dates.

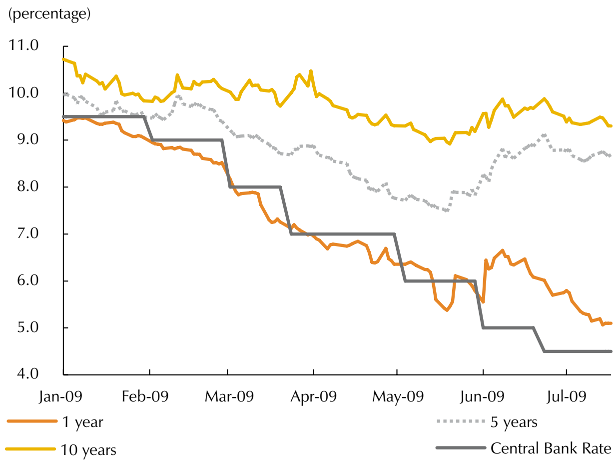
b. Change in Interest Rates on Government Bonds to Date in 2009

The first half of 2009 was a good time for the local government bond market. The first weeks of June saw a temporary halt in the downward trend exhibited in interest rates on TES at all maturities up to late May. For example, the rate on TES maturing in July 2020 went from 10.55% in early January to 8.9% at the end of May, while the interest rate on TES maturing in May 2011 declined from 9.61% to 6.30% during the same period (Graph 34).

The TES yield curve (Graph 35) is a graphic description of the relationship between the interest rate on a bond of the same credit quality with different maturities.[34] A shift, steepening, or curvature can send signals to monetary policy makers about expectations: inflation, growth, interest rates, government spending, changes in risk, etc.

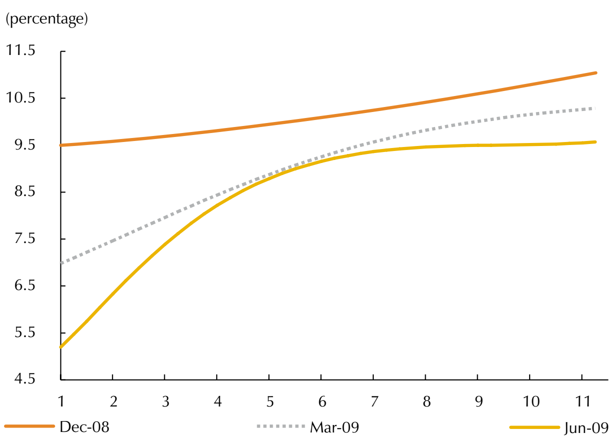
34 The yield curve makes it possible to estimate the time structure of interest rates on financial assets that are identical in terms of their intrinsic features and to observe the range of returns offered by those assets, theoretically identical in every aspect with the exception of their maturity. Some agents pose that relationship of interest rates on financial paper in terms of the concept of "duration" (Camaro et al., 2005).

Graph 34
Zero-coupon Bond Yield Curve for TES in Pesos and Banco de la República Intervention Rate (January-June 2009)



Sources: Bolsa de Valores de Colombia (BVC) and Banco de la República.

Graph 35
TES Yield Curve



Sources: BVC and Banco de la República.

In the case of Colombia, besides the downward shift in the TES yield curve (due to appreciation of these bonds), it showed a steepening as well, implying a more pronounced drop in short-term interest rates compared to those on longer term TES. This is explained mainly by three factors:

International preference for short-term liquidity, due to an increased perception of risk, greater expectations of added government spending, or some sign of change in the economic cycle. The government bond curve has seen a steepening in several countries including the United States. This, in turn, eventually affects the TES domestic yield curve.

Announcements such as those made by the government concerning additional TES issues during 2009 and in the years ahead to finance the fiscal deficit might affect relative valuations in the long-term debt compared to the short-term debt.

The sharp cut in Banco de la República's policy rate (-550 bp) in just six months might have influenced how market agents view the future of variables such as interest rates, inflation and growth.

The TES curve has steepened since June 2009, showing a modest increase in medium and long-term interest rates. For the most part, this can be explained by several factors: i) TES were sold for profit-taking in response to expectations of smaller policy rate cuts, ii) several commercial banks sold positions in debt securities to obtain additional resources for a loan to Ecopetrol, and iii) there was the government's announcement mentioned earlier. However, on June 25, these rates were below their opening levels for the year and well below the levels of global risk aversion observed in the fourth quarter of last year.

The downward drift in inflation and growth was the scenario in which monetary policy decisions were adopted. Banco de la República's intervention interest rate, which was 10% in November 2008, was cut gradually by 550 basis points to 4.5% at the end June 2009.

2. Monetary Base, Lending and Sources of Financing for the Financial System

As explained on previous occasions, the development of monetary and credit aggregates reflects the performance of agents in the economy, partly in response to the policy measures adopted by monetary authorities. The central bank is responsible for maintaining the one-day interest rate at a level determined by the Board of Directors and supplies all the liquidity agents require at that rate. In other words, the pattern in monetary base is determined by the decisions

Lending rates have declined in line with the policy rate. However, the pass-through has been varied, depending on the type of lending.

adopted by agents and the financial system in the primary liquidity market. The course of credit reflects the spending needs of agents, and the performance of M3 reflects what agents decide in terms of the demand for money.

a. *Monetary Base: Use and Sources*

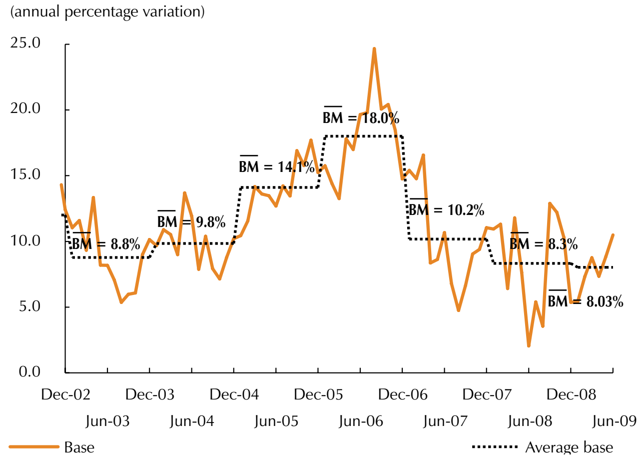
i. *Use*

Policy interest rate pass-through was more pronounced for rates on commercial loans compared to other types of lending.

During the course of 2009 to June, the average annual increase in monetary base was 14.2%, which is equivalent to 8.0% in real terms (Graph 36). This real variation was 0.3 pp less than the one observed in the same period in 2008, mainly because of the movement in bank reserves. Specifically, the real annual increase in bank reserves during the first half of 2009 came to 14.6% (21.1% in nominal terms), which is 8 pp less than during the same period in 2008. The real average annual increase in cash during this same period was 4.9% (10.8% in nominal terms); that is, 2.2 pp higher than during the period from January to June 2008.

Less growth in bank reserves was due, in part, to the measure adopted by the BDBR at the end of 2008, when it lowered the average reserve requirement for lending institutions by about 1 pp. Specifically, the reserve requirements on sight deposits was lowered from 11.5% to 11%.[35] The requirement for CDs and bonds at less than 18 months[36] was reduced from 6% to 4.5%.

Graph 36
Real Monetary Base



Source: Banco de la República.

ii. *Sources of Growth in Monetary Base*

Although monetary base was up 18.2% by the end of June 2009 with respect to the same period last year, it was Col$1,771 b less compared to December 2008. According to the information in Table 6, the following were the sources of supply for this liquidity in dollars during the course of the year to June 2009:

The interest rate cut has helped to sustain the real growth in lending.

- The increased liquidity provided by Banco de la República in operations with the financial system. The repo balance, in particular, was up Col$5,678 b by June 2009 compared to December 2008, while

35 Current accounts, savings accounts, trust deposits, sight deposits and repos with the productive sector.

36 The average reserve required for CDs and bonds at more than 18 months is 0%.

Table 6
Sources of the Monetary Base
Quarterly Variation
(Billions of pesos)

	2007	2008					2009		
		I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Cumulative	I Qtr.	II Qtr.	Jan.-Jun.
I. Government	(2,117)	(4,187)	271	2,936	4,539	3,559	(3,945)	(4,784)	(8,729)
Transfer of profits[a/]	0	1,415	0	0	0	1,415	0	0	0
Pesos	0	1,415	0	0		1,415	0	0	0
Deposits with the Banco de la República	(2,117)	(5,602)	271	2,936	4,539	2,144	(3,945)	(4,784)	(8,729)
II. Regulation TES	(1,161)	(147)	(981)	(0)	616	(513)	(501)	(20)	(520)
Definitive purchases	60	0	0	0	625	625	0	0	0
Definitive sales	(660)	(137)	(823)	0	0	(960)	(499)	0	(499)
Matured	(561)	(10)	(158)	(0)	(9)	(178)	(1)	(20)	(21)
III. Banco de la República Liquidity Operations	(1,492)	(1,571)	733	(5,077)	693	(5,221)	1,698	5,438	7,137
Expansion[b/]	(1,233)	(1,713)	1,102	(3,439)	193	(3,856)	1,194	4,484	5,678
Contraction	(259)	142	(369)	(1,638)	500	(1,365)	505	954	1,459
IV. Foreign exchange[c/]	10,326	505	1,346	2,404	(356)	3,899	(460)	369	(90)
Put options to control volatility	1,119	505	422	0	5	932	429	369	798
Call options to control volatility	(732)	0	0	0	(535)	(535)	(888)	0	(888)
Reserve accumulation options		0	798	0	0	798	0	0	0
Direct purchaseauction		0	126	2,404	174	2,705	0	0	0
Discretional intervention	9,939	0	0	0	0	0	0	0	0
Sale of foreign exchange to the government	0	0	0	0	0	0	0	0	0
V. Others [d/]	(173)	275	454	890	434	2,053	242	190	432
Total variation in monetary base	5,383	(5,125)	1,823	1,154	5,925	3,778	(2,965)	1,194	(1,771)
Monetary base balance	32,415	27,290	29,114	30,268	36,193	36,193	33,228	34,422	34,422

a/ Government profits drawn in dollars on February 27, 2009 (US$320,4 m equivalent to COP$818,6 b), Government profits drawn in dollars on February 28, 2007 (US$533 m, equivalent to COP$1,186 b).
b/ Includes one-day, overnight and medium-term repos.
c/ Does not include operations with international organizations.
d/ Primarily includes, among others, the monetary effect of the Banco de la República's income statement, as well as the monetary effect of deposits for borrowing and the external loan portfolio,
Source: Banco de la República.

the balance of non-reserve interest-bearing deposits (NRIBD) was Col$1,459 b less.

- Other factors accounted for an increase of Col$432 b, mainly fewer deposits in pesos with Banco de la República for borrowing and external portfolio operations, and the net expansionist effect of Banco de la República P&L operations.

This expansion was more than offset by:

- An increase of Col$8,729 b in government deposits with the Banco de la República.

- The definitive sale of Col$499 b in TES held by Banco de la República, together with maturity of the balance under this heading (Col$21 b).

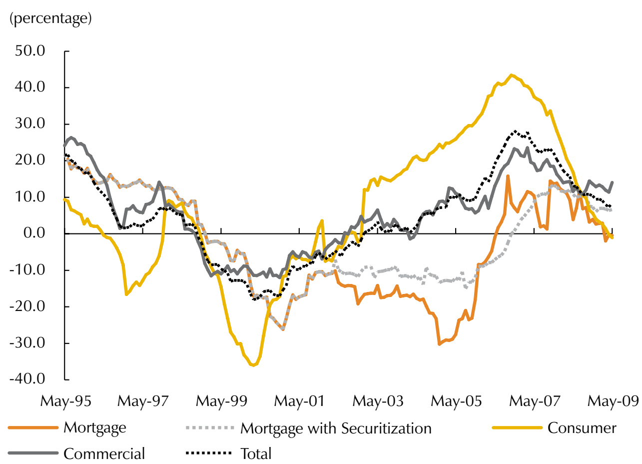
- Col$90 b in net foreign exchange sold on the currency market by the Banco de la República, owing to sales through the exercise of Col$888 b in call options to control the volatility and purchases through the exercise of Col$798 b in put options to control the volatility.

Loan portfolio growth continued to slow during the first few months of 2009, as it has since early 2008.

This distribution of primary market liquidity by Banco de la República during the first part of the year was different from what was observed during the same period last year, when the main source of expansion in monetary base was the net purchase of foreign currency in the exchange market, which was offset by larger amounts deposited with Banco de la República by the Treasury Department, the decline in outstanding TES held by Banco de la República and less liquidity provided to the financial system through repos and non-reserve interest-bearing deposits.

b. Loan Portfolio

Graph 37
Real Growth by Portfolio Type [a/]



a/ With non-food CPI
Sources: Financial Superintendence of Colombia; calculations by Banco de la República

Loan portfolio growth continued to slow during the first few months of 2009, as it has since early 2008. The consumer loan portfolio has been among the most affected, posting 1.1% negative real annual growth in May 2009,[37] which is 17.9 pp less than the year before (16.8 %).

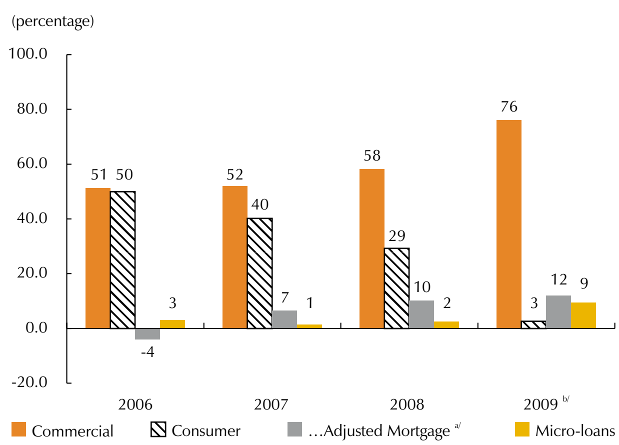
The same also was true of the mortgage loan portfolio (with and without securitization), with real annual variations in May of 6.7% and -0.4%, respectively (Graph 37). The slowdown in portfolio growth is due to a set of factors, particularly slower economic growth, rising unemployment and the limited response of interest rates on consumer lending. The result was no more than an 8.5% real annual increase in the total gross portfolio by

37 These figures are taken from the balance sheets at May 2009.

May, which is 4.6 pp less than during the same period in 2008. However, it is important to highlight the development in the commercial loan portfolio during the last six months, as it is the type of lending with the largest real annual increase, having gone from 11.6% in May 2008 to 14.1% in May 2009.

An analysis of how these types of loans have contributed to real growth in the total loan portfolio shows that, while the increase in the commercial loan portfolio accounted for half the variation in total during 2006 and 2007, this contribution is up to 76% so far this year to June. The situation with the consumer loan portfolio is totally different. Its share of total real portfolio growth has declined gradually from 50% in 2006 to 3% in the first half of 2009 (Graph 38).

Graph 38
Share of Real Growth in the Financial System's Gross Loan Portfolio



a/ Includes leasing and pertains only to domestic currency. The mortgage and total portfolios are securitization- adjusted.
b/ The figures are the January-December average for all years, except 2009, when the average is for January-June.
Sources: Financial Superintendence of Colombia and Titularizadora Colombia; calculations by Banco de la República

In June 2009,[38] the nominal increase in the total gross loan portfolio (in domestic currency, including leasing and securitization) was 14.1%. According to the type of loan (including leasing), the nominal annual increases in the consumer, mortgage-adjusted and commercial loan portfolios were lower than those witnessed in June 2008,[39] while micro-credit increased at higher rates than those of the same month in 2008 (Table 7).

It is important to emphasize that the slowdown in the portfolio growth rate was greater than the slowdown in the economy. This caused a slight decline in the financial depth index, which is measured as the proportion of the loan portfolio to GDP, which went from 30.9% in December 2008 to 30.5% in March 2009. A Similar behavior was witnessed in commercial and consumer lending, with respective reductions of 23 bp and 16 bp. However, despite this performance, these indicators are still at higher levels than those registered during the period prior to the crisis in the late nineties (Graph 39).

Growth in the total risky portfolio[40] so far this year is slightly lower, although it remains historically high. As shown in Graph 40, its real annual increase by May was 45.3%, which implies a reduction of 1.4 pp compared to December

38 This is weekly data from Form 281 submitted to the Financial Superintendent by credit institutions. The last available figure is for the week of July 3, 2009.

39 By the week of July 4, 2008, these increases were 22.1%, 19.9% and 20.2%, respectively, for the consumer, mortgage-adjusted and commercial loan portfolios. They were 2.8%, 15.4% and 18.3%, respectively, by the week of July 3, 2009. During that same week, the micro-credit portfolio posted 59.6% annual growth, compared to 19.9% the year before.

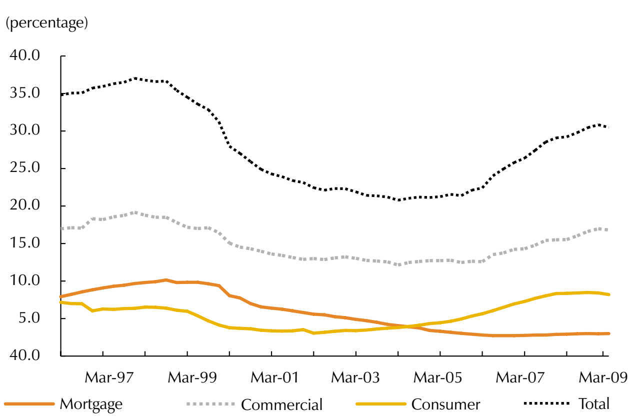
40 The risky loan portfolio is comprised of all non-A rated loans.

Table 7
Financial System's Gross Portfolio[a/]

	Balance in billions of pesos at the end of June [d/]:			Annual Growth (%), end of June [d/]:		
	2007	2008	2009	2007	2008	2009
A. Domestic currency without leasing	95,444	114,995	130,639	28.9	20.5	13.6
Mortgage	8,197	9,829	10,152	7.5	19.9	3.3
Consumer	31,245	38,204	39,276	44.5	22.3	2.8
Micro-credit	1,839	2,205	3,516	27.2	19.9	59.5
Commercial	54,163	64,757	77,694	24.9	19.6	20.0
B. Financial leasing [b/]	9,345	11,686	12,861	42.7	25.0	10.1
Mortgage	615	920	1.285	198.8	49.5	39.7
Consumer	316	326	346	58.6	3.3	6.0
Micro-credit	0	0	2	n.a.	n.a.	374.5
Commercial	8,414	10,439	11,228	36.9	24.1	7.6
C. Domestic currency with leasing	104,789	126,680	143,499	30.0	20.9	13.3
Mortgage	8,813	10,749	11,438	12.5	22.0	6.4
Consumer	31,560	38,530	39,622	44.7	22.1	2.8
Micro-credit	1,839	2,205	3,518	27.2	19.9	59.6
Commercial	62,577	75,196	88,921	26.4	20.2	18.3
D. Adjusted mortgage loan portfolio with leasing [c/]	11,764	14,101	16,270	21.1	19.9	15.4
E. Adjusted domestic loan portfolio with leasing [d/]	107,741	130,033	148,332	30.6	20.7	14.1
F. Foreign exchange	5,716	6,577	4,688	15.1	15.1	-28.7
G. Total adjusted loan portfolio with leasing (E+F)	113,456	136,610	153,020	29.7	20.4	12.0

n.a. Not applicable.
a/ Excluding FEN and institutions in the process of being liquidated.
b/ Figures at the end of the monetary month.
c/ Securitized.
d/ The last figure is for July 3, 2009.
Source: Form 281 from the Financial Superintendence of Colombia and calculations by Banco de la República.

Graph 39
Financial Depth: Loan Portfolio/GDP

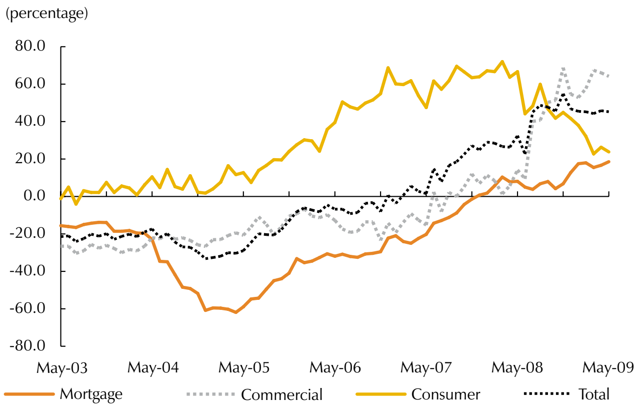


Source: Financial Superintendence of Colombia; calculations by Banco de la República.

2008. This is explained by the developments in the risky portion of the consumer loan portfolio, which went from a real annual increase of 41.6% at the end of 2008 to 23.8% (real annual) in May this year. However, it is important to highlight the rapid decline in commercial lending, since the risky portion of that portfolio was up 64.2% by May, in real annual terms, which is 9.5 pp higher than in December 2008.

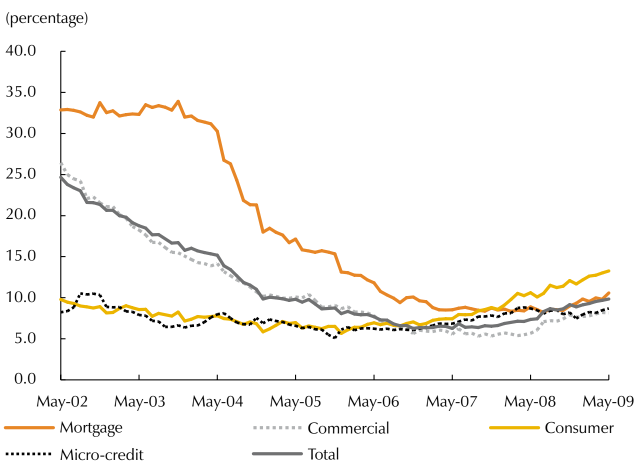
Because the risky portion of the loan portfolio has grown relatively more than the gross loan portfolio,

Graph 40
Real Growth in the Risky Portfolio



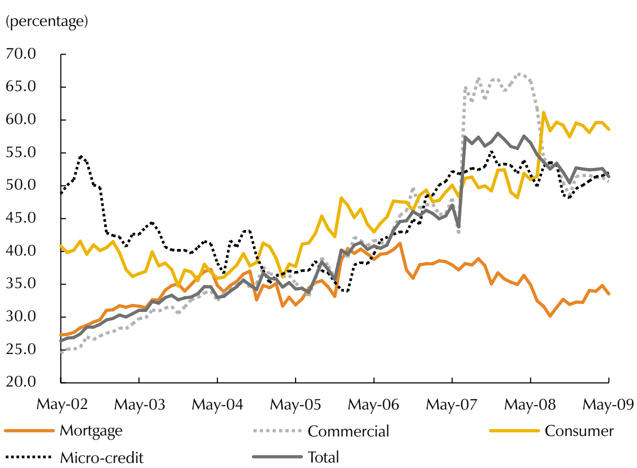
Source: Financial Superintendence of Colombia; calculations by Banco de la República.

Graph 41
Portfolio Quality by Loan Type:
Risky Portfolio /Gross Portfolio



Source: Financial Superintendence of Colombia; calculations by Banco de la República.

Graph 42
Coverage Indicator: Loan-loss Provisions/Risky Portfolio



Source: Financial Superintendence of Colombia; calculations by Banco de la República

the portfolio quality indicator (QI)[41] has deteriorated significantly with respect to what it was in December 2008. The QI for the total loan portfolio went from 8.9% at the end of 2008 to 9.9% in May 2009 (Graph 41). This decline in quality has been present since late 2007 and can be explained mainly by the deterioration of consumer and commercial lending, with QI levels in May that were 13.3% and 8.2% respectively. These figures are 1.6 pp and 54 bp higher than those observed last December.

Despite the decline in portfolio quality, the profitability of the system has remained relatively stable, having gone from 2.43% in May 2008 to 2.41% in May 2009. Profitability has not been considerably, since the intermediation margin has increased.

Loan-loss provisions have has increased in absolute terms and came to Col$7.6 t in May of this year (Col$6.9 t in December 2008). However, the increase in the risky portfolio has been more than proportional to the increase in provisions, causing the coverage indicator for the total portfolio to decline to 51.4% in May, which 5.1 pp less than the year before (Graph 42). This deterioration is explained by the fact that the increase in the risky portion of the commercial loan portfolio was not accompanied by a proportional increase in loan-loss provisions. As a result, this coverage indicator went from 65.9% in May 2008 to 50.6% in May 2009. The consumer loan portfolio was the only one to show a significant improvement in its coverage indicator, which was 58.6% in May. This is 7.7 pp higher than it was a year earlier.

As to the soundness of financial intermediaries, it appears the capital adequacy ratio so far this year (13.5%) is above the average for the decade, having reached 14.7% in May 2009, which is 94 bp higher than the ratio posted in December 2008. The behavior of this indicator suggests that financial intermediation activities are not being constrained by capital requirements.

41 The portfolio quality indicator is the ratio of the risky loan portfolio to the gross loan portfolio.

The edition of the *Financial Stability Report* due out next September contains a detailed analysis of the various risks faced by the financial system.

c. *Source of Funding for the Financial System and M3*

By June 2009, the annual increase in the gross loan portfolio (with leasing) in domestic currency came to Col$ 25,451 b (13.7%), supported almost entirely by the growth in deposits with the financial system, which registed Col$ 25,124 b (17.8%) (Table 8).

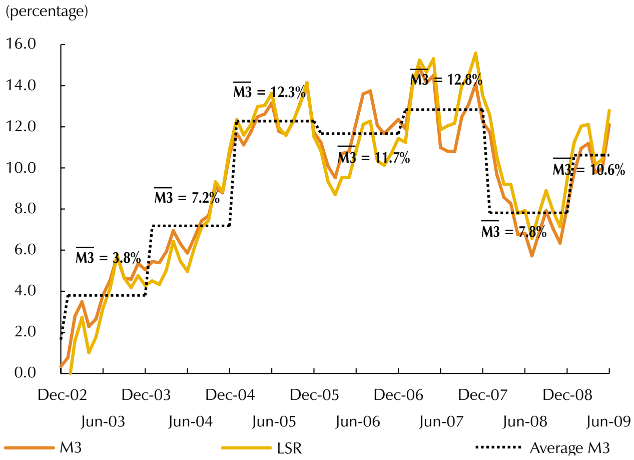
Table 8
Main Balance Accounts of Credit Institutions without FEN

	Balances end of (COP billions):			Annual variation (COP billions):		Annual percentage variation:	
	Jun-07	Jun-08	Jun-09	Jun-08	Jun-09	Jun-08	Jun-09
Assets							
Own cash position[a/]	1,740	3,087	3,964	(282)	(2,843)	(0.1)	(0.3)
Bank reserve	8,417	9,743	11,469	1,326	1,725	15.8	17.7
Banco de la República OMO liabilities and non-reserve interest-bearing deposits	1,160	486	187	(674)	(299)	---	---
Total gross loan portfolio, with leasing	105,023	126,530	143,900	20,471	25,451	20.5	13.7
Gross loan portfolio	95,699	114,918	131,037	19,220	16,118	20.1	14.0
Net loan portfolio with leasing	9,325	11,612	12,863	1,252	9,333	24.5	10.8
Investments	33,749	35,001	44,333	2,287	1,251	3.7	26.7
Other net assets	(22,531)	(29,025)	(32,489)	(6,494)	(3,464)	28,8	11.9
Total	**127,559**	**145,822**	**171,364**	**18,264**	**25,542**	**14,3**	**17.5**
Liabilities							
Repos with the Banco de la República	6,205	4,642	5,060	(1,564)	419	(25.2)	9.0
LSR	121,353	141,181	166,304	19,827	25,124	16.3	17.8
Savings	54,578	54,847	60,913	269	6,066	0.5	11.1
Current accounts	17,972	20,003	22,322	2,032	2,319	11.3	11.6
CDs	37,581	52,034	65,133	14,453	13,099	38.5	25.2
Trust deposits	3,959	4,431	5,332	472	902	11.9	20.4
Demand deposits	2,002	2,574	2,476	572	(98)	28.6	(3.8)
Bonds	4,922	6,812	9,909	1,890	3,098	38.4	45.5
Repos (National Treasury + productive sector)	339	478	218	139	(260)	41.2	(54.4)
Bond coupons	0	0	0	(0)	(0)	(10.9)	(27.9)
Total	**127,559**	**145,822**	**171,364**	**18,264**	**25,542**	**14,3**	**17.5**

Note: Pertains to the monetary month.
a/ Does not include brokerage firms. The absolute variations correspond to the variations in dollars multiplied by the average exchange rate during the period.
Source: Banco de la República.

With respect to deposits it is worth highlighting the momentum in CDs and bonds, with balances showing Col$13,099 b and Col$3,098 b in respective annual increases (25.2% and 45.5%). Moreover, elimination of marginal reserve requirement as

Graph 43
Real Broad Money: M3



Source: Banco de la República.

of September 2008[42] provided a renewed incentive to deposits with financial institutions in the form of checking and savings accounts. In fact, in June 2009, savings and checking accounts showed 11.1% and 11.6% annual growth, respectively, which is more than the increases a year earlier. The tendency in liabilities subject to reserve requirements (LSR) led to 16.9% average annual growth in M3 during the course of 2009 to June (10.6% in real terms) (Graph 43).

By May 2009, the annual increase in M3 was 17.2%, thanks largely to the increase in the aggregate of the private sector, which came to 17.3% (Table 9).

Table 9
Broad Money: Public and Private M3
(Billions of pesos)

	Balances at May		Annual percentage growth	
	2008	2009	2008	2009
Private M3	**130,343**	**152,909**	**17.3**	**18.1**
Cash	19,029	21,236	11.6	11.6
LSR	111,313	131,673	18.3	19.3
Checking accounts	13,702	14,840	8.3	5.6
CDs	47,565	61,920	30.2	35.8
Savings accounts [a/]	41,036	43,060	4.9	2.4
Others	9,010	11,853	31.6	40.9
Public M3	**29,221**	**32,998**	**12.9**	**12.8**
Checking accounts	4,966	6,105	22.9	22.0
CDs	3,196	3,992	24.9	69.0
Savings accounts	14,397	16,081	11.7	6.6
Others	6,900	6,820	2.4	2.7
Total M3	**159,564**	**185,907**	**16.5**	**17.2**
Cash	19,029	21,236	11.6	11.6
LSR	140,535	164,670	17.2	17.9
Checking accounts	18,668	20,945	12.2	9.8
CDs	50,761	65,912	29.8	37.2
Savings accounts	55,433	59,141	6.7	3.4
Others	15,672	18,673	19.1	23.8

a/ Does not include deposits with the Military Home Loan Fund, created in July 2006.
Source: Banco de la República and Financial Superintendence of Colombia.

42 External Resolution 05 adopted by Banco de la República on June 20, 2008.

During first quarter of 2009, the risk perception of emerging economies remained high and was the primary factor behind the sharp depreciation in the Colombian peso.

E. EXTERNAL SECTOR

1. *Developments in the Exchange Rate*

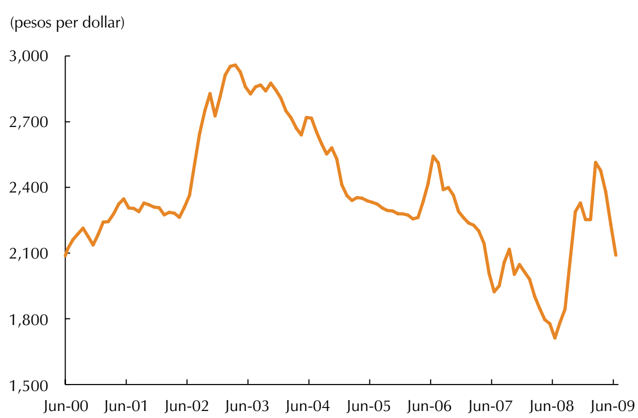
a. *Nominal Exchange Rate*

Similar to several of the region's currencies, the price of the Colombian peso during the first half of 2009 was determined largely by the change in the market's risk perception with respect to each country, as new information became available about the economic crisis in industrialized countries and its impact on the developing countries.

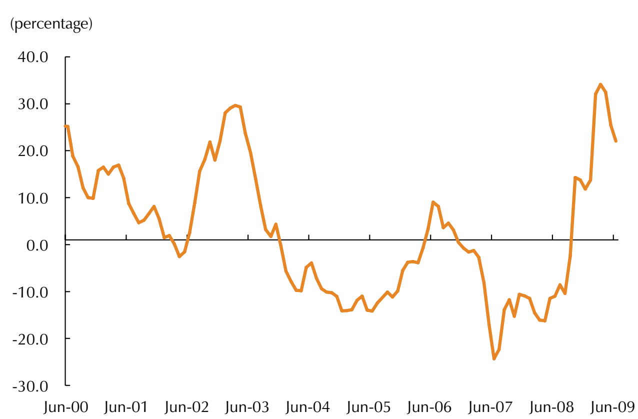
The deepening recession in the developed economies during the first quarter of 2009, together with the drop in world trade and the plunge in international commodity prices kept risk perception high for the emerging economies and was the primary factor behind the sharp depreciation in the Colombian peso. During the second quarter of the year, the balance sheets of the world's largest financial institutions showed some improvement, household and business confidence in the United States rose, signs of recovery in international trade were observed in a number of Asian countries, and international commodity prices began to increase once again. These news, which improved the outlook for emerging countries, together with other internal events described later in this report, explains most of the reversal of the trend in the exchange rate and the appreciation witnessed during the second quarter of 2009.

Graph 44

A. Nominal Exchange Rate



B. Annual Nominal Devaluation



Source: Banco de la República.

The currencies of the major Latin American countries depreciated between January and March 2009 at annual rates similar or superior to that of the Colombian peso. During that period, the Colombian peso registered 26.3% annual depreciation, the Chilean peso, 31.5%, the Mexican peso, 33.1% and the Brazilian real, 33.4%.

The depreciation in the price of the Colombian peso observed since the second half of 2008 (Graph 44) continued in February 2009, when annual depreciation peaked at 34%. This activated Banco de la República's auctions of call options on three occasions to control volatility. As a result, during the first two months of the year, Banco de la República's sold US$368.5 million (m) in international reserves through this mechanism.(Table 10). However, the representative market exchange rate (TRM) declined by almost Col$165 between March 1 and March 17, prompting Banco de la República to auction US180 m in put options to control volatility; US$179.9 m of those options were exercised (Table 10).

Table 10
Banco de la República Foreign Exchange Purchase/Sale Transactions

Item	Accumulated Jan.-Dec.	2009						
		Jan.	Feb.	Mar.	Apr.	May.	Jun.	Accumulated up to June
Purchases	2,381,3	0.0	0.0	179.9	0.0	0.0	180.0	359.9
Put options	965.5	0.0	0.0	179.9	0.0	0.0	180.0	359.9
To accumulate international reserves	450.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
To control volatility	515.5	0.0	0.0	179.9	0.0	0.0	180.0	359.9
Direct purchase auctions	1.415.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discretional intervention	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Sales	234.6	175.0	193.5	0.0	0.0	0.0	0.0	368.5
Call options	234.6	175.0	193.5	0.0	0.0	0.0	0.0	368.5
To control volatility	234.6	175.0	193.5	0.0	0.0	0.0	0.0	368.5
National government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Purchases	2,146,7	(175.0)	(193.5)	179.9	0.0	0.0	180.0	(8.6)

Source: Banco de la República.

The average TRM lost Col$387.17 (-15.6%) between March and June, implying 7.2% appreciation during the year to date. In that period, Banco de la República acquired US$359.9 m through put options to control volatility (Table 10). Several factors led to this change in the trend in the exchange rate:

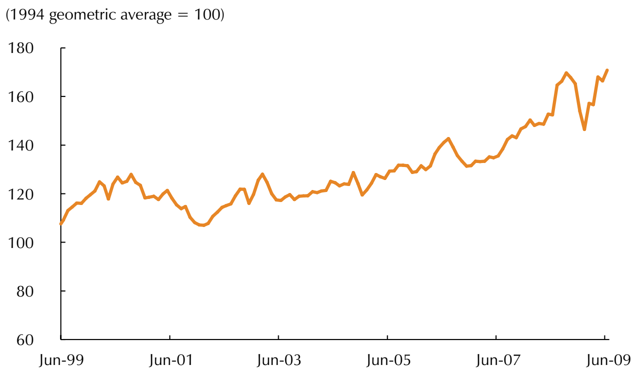
- The improvement in confidence on the world's major stock market prompted a recovery in equity markets that drew investor capital out of U.S. Treasury bonds and into a *search for profitability* focused mainly on the developing economies that had been less affected by the international crisis.

The average TRM declined 15.6% between March and June, thanks to an improvement of investor confidence and expectations of investment by companies in the productive sector.

- Terms of trade, which had plummeted since October 2008, reaching levels in January 2009 not seen since December 2007, began to recover in February of this year and, by June, were at levels similar to those registered a year earlier (Graph 45). For the most part, this was due to higher commodity prices (particular for oil and coffee) and to lower prices for the goods imported by Colombia.

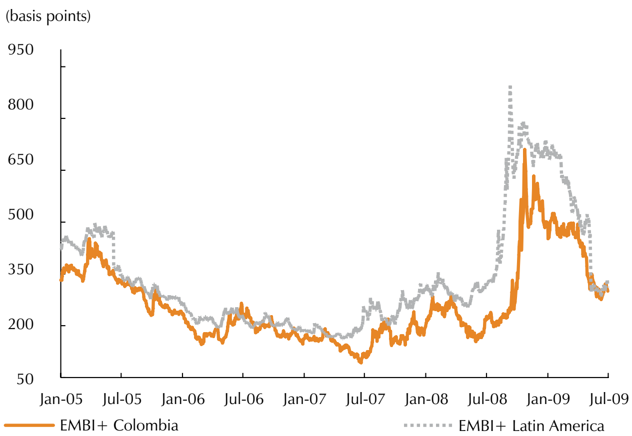
- Colombia's risk premiums declined in line with the improvement in international financial conditions and growing investor confidence in the emerging economies (Graph 46).

Graph 45
Terms of Trade a/



a/ Estimated on the basis of the PPI. Defined as the coefficient between the goods export price index and the goods import price index.
Source: Banco de la República.

Graph 46
EMBI+ Colombia and Latin America



Source: Bloomberg.

Table 11
Nominal Exchange Rate: Foreign Currency against the Dollar

	Average annual percentage variations		
	2003-2007	2008	to June 2009
Colombia	(3.1)	(5.8)	26.4
Venezuela	14.6	0.0	0.0
Ecuador	0.0	0.0	0.0
Mexico	2.6	1.6	30.4
Brazil	(7.2)	(6.6)	29.3
Euro Zone	(7.0)	(6.6)	15.0
Peru	(2.4)	(6.6)	9.0
Japan	(1.1)	(12.3)	(9.0)
Chile	(5.3)	(0.8)	25.7
Canada	(7.3)	(0.8)	19.7
England	(5.5)	8.6	32.6
Argentina	1.0	1.4	15.9

Source: Central Banks and Banco de la República.

- The foreign exchange balance figures in the second quarter of 2009 show that the net foreign exchange earnings in the capital and financial account were US$$3,557 b more than the outlays produced by the current-account deficit. Part of this performance is explained by the foreign direct investment flows that coincided with an important monetization to pay the taxes of companies in the oil sector. Additionally, expectations of appreciation increased in the wake of major announcements by several companies in the productive sector concerning investment plans financed with external resources.[43]

Although the price of the U.S. dollar declined in recent months, when comparing the first half of 2009 to the same period in 2008, the Colombian peso depreciated 26.4% against the dollar, on average. That variation is less than what was observed between the dollar and currencies such as the Mexican peso, the Brazilian real and the British pound, which depreciated 30.4%, 29.3% and 32.6%, respectively, and is similar to the devaluation in the Chilean peso (25.7%) (Table 11). However, the Colombian peso depreciated more than the Canadian and Argentine currencies, which depreciated between 16% and 20% during the same period. The Peruvian currency weakened less, having depreciated at an annual rate of 9%.

b. Developments in the Real Exchange Rate

As mentioned in past editions of this report and in a number of publications by Banco de la República,[44] the change in external and internal prices must be taken into account when analyzing the implications

43 Ecopetrol announcements are an example.

44 See Alonso *et al.* (2008), "Medidas alternativas de tasa de cambio real para Colombia," in *Borradores de Economía* No. 514; Huertas *et al.* (2003), "Índice de competitividad colombiana con terceros países en el mercado estadounidense (ITCR-C)," in *Borradores de Economía* No. 273; Echavarría and Arbeláez (2005), "Tasa de cambio y crecimiento económico en Colombia durante la última década," in *Borradores de Economía* No. 338; available at <http://www.banrep.gov.co/publicaciones/pub_borra.htm>

that the performance of the Colombian peso has on the country's competitiveness. The real exchange rate (RER), which compares external and international inflation in the same currency, is an indicator that can be interpreted as a differential of production costs of the economies or changes in competiveness. The RER can be calculated in a bilateral way for each that trades or completes with Colombia or competes, and can be included in a multilateral RER that sheds light on the country's competitiveness compared to the trading partners or competitors.

Table 12
Bilateral Real Exchange Rate: Colombian Peso Against Foreign Currencies

	Average annual percentage variations			
	2006	2007	2008	to June 2009
United States	2.1	(8.7)	(3.5)	7.3
Venezuela	8.3	3.8	9.1	55.9
Ecuador	0.4	(10.9)	(4.8)	27.7
Mexico	3.9	(9.9)	(7.9)	(0.7)
Brazil	9.8	2.9	6.9	(3.7)
Euro Zone	3.9	(2.9)	(0.3)	2.4
Peru	1.2	(6.5)	2.4	12.3
Japan	(5.8)	(12.4)	4.6	26.8
Chile	9.9	(5.6)	3.0	6.9
Canada	6.6	(6.4)	(7.7)	(1.9)
England	1.2	(2.4)	(12.9)	(8.0)

Source: Central Banks and Banco de la República.

So far this year to June 2009, the bilateral RER indexes show the Colombian peso, compared to the country's three major trading partners (United States, Venezuela and Ecuador) and after an important real appreciation in 2007, has become more competitive. The real appreciations with respect to Venezuela (55.9%) and Ecuador (27.7%) stand out during the period from January to June 2009 (Table 12).

Between January and June of this year, the multilateral RER indexes,[45] traditionally published by Banco de la República, and the index that evaluates the competitiveness of a group of items (coffee, flowers, bananas and textiles) in the U.S. market show significant annual depreciation in the real exchange rate (Graph 47). Specifically, the PPI deflated RERI shows 13.2% average annual depreciation, the RERI-CPI, 17.5% and the RERI of competitiveness, 14.9%. This has pushed the RER to historic highs. It is above the average for the 1990s and near the average for the current decade (Graph 48).

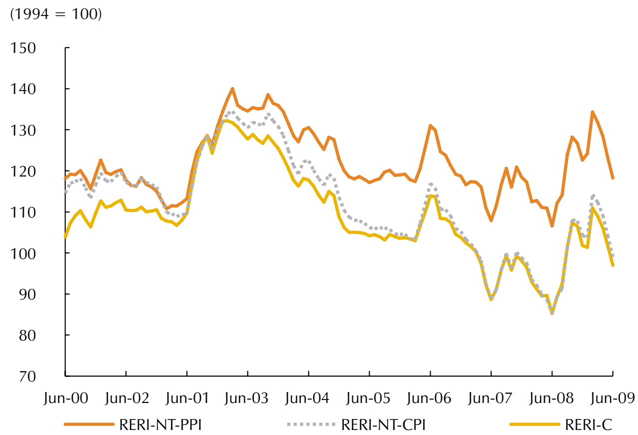
The RER indexes showed a significant real annual depreciation and a gain in competitiveness between January and June of this year.

Other alternative RER indexes calculated by Banco de la República and described in detail in the last edition of this report, show higher levels than those observed in 2008 (Graph 49). Interestingly, the alternative measurements reflect less depreciation (between 7% and 9% annually for the period from January to June 2009[46]) compared to the measurement calculated on the basis of the RERI-IPC, which shows 22% average annual depreciation during the same period.

45 Calculated with respect to Colombia's 20 principal trading partners. The difference between them is the weight given to each country and the inflation measurement that is used (CPI or PPI).

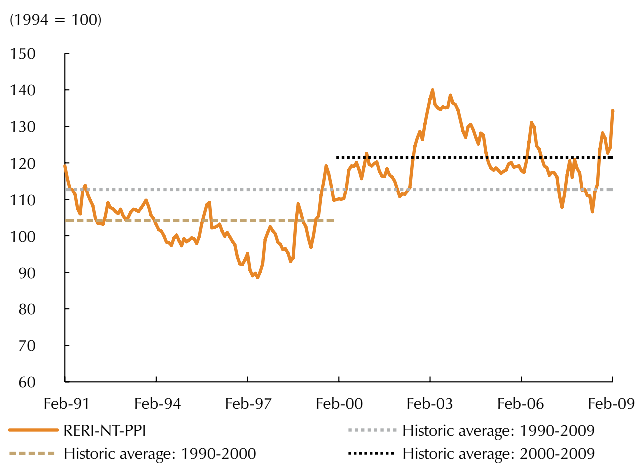
46 The last date for which there is alternative RERI data.

Graph 47
Real Exchange Rate Index (RERI)



Source: Banco de la República.

Graph 48
Real Exchange Rate Index and Historic Averages

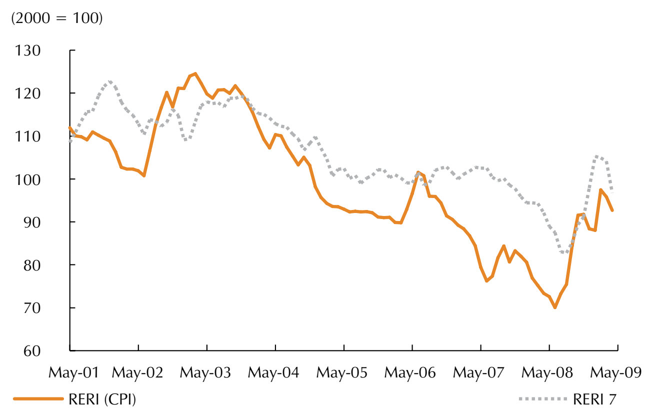


Source: Banco de la República.

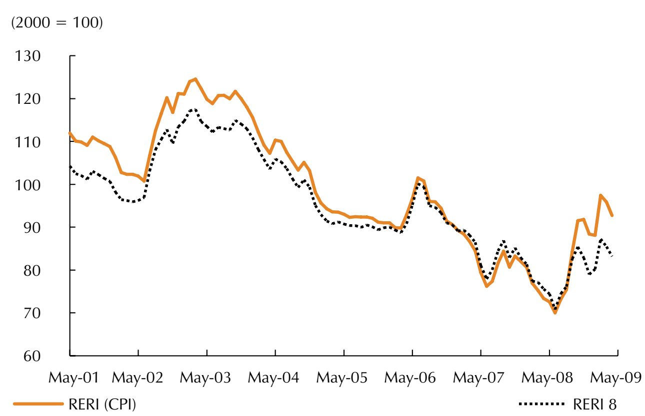
Graph 49
Alternate Measurements of the Real Exchange Rate

A. Index of Real Exchange Rate Competitiveness in Colombian Export Markets (RERI 6) vs. RERI-CPI

B. Index of Real Exchange Rate Competitiveness in International Markets (RERI 7) vs. RERI-CPI



C. Index of Real Exchange Rate Competitiveness in the Local Market (RERI 8) vs. RERI-CPI



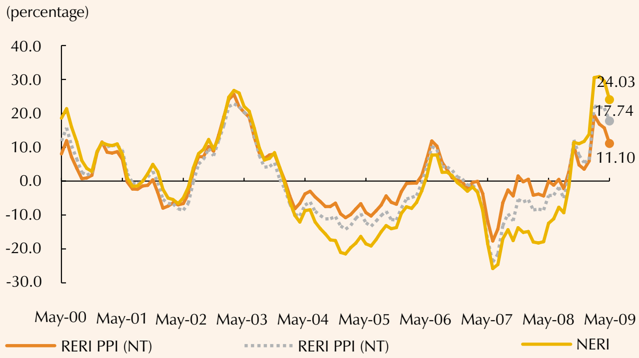
Source: Banco de la República.

Every measurement of the real exchange rate can be divided into two components: (i) the nominal exchange rate of the peso with respect to the country's trading partners (NERI) and (ii) the quotient between the external and internal price indexes (PI* and PI). The purpose is to identify which of those components exerts the most pressure on the real exchange rate (RER).

RERI = NERI x (PI/PI)*

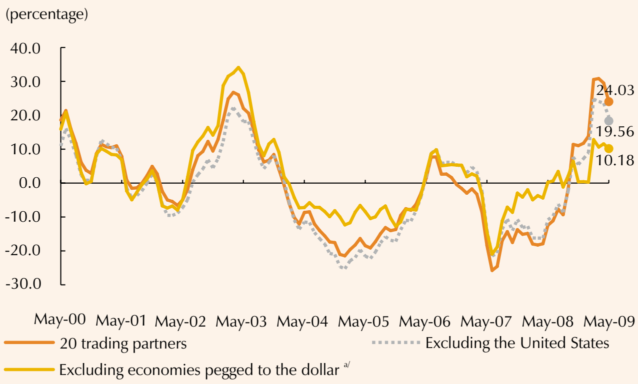
As illustrated in Graph A, nominal devaluation of the peso with respect to the various currencies (NERI) was what contributed to the real annual depreciation witnessed during the first half of 2009. However, it is important to point out that annual peso depreciation is less when the United States, or trading partners with dollarized economies or with an exchange rate pegged to the dollar (Ecuador, Panama and Venezuela) are excluded from the NERI calculation (Graph B).

Graph A
Real and Nominal Depreciation
(annual variation)



Source: Banco de la República.

Graph B
NERI Depreciation
(annual variation)

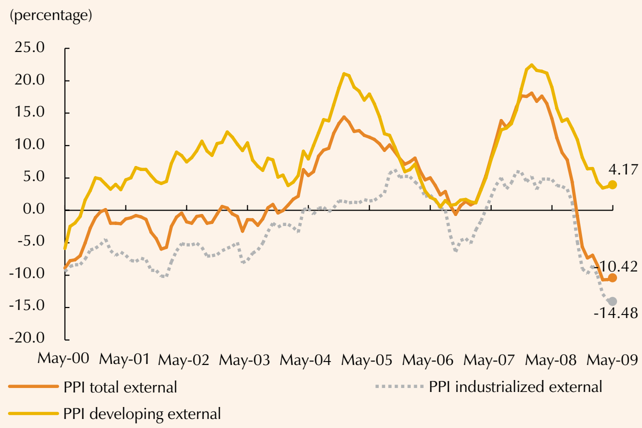


a/ United States, Venezuela, Ecuador and Panama.
Source: Banco de la República.

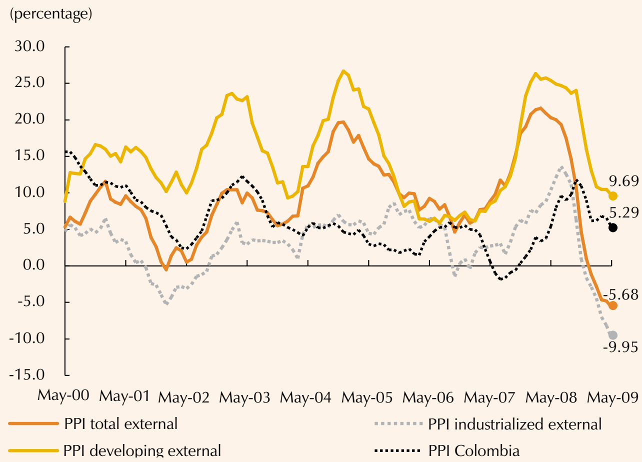
As for relative prices (PPI*/PPI), the sharp drop in external inflation measured with the PPI exerted downward pressure on the RER measurements. As shown in Graph C, that behavior is explained by deflation in the industrialized countries, associated with the economic slowdown in these economies. Average inflation in the developing countries that are Colombia's trading partners has slowed less than the PPI in our country. The result is an increase in Colombian competitiveness via costs compared to those economies.

Graph C

1. Relative Prices (annual variation)



2. Annual Inflation: External vs. Local



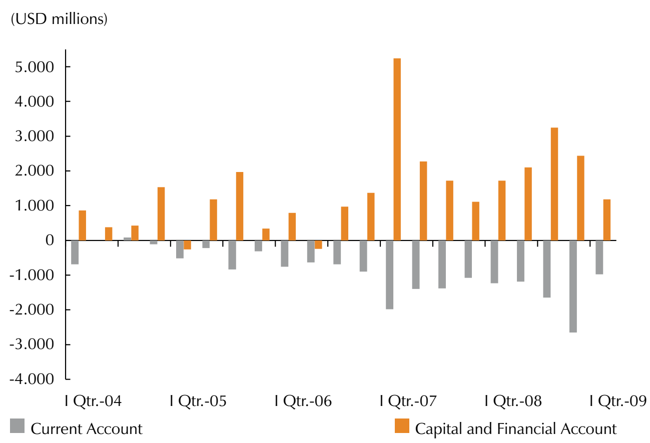
Source: Banco de la República.

In short, the different measurements of RER show a gain in competitiveness generated largely by devaluation in the NERI. This situation has been particularly evident with respect to the developing economies, given the better performance of domestic wholesale inflation.

2. Evolution of Colombia's Balance of Payments in the First Quarter of 2009

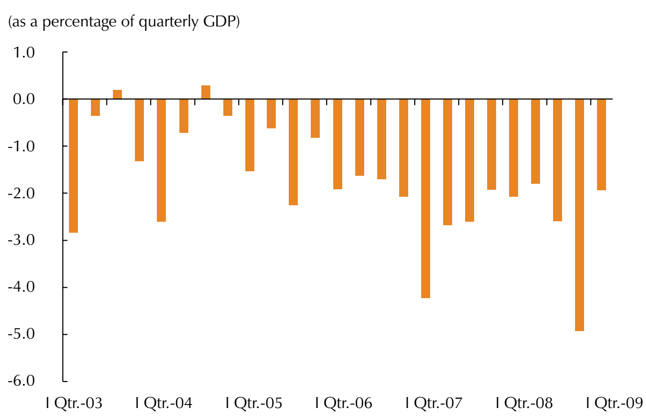
There was a 1.9% current account deficit in the first quarter of 2009, as a share of GDP. This figure is lower than the deficit registered the year before and is below the average for all of 2008. Lower values for imports and fewer profits remitted by multinational companies to their headquarters explain most of this evolution. The value of the capital and financial account was down as well, although it did exceed the value of the current account deficit. Specifically, there was less foreign direct investment, less external borrowing by the private sector, and more Colombian investment abroad. The decline in the financial and capital account was not larger due to the increase in external government financing.

Graph 50
Current Account and Capital and Financial Account in the Balance of Payments: 2004-2009



Source: Banco de la República

Graph 51
Quarterly Current Account in the Balance of Payments: 2003-2009



Source: Banco de la República

The balance of payments in March 2009 showed a US$976 m current account deficit[47] (1.9% of quarterly GDP), US$256 m less than during the same period in 2008. The capital and financial account posted a US$1,183 b surplus (2.3% of quarterly GDP), US$541 m less than during the first quarter of 2008 (Graphs 50 and 51).

The annual reduction in the current account deficit in the first quarter of 2009, was due to a greater decline in outlays (-US$1,496 b) than in income (-US$1,239 b) (Table 13). The value of imports dropped sharply in annual terms during this period (-9.4%), as did profits remitted to home offices or subsidiaries (-24.6%) by companies with foreign capital. As for income, the most important annual reductions concern the value of exported goods and services (-11.1%) and the inflow of worker remittances (-4.1%).

The capital account also exhibited an annual decline in the inflow of foreign exchange during the first quarter of 2009; however, the level reached during the quarter was enough to finance the current account deficit. Specifically, there was less income associated with private-sector external debt flows and foreign direct investment. Also, there was an increase in Colombian investment abroad. In annual terms, the Colombian private

47 An estimate of GDP in current dollars calculated by Banco de la República, using preliminary data from DANE.

The annual reduction in the current account deficit in the firs quarter of 2009, is explained by a greater decline in expenses (-US$1.446m) than in income (-US1.239m).

sector reduced its foreign debt by US$619 m, and increased its external assets through US$909 m in loans and financial investments. The public sector increased its external borrowing through the sale of US$1 b in bond issues and US$551 m in net disbursements on long-term loans. The increase in the country's external debt suggests the international financial crisis has not seriously affected access to new funding in the case of Colombia.

Table 13
Colombia's Balance of Payments
(UD$ millions)

	I Qtr. 2008 (pr)	I Qtr. 2009 (pr)	Annual Variation (dollars)
I. Current Account	**(1,232)**	**(976)**	**256**
Income	11,645	10,406	(1,239)
Expenditures	12,877	11,381	(1,496)
A. Non-factor goods and services	(216)	(359)	(143)
Income	9,827	8,740	(1,087)
Expenditures	10,042	9,099	(944)
1. Goods	443	144	(299)
Income	8,826	7,754	(1,072)
Expenditures	8,383	7,610	(773)
2. Non-factor services	(659)	(503)	156
Income	1,001	986	(15)
Expenditures	1,660	1,489	(171)
B. Factor income	(2,323)	(1,837)	486
Income	430	335	(95)
Expenditures	2,753	2,172	(581)
C. Transfers	1,307	1,220	(86)
Income	1,389	1,331	(58)
Worker remittances	1,141	1,094	(47)
Other transfers	248	237	(10)
Expenditures	82	111	29
II. Capital and financial account (a+b)	**1,724**	**1,183**	**(541)**
A. Financial account (1+2)	1,724	1,183	(541)
1.Long-term financial flows (b+c-a)	2,750	3,156	405
a. Assets	384	1,168	784
i. Colombian investment abroad	384	1,168	784
Direct	384	1,168	784
Portfolio	0	0	0
ii. Loans	0	0	0
iii. Commercial lending	0	0	0
iv. Other assets	0	0	0

Table 13 (continuation)
Colombia's Balance of Payments
(UD$ millions)

	I Qtr. 2008 (pr)	I Qtr. 2009 (pr)	Annual Variation (dollars)
b. Liabilities	3,134	4,323	1,189
i. Colombian investment abroad	2,732	3,525	793
Direct	2,874	2,528	(346)
Portfolio	(142)	997	1,139
ii. Loans	403	604	201
iii. Commercial lending	42	149	107
iv. Financial leasing	(42)	45	88
v. Other liabilities	0	0	0
c. Other long-term financial movement	0	0	0
2. Short-term financial flows (b-a)	(1,026)	(1,973)	(946)
a. Assets	798	1,104	306
i. Portfolio investment	785	(47)	(833)
ii. Commercial lending	(56)	134	190
iii. Loans	(117)	545	662
iv. Other assets	186	473	287
b. Liabilities	(228)	(869)	(641)
i. Portfolio investment	(43)	(23)	20
ii. Commercial lending	(31)	(249)	(217)
iii. Loans	(183)	(582)	(400)
iv. Other assets	29	(15)	(44)
B. Special capital flows	0	0	
III. Net errors and omissions	154	(196)	
IV. Variation in gross international reserves	646	12	
Memorandum accounts (figures in USD millions)			
I. Balance of gross international reserves	22,138	23,845	
II. Variation in gross international reserves due to balance of payment transactions	646	12	
III. Valuation gain/loss on international reserves	537	(208)	
IV. Variation in gross international reserves (II + III)	1,183	(197)	

(pr) provisional
Source: Banco de la República.

There was a 1.9% current account deficit in the first quarter of 2009, as a share of GDP. This figure is lower than the deficit registered the year before and is below the average for all of 2008.

The main balance of payments results for the first quarter are outlined below.

a. *Current Account*

Net outflows for factor income (-US$1,837 m) and the deficit in non-factor services (-US$503 m) contributed to the current account deficit in the first quarter, which was offset in part by net current transfers (US$1,220 m) and a trade surplus (US$144 m).

The decline in current outflows was largely the result of a US$773 m drop in goods imports, US$581 m less in factor income outlays, and a reduction of US$171 m in service imports. The decrease in current income was due to a US$1,072 m drop in good exports, fewer inflows for factor income (-US$95 m) and a US$58 m decline in income from transfers (Table 14).

i. *Trade Balance*

The drop in international trade and weak internal demand were reflected in lower values for exports and imports during the first quarter of 2009. The reduction in export value was due fundamentally to the momentum in terms of trade originating from the downturn in export prices for commodities, mainly oil, most of which goes to the U.S. market. Plummeting world demand also affected foreign sales, particularly non-traditional exports. The reduction in imports is mainly explained by less internal demand for intermediate and consumer goods.

The increase in the country's external debt suggests the international financial crisis has not seriously affected access to new funding in the case of Colombia.

During the first quarter of 2009, the US$144 m goods trade surplus (excluding special foreign trade operations[48]) was the result of a balance that included US$7,754 b in exports and US$7,610 b in imports.[49] The surplus reported for that period was less compared to the one registered for the same period in 2008 (US$443 m), because the US$1,072 b annual decline in exports (-12.1%) exceeded that of imports: US$773 m (-9.2%) (Table 14):

The drop in international commodity prices, particularly for oil, was the prime reason for the decline in the value of traditional exports between January and

48 Foreign trade in duty-free zones and goods re-exports originating mainly in foreign trade based on leasing.

49 Given the method used to calculate the balance of payments, the value of exports includes re-exports associated with imports through leasing, in which case the balancing entry is the cancellation of liabilities for leasing. The balance of payments for the first quarter of 2009 showed US$146 m in receipts for transaction of this type. When those transactions are excluded, the US$144 m trade surplus is reduced to a deficit of US$2.1 m.

Table 14
Colombia's Balance of Payments
Current Account
(USD millions)

	I Qtr. 2008 (pr)	I Qtr. 2009 (pr)	Annual variation (dollars)
Current Account (A+B+C)	**(1,232)**	**(976)**	**256**
Income	11,645	10,406	(1,239)
Expenditures	12,877	11,381	(1,496)
A. Non-factor goods and services	**(216)**	**(359)**	**(143)**
1. Goods	**443**	**144**	**(299)**
Income	8,826	7,754	(1,072)
Expenditures	8,383	7,610	(773)
a. General trade	401	(48)	(450)
i. Exports	8,495	7,330	(1,165)
Traditional exports	4,621	3.644	(977)
Coffee	589	472	(117)
Oil and derivatives	2,687	1,525	(1,161)
Coal	1,095	1,468	372
Ferronickel	249	179	(70)
Non-traditional exports [a/]	3,874	3,685	(188)
Agricultural sector	714	790	76
Industrial sector	2,775	2,454	(321)
Mining sector	385	442	57
ii. Imports (FOB)	8,094	7,378	(716)
Consumer goods	1,459	1,399	(61)
Intermediate goods	3,449	2,727	(722)
Capital goods	3,185	3,252	67
b. Special foreign trade operations	42	193	151
i. Exports	331	425	93
ii. Imports	289	232	(57)
2. Non-factor services	**(659)**	**(503)**	**156**
Income	1,001	986	(15)
Expenditures	1,660	1,489	(171)
a. Exports	1,001	986	(15)
Transport	309	276	(33)
Travel	446	474	28
Communications, information and data processing	85	87	2
Insurance and financial	18	15	(3)
Business and construction	106	97	(9)
Other services	37	37	(1)

Table 14 (continuation)
Colombia's Balance of Payments
Current Account
(USD millions)

	I trim. 2008 (pr)	I trim. 2009 (pr)	Variación anual (dólares)
b. Imports	1.660	1.489	(171)
Transport	704	545	(159)
Travel	422	432	10
Communications, information and data processing	61	68	7
Insurance and financial	154	111	(43)
Business and construction	229	252	23
Other services	90	81	(9)
B. Factor income	**(2.323)**	**(1.837)**	**486**
Income	430	335	(95)
Expenditures	2.753	2.172	(581)
Income	430	335	(95)
1. Interest	314	204	(110)
Public sector	206	148	(58)
Private sector	108	56	(52)
2. Profits and dividends	107	123	17
3. Employee remuneration	8	7	(2)
Expenditures	2.753	2.172	(581)
1. Interest	901	774	(128)
Public sector	682	559	(123)
Private sector	219	215	(5)
2. Profits and dividends	1.845	1.391	(453)
3. Employee remuneration	7	7	0
C. Current Transfers	**1.307**	**1.220**	**(86)**
Income	1.389	1.331	(58)
1. Worker remittances	1.141	1.094	(47)
2. Other transfers	248	237	(10)
Expenditures	82	111	29

(pr) provisional
a/ Exports of non-monetary gold and emeralds were reclassified as non-traditional exports, which makes it easier to draw a comparison between the figures published by DANE on non-traditional exports and those reported Banco de la República in the balance of payments.
Source: Banco de la República.

March 2009, whien they fell by -US$977 m. This explains 83.9% of the reduction in foreign sales.

Traditional exports totaled US$3,644 b, registering an annual decline of 21.1% compared to total exports during the same period in 2008 (US$4,621 b). Exports

The reduction in export value was due fundamentally to the momentum in terms of trade originating from the downturn in export prices for commodities.

of petroleum and oil derivatives were down US$1,161 b,[50] mainly because of the drop in sales to the United States. Fewer exports of green coffee (-19.9%), due to less internal production and the drop of the export price of coffee, also contributed to the negative performance of traditional exports, as did the reduction in ferronickel sales[51] (-28.2%). On the other hand, coal exports came to US$1,468 b, with 34.0% annual growth due to an increase in the export price (29.8%) and the quantity sold (1.8%), most of which went to the European market.

Non-traditional exports were down US$188 m (-4.9%), largely as a result of less demand in Venezuela and Ecuador for textiles, products of the chemical industry, and leather and its manufactures. During the first quarter of 2009, non-traditional exports[52] totaled US$3,685 b, with a 4.9% annual declined. The annual reduction in industrial exports came to US$321 m (-11.6%) due to the decline in clothing (-30.6%), industrial chemicals (-11.4%), transport material[53] (-39%), leather and its manufactures (-22.8%) and wood and its manufactures (-51.5%). Agricultural and mining exports, primarily for Venezuela, Europe and the United States, totaled US$790 m and US$442 m, respectively, showing positive annual variations of 10.7% and 14.8%, in that order.

Non-traditional exports declined US$188 m (-4.9%), largely as a result of less demand in Venezuela and Ecuador for textiles, items produced by the chemical industry, and leather and its manufactures.

Goods imports came to US$7,610 b during the first quarter of 2009, including an annual variation of -9.2% (-US$773 m). According to the international trade classification by economic use or destination (Cuode), intermediate goods accounted 37% of all external purchases[54] during the period in question, while capital equipment accounted for 44% and consumer goods, 19%. Import performance was characterized by fewer purchases of intermediate goods (-20.9%), especially fuels and chemical, pharmaceutical and mining products, and a 4.2% decline in imports of consumer goods. However, there was a 2.1% annual increase in imports of capital equipment.

ii. Balance of Services, Factor Income and Transfers

Foreign trade in services posted a deficit of US$503 m (1.0% of GDP) for the first quarter of 2009. This is US$156 m less than the deficit a year earlier.

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50 The implicit average export price of crude oil went from US$89/barrel in 2008 to US$37/barrel in 2009.

51 Due to lower implicit export prices, which declined from US$4/pound to US$2/pound during the period in question, despite a 95.7% increase in export volume from 27 thousand tons in 2008 to 53 thousand tons in 2009.

52 Exports of non-monetary gold and emeralds were reclassified as non-traditional exports, making it easier to draw a comparison between the figures published by DANE on non-traditional exports and those reported by Banco de la República in the balance of payments.

53 This was due primarily to Venezuela's imposition of automobile import quotas.

54 Most imports come from the United States, the countries of the Latin American Integration Association (ALADI), the European Union, China and Japan.

The reduction in imports is mainly explained by less internal demand for intermediate or consumer goods.

The reduction is due largely to fewer transport service imports (freight and passenger fares), which were down US$159 m as a result of the decline in goods imports. The increase in payments for technical services purchased mainly by the oil sector and associated with the build-up in exploration and development in recent years was an important aspect of business services.[55]

As for factor income, the period under review witnessed US$1,837 b in net outflows. This is US$486 m (-20.9%) less than the figure reported a year earlier, resulting from an annual reduction of US$453 m (-24.6%) in profits and dividends remitted by foreign companies, particularly fewer profits remitted by multinational companies that export oil, coal and ferronickel. They faced lower export prices for their products on international markets. Colombian investments outside the country generated less income as well.

Net income from current transfers came to US$1,220 b. This amount represents a 6.7% decline during the first quarter of 2009, primarily due to an annual reduction of 4.1% (-US$47 m) in income attributed to worker remittances.[56] With respect to country of origin, remittances from the United States and Venezuela were down (-9.3% and -23.4%, respectively); those originating in the Euro Zone were up 6.9%.

b. Capital and Financial Account

In the March 2009, the capital and financial account showed a US$1,183 b surplus. This is US$541 m less than the surplus reported for the same period in 2008, when the Colombian economy received US$1,724 b in capital inflows. The reduction in net capital inflows during the period was associated mainly with the US$346 m decline in the flow of foreign investment in Colombia, with the increase in Colombian direct investment abroad (US$784 m) and with more outflow of capital related to investment in other external assets (US$331 m). Inflows from net foreign borrowing were up US$919 m during the first quarter of the year (Graph 52 and Table 15).

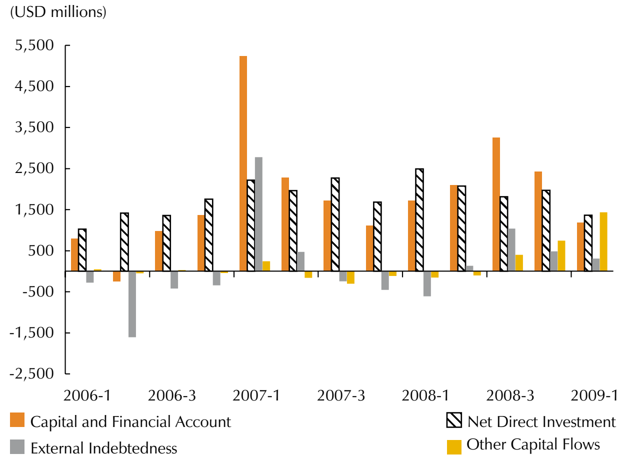
The decline in current transfers was primarily due to an annual reduction of 4.1% (-US$47 m) in income from worker remittances.

Colombia received US$2,528 m (5.0% of GDP) in foreign direct investment between January and March 2009. This amount is US$346 m less than the year before, when it received US$2,874 b. The main recipients of foreign resources were the oil industry (US$633 m), mines and quarries (US$866 m), the manufacturing industry (US$295 m), the financial sector (US$413 m), commerce (US$104 m) and the telecommunications sector (US$122 m).

55 Activities related to transport, travel, business services and communications account for an important part of total foreign trade in services (exports plus imports), having generated 94.8% of the receipts and 87.1% of the outlays.

56 Worker remittances accounted for 2.2% of GDP and 10.5% of current income in the balance of payments.

Graph 52
Capital and Financial Account in the Balance of Payments: 2006-2009



Source: Banco de la República.

For their part, Colombian investors purchased US$1,168 b in stock in foreign companies, especially those involved in fuel distribution and oil exploration in several Latin American countries and in the United States.

During the first quarter of the year, Colombia's net external indebtedness was US$310 m, given an increase of US$1,964 b in net foreign liabilities of the public sector and less external borrowing by the private sector (-US$1,653 b). The public sector increased its external liabilities by US$1,552 b, through US$1 b in bonds placed on international financial markets and US$551 m in net disbursements on long-term loans extended to Colombia, mostly by multilateral banks. It also constituted US$411 m in foreign assets, including US$293 m in portfolio investments and US$118 m in the reduction in overnight operations from financial institutions.

Table 15
Colombia's Balance of Payments
Capital and Financial Account
(US$ millions)

	I Qtr. 2008 (pr)	I Qtr. 2009 (pr)	Annual variation (dollars)
Capital and Financial Account (A+B+C)	1,724	1,183	(541)
A. Direct investment (i – ii)	2,490	1,360	(1,129)
i. Foreign investment in Colombia	2,874	2,528	(346)
ii. Colombian investment abroad	384	1,168	784
B. Total External Indebtedness	(609)	310	919
i. Public sector (a-b)	(246)	1,964	2,209
a. Liabilities	(60)	1,552	1,612
Loan portfolio investment	(188)	1,012	1,200
Bonds	(139)	1,000	1,139
Disbursements	1,000	1,000	0
Debt repayment	1,139	0	(1,139)
TES	(49)	12	61
Loans	134	551	417
Long-term disbursements	389	895	506
Long-term debt repayment	320	246	(74)
Short-term	66	(98)	(164)

Table 15 (continuation)
Colombia's Balance of Payments
Capital and Financial Account
(US$ millions)

	I Qtr. 2008 (pr)	I Qtr. 2009 (pr)	Annual variation (dollars)
Commercial loans	(4)	(10)	(6)
Financial leasing	(3)	(1)	1
b. Assets	185	(411)	(597)
Loan portfolio investment	180	(293)	(473)
Loans	6	(118)	(124)
ii. Private sector (a-b)	(363)	(1,653)	(1,290)
a. Liabilities	63	(611)	(674)
Portfolio investment	2	(38)	(41)
Disbursements	6	0	(6)
Debt repayment	3	38	35
Loans	86	(529)	(615)
Long-term disbursements	686	253	(433)
Long-term debt repayment	351	297	(54)
Short-term	(248)	(485)	(236)
Commercial lending	15	(90)	(104)
Financial leasing	(40)	47	86
b. Assets	426	1,042	616
Loan portfolio investment	606	246	(360)
Loans	(123)	663	786
Commercial lending	(56)	134	190
C. Other capital flows	(157)	(488)	(331)
Liabilities [a/]	29	(15)	(44)
Public sector	0	23	23
Private sector	29	(38)	(67)
Assets [a/]	186	473	287
Public sector	(66)	24	90
Private sector	252	449	197
Contributions to international organizations	0	0	0

(pr) provisional
a/ Mostly deposits abroad and currency and banknotes of other economies.
Source: Banco de la República.

In March 2009, the capital and financial account showed a US$1,183 b surplus. This is US$541 m less than the surplus reported for the same period in 2008, when the Colombian economy received US$1,724 b in capital inflows.

The private sector reported US$1.042 b in external assets during the first quarter of 2009 (US$616 m more than during the same period in 2008), thanks to US$663 m in loans granted, US$246 m in portfolio investments[57],

57 The latter is due largely to the shift in the composition of the pension fund investment portfolio.

During the first quarter of the year, Colombia's net external indebtedness was US$310 m, given an increase of US$1,964 b in net foreign liabilities of the public sector and less external borrowing by the private sector (-US$1,653 b).

and US$134 m in commercial loans extended to foreign buyers by Colombian exporters and companies. The private sector reduced its external liabilities by US$611 m during the first quarter of the year, owing to US$529 m in net payments on direct loans and US$90 m on commercial lending.

Finally, there were US$488 m in other net capital outflows, primarily to constitute US$473 m in foreign deposits by the private sector.

c. *International Reserves*

At the end of the first quarter of 2009, the overall balance of payment surplus generated an accumulation of US$12 m in gross international reserves resulting from US$115 m in net returns on international reserves, US$85 m in income from other Banco de la República operations and US$189 m in net expenses from net sales of foreign exchange to the market (Table 16). When taking into account US$208 m in devaluations due to prices and the exchange rage, the change in gross reserves came to -US$197 m.

Banco de la República held US$23,845 b in gross international reserves at the close of March 2009. This amount is five times the outstanding short-term external debt, based on original maturity, and 2.4 times external debt repayment with residual maturity in one year.[58]

3. Balance of Payments Outlook for 2009

Banco de la República held US$23,845 b in gross international reserves at the close of March 2009. This amount is five times the outstanding short-term external debt, based on the original maturity, and 2.4 times external debt repayment with residual maturity in one year.

Due to a trade imbalance, Banco de la República expects the current account deficit in 2009 to be around US$6,920 b (3.1% of GDP). The goods trade account would shift from a US$976 m surplus (0.4% of GDP) in 2008 to a US$1,934 b deficit (-0.9% of GDP) in 2009 (Table 17). This would originate from the deterioration in terms of trade, particularly international prices for products such as crude oil, coal and ferronickel, among others, and also with less demand for non-traditional Colombian exports to Venezuela, the United States, Ecuador and the European Union. Although the country is expected to see a 14.3% drop in total imports, it would not be enough to offset the projected 21.5% fall in total exports.

On the other hand, the factor income deficit is expected to decline by nearly US$2.4 b, as a reflection of fewer profits remitted abroad by foreign companies that operate in Colombia. A reduction of approximately 15% in current transfers is forecast, largely because of the drop in worker remittances.

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58 Includes all outstanding obligations contracted at one year or less and repayment of debts contracted at more than one year.

Table 16
Variation in Gross International Reserves
(USD millions)

Item	I Qtr. 2008 (pr)	I Qtr. 2009 (pr)
Total Variation in Gross Reserves (A+B)	1,183	(197)
A. Due to Balance of Payments Transactions	646	12
1. Return on Net Investment Portfolio	145	115
2. Net foreign exchange purchases (a-b)	271	(189)
a. Purchases	271	180
Put options	271	180
To accumulate international reserves	0	0
To control volatility	271	180
Direct purchase auctions	0	0
Discretional intervention	0	0
b. Sales	0	369
Call options to control volatility	0	369
Discretional intervention	0	0
Sales to the national government	0	0
3. Other Banco de la República operations	230	85
B. Other variations	537	(208)
Variations due to price	208	(25)
Variations due to the exchange rate	329	(183)

(pr) provisional
Source: Banco de la República.

Due to a trade imbalance, Banco de la República expects the current account deficit in 2009 to be around US$6,920 b (3.1% of GDP).

While the international crisis definitely has created problems with liquidity and access to external financing that limit the inflow of capital into the developing economies, there is still a great deal of uncertainty about its true impact on the Colombian economy. So far, Colombia has not experienced difficulties in access to international financial markets. According to the Banco de la República's projections, the current account deficit forecast for 2009 would be financed, in part, with up to US$4,498 b in external financing contracted by the public sector and provided by multilateral banks. On the other hand, according to estimates, the private sector could receive as much as US$2,512 b in resources, including an inflow of foreign investment for projects in the oil, coal, commerce and communications sectors, among others. These influxes would be less than those received in 2008, by more than 1.5% of GDP.

Table 17
Colombia's Balance of Payments

	Millions of dollars				Percentage of GDP			
	2006 (pr)	2007 (pr)	2008 (pre)	2009 (proj)	2006 (pr)	2007 (pr)	2008 (pre)	2009 (proj)
I. Current Account	**(2.983)**	**(5.819)**	**(6,713)**	**(6,920)**	**(1.8)**	**(2.8)**	**(2.8)**	**(3.1)**
A. Nonfactor goods and services	**(1,797)**	**(3,203)**	**(2,165)**	**(4,024)**	**(1.1)**	**(1.5)**	**(0.9)**	**(1.8)**
1. Goods	322	(596)	976	(1,934)	0.2	(0.3)	0.4	(0.9)
2. Nonfactor services	(2,119)	(2,607)	(3,140)	(2,090)	(1.3)	(1.3)	(1.3)	(0.9)
B. Factor income	**(5,929)**	**(7,847)**	**(10,063)**	**(7,573)**	**(3.6)**	**(3.8)**	**(4.1)**	**(3.4)**
C. Transfers	**4,743**	**5,231**	**5,514**	**4,678**	**2.9**	**2.5**	**2.3**	**2.1**
II. Capital and Financial Account	**2,890**	**10,347**	**9,511**	**7,011**	**1.8**	**5.0**	**3.9**	**3.1**
A. Private sector: net direct investment and other capital flows[a/]	3.275	8.128	9,174	2,512	2.0	3.9	3.8	1.1
B. Public sector [b/]	(385)	2,218	337	4,498	(0.2)	1.1	0.1	2.0
III. Errors and Omissions	**115**	**186**	**(160)**	**(196)**	**0.1**	**0.1**	**(0.1)**	**(0.1)**
IV. Variation in Gross International Reserves (IMF method) [c/]	**23**	**4,714**	**2,638**	**(105)**	**0.0**	**2.3**	**1.1**	**(0.0)**

(pr) provisional
(pre) preliminary
(proj) projection
a/Includes net inflows of foreign direct investment, portfolio investment, and net external borrowing operations.
b/Does not include Ecopetrol operations as of 2008.
c/ Net international reserves include the contributions to the Latin American Reserve Fund (LARF)
Source: Banco de la República.

The estimated variation in gross international reserves during 2009 takes into account the yield on those reserves, as well as the transfer of US$320.4 m in profits to the government and net sales of foreign exchange to the market through auctions up to May 2009.

4. External Vulnerability Indicators

Banco de la República's strategy to accumulate international reserves acknowledges the importance of having enough international liquidity to deal with capital flights from the country, which may be provoked by factors such as declining terms of trade, financial panic or financing crisis in neighboring countries. In this context, maintaining an adequate level of international reserves also helps to improve confidence in the country and, hence, to be in a better position to address an external market crisis.

Comparing several international liquidity indicators for Colombia to those of other countries in the region, it can be seen that the ratio of reserves to GDP is at an intermediate level, close to that of Brazil and Mexico.

In addition, on May 11, 2009 the IMF approved US$10.4 b for a one-year contingency financing facility granted to member countries with good economic performance, prudent policies and a solid economic policy framework. Although Colombia's economic authorities do not foresee the need to use those resources, they believe it is wise to have them in the event of an abrupt cut down in external funding.[59]

Several vulnerability indicators are used to determine whether or not a country's international reserves are sufficient to prevent and combat external shocks. The ratio of international reserves to monetary aggregates and the ratio of reserves to debt payment during the next twelve months are the most important indicators in this respect. A comparison of reserves to monetary aggregates, such as M2 or M3, is intended to determine the economy's capacity to respond to capital outflows caused by a speculative attack. The ratio of reserves to short-term external debt, which takes the current account deficit into account, is an indication of the country's ability to meet its debt obligations with the rest of the world in an extreme scenario where there is absolutely no access to international financing. Broadly speaking, the international markets regard low values for these indicators as a warning sign of external vulnerability in an economy.

Table 18 shows the evolution of various indicators of net international reserves during the period from 2003 to 2009 in the case of Colombia. The indicators in groups A and B are above one, which is the IMF-recommended level. As illustrated, all the indicators in these groups improved substantially during the period. On the other hand, the ratios in group C have remained stable and are at adequate levels. In particular, the ratio of net reserves to goods imports, which is one of the measurements most commonly used, is estimated at 8.8 months.

Comparing several international liquidity indicators for Colombia to those of other countries in the region, it can be seen that the ratio of reserves to GDP is at an intermediate level, close to that of Brazil, Chile and Mexico (Graph 53). The increase and level of this fraction for Peru is particularly striking, since as local banks are able to receive deposits in dollars and the reserve requirement on those deposits is registered as a reserve.

Reserves measured as months of goods imports, which is another indicator of international liquidity, shows that Colombia is in a relatively higher position than Chile and Mexico, but below Brazil and Peru.

Reserves measured as months of goods imports, which is another indicator of international liquidity, shows that Colombia is in a relatively higher position than Chile and Mexico, but below Brazil and Peru (Graph 54).

As for the ratios of international reserves to debt repayment, debt service and the current account deficit plus debt repayment, Colombia has higher indicators than Chile and Mexico, but lower than those of Peru and Brazil (Graph 55).

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59 See the Editorial Note in *Revista Banco de la República*, No. 978, April 2009.

Table 18
International Reserve Indicators for Colombia

	2003	2004	2005	2006	2007	2008 (pr)	2009 (proj)
Balance							
Net International Reserves-NIR (USD millions)[a/, b/]	**10,916**	**13,536**	**14,947**	**15,436**	**20,949**	**24,030**	**23,723**
Indicators							
A. External Debt Repayment Indicator							
External debt repayment (USD millions)	10,068	8,688	13,068	13,189	10,237	10,251	11,015
Net reserves/current-year external debt repayment	1.08	1.56	1.14	1.17	2.05	2.34	2.15
Net reserves/ external debt repayment, following year	1.26	1.04	1.13	1.51	2.04	2.18	2.12
B. Adequate External Liquidity Position							
NIR/ debt service, current year	0.87	1.21	0.93	0.96	1.56	1.78	1.66
NIR/debt service, following year	0.98	0.85	0.93	1.15	1.55	1.68	1.58
NIR/(current-year debt repayment + current-year current account deficit)	0.99	1.41	1.00	0.95	1.30	1.42	1.32
NIR/ (following-year debt repayment + following-year current account deficit)	1.14	0.91	0.92	0.96	1.23	1.34	1.28
C. Other International Reserve Indicators							
NIR as month of goods imports [c/]	9.9	10.2	8.9	7.5	8.1	7.7	8.8
NIR/M3 (percentage) [d/]	36.3	33.1	30.1	26.1	27.0	29.2	25.8
NIR/GDP (percentage) [e/]	11.9	11.9	10.3	9.5	10.1	9.9	10.5

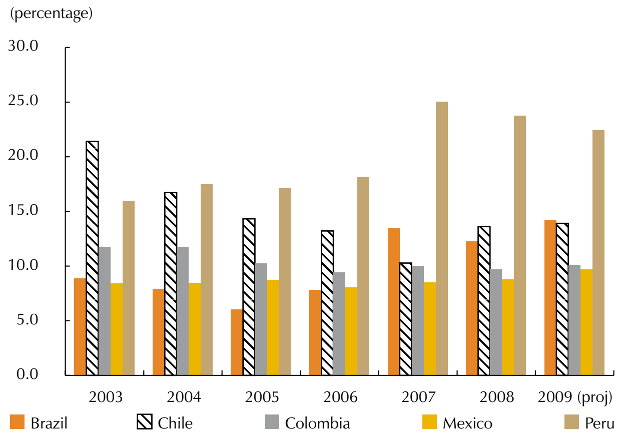
(pr) preliminary
(proj) projected
a/ Estimated balance of net international reserves for 2009.
b/ The net international reserve balance considers the contributions to the Latin American Reserve Fund (LARF)
c/ The value of goods imports is a projection for 2009.
d/ The broad M3 balance is the projection for 2009.
e/ The value of GDP in dollars is an estimate for 2009.
Source: Estimates developed by Banco de la República.

F. FISCAL POLICY

1. Final Results for the First Quarter of 2009

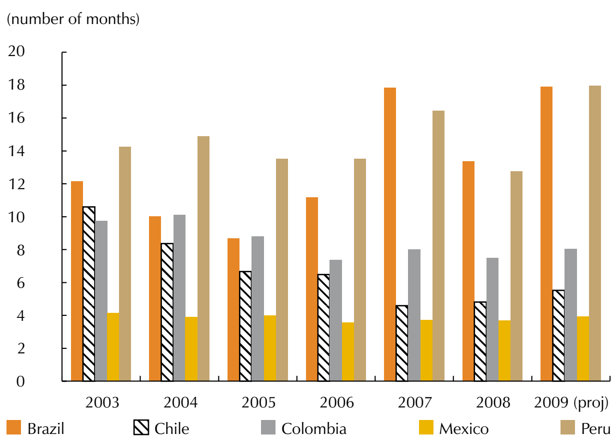
By the end of the first quarter of 2009, the finances of the consolidated public sector had accumulated a Col$1,277 b deficit, which is equivalent to 0.3% of GDP. Compared to the surplus during the same period in 2008, which was equivalent to 0.6% of GDP, the country's fiscal situation has deteriorated. This was to be expected, given the effect of the economic slowdown in central

Graph 53
International Reserves /GDP



(proj) projected
Sources: Central banks, The Economist Intelligence Unit and the Banco de la República.

Graph 54
International Reserves as Months of Goods Imports



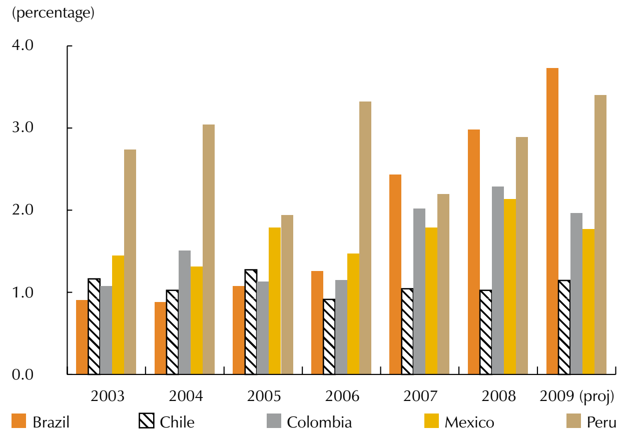
(proj) projected
Sources: Central banks, The Economist Intelligence Unit and Banco de la República.

government (CG) tax revenue. An assessment of fiscal results by sector shows a deficit equivalent to 0.6% of GDP in CG finances, which is offset by a surplus in the decentralized public sector. The cash balances of Banco de la República and Fogafin showed a situation of virtual equilibrium and the cost of financial restructuring came to 0.1% of GDP (Table 19).

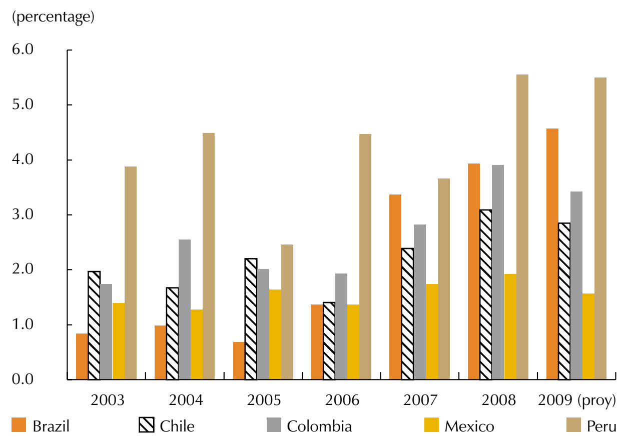
Central government finances saw a 12.9% drop in revenue and a 3.1% rise in expenditure. Tax revenue was down 6.0% and capital income, 52.1%. Income tax and the domestic VAT were the levies affected

Graph 55

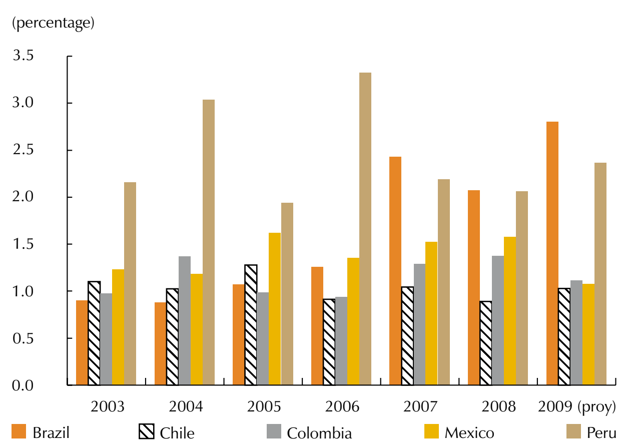
A. International reserves /repayment of outstanding debt



B. International Reserves /External Debt Service



C. International Reserves/(Current Account Deficit and Debt Repayments)



(proj) projected
Source: Central banks, EIU and Banco de la República.

Compared to the surplus equivalent to 0.6% of GDP during the same period in 2008, the country's fiscal situation has deteriorated. This was to be expected, given the effect of the economic slowdown on the central government's (cg) tax revenue.

the most by the economic slowdown, with respective reductions of 0.2% and 3.4% (Table 20). The bulk of the drop in capital income was due primarily to the transfer of US$375 m from the Fondo de Ahorro y Estabilización Petrolera(FAEP, Oil Savings and Stabilization Fund), compared to US$1,124 b registered during the first quarter of 2008. No revenue from the tax on wealth was registered because it is scheduled for collection in May-October.

Table 19
Consolidated Public-Sector Fiscal Balance:
First Quarters of 2008 and 2009

Item	Billions of pesos		Percentage of GDP	
	2008	2009 (pr)	2008	2009 (pr)
A. Total nonfinancial public sector (NFPS) (1+2)	3,841	(253)	0.8	(0.1)
1. National government [a/]	(90)	(3,263)	0.0	(0.6)
2. Sector subtotal decentralized [b/]	3,930	3,010	0.8	0.6
Electric	(80)	(29)	0.0	0.0
Emcali (Cali municipal utilities co.)	65	9	0.0	0.0
EPM (Medellín municipal utilities co.)	(247)	(159)	(0.1)	0.0
FAEP (oil stabilization fund)	(2,409)	(938)	(0.5)	(0.2)
Other entities	1,732	1,182	0.4	0.2
Social security	2,220	1,946	0.5	0.4
Regional and local	2.649	999	0.6	0.2
B. Banco de la República's quasi-fiscal balance	594	235	0.1	0.0
C. Fogafin balance	73	229	0.0	0.0
D. Financial restructuring costs	(493)	(425)	(0.1)	(0.1)
E. Adjustments	(1,358)	(1,063)	(0.3)	(0.2)
F. Total consolidated public sector (A+B+C+D+E)	**2,656**	**(1,277)**	**0.6**	**(0.3)**

(pr) Preliminary
a/ The floating debt does not include the change in budgeted reserves.
b/ Does not include Ecopetrol, Isagen or ISA balances.
Note: deficit(-) or surplus (+)
Source: Ministry of the Treasury and Public Credit.

As for central government expenditure, there was an increase of 16.7% in operating expenses, coupled with a reduction of 0.8% in interest on the debt and 14.0% in investment. Personal services were up 14.1% and transfers, 19.0%.

Income tax and the domestic VAT were the levies affected the most by the economic slowdown, with respective reductions of 0.2% and 3.4%.

As part of this last item, payments for the General Revenue Sharing System (SGP) came to Col$5,689 b and for pensions, Col$4,086 b. Payment of the fuel consumption subsidy, which is classified as a transfer, came to Col$778 b during the quarter. The decline in investment stems from less spending by the defense and agriculture ministries.

Table 20
Central Government Fiscal Balance
First Quarters of 2008 and 2009
(billions of pesos)

	2008	2009 (pr)	Growth 2008-2009
I. Total revenue (A + B + C + D + E)	**19,892**	**17,329**	**(12.9)**
A. Tax revenues	16,640	15,635	(6.0)
Income	5,790	5,775	(0.2)
Domestic VAT	5,679	5,485	(3.4)
External VAT	2,020	2,210	9.4
Duty	981	1,040	6.0
Gasoline	331	310	(6.1)
Financial-transaction tax	748	771	3.2
Wealth	1,069	11	(99.0)
Others	23	32	39.0
B. Non-tax revenue	140	96	(31.1)
C. Special funds	232	215	(7.3)
D. Capital resources	2,876	1,378	(52.1)
Financial returns	317	215	(32.3)
Financial surplus	192	198	3.1
Others	2,367	966	(59.2)
E. Accrued interest	4	4	0.0
II. Total expenditure (A + B + C + D + E) [a/]	**19,982**	**20.591**	**3.1**
A. Interest	2,798	2,775	(0.8)
Foreign	1,150	1,073	(6.7)
Domestic	1,648	1,702	3.3
B. Operating expenses	13,455	15,697	16.7
Personal services	1,934	2,206	14.1
General overhead	830	771	(7.1)
Transfers	10,690	12,719	19.0
C. Investment	3,521	3,028	(14.0)
D. Net loans	47	29	(37.6)
E. Accrued payments	161	(937)	(683.8)
III. Deficit (-) or surplus (+) (I - II) [b/]	**(90)**	**(3,263)**	**3,537,8**
Financial restructuring costs	493	425	(13.7)

Table 20 (continuation)
Central Government Fiscal Balance
First Quarters of 2008 and 2009
(billions of pesos)

	2008	2009 (pr)	Crecimiento 2008-2009
IV. Funding (A + B + C + D + E)	**583**	**3,688**	**532.7**
A. Net external credit	291	3,479	1,093,6
Disbursements	2,881	3,706	28.7
Repayment	2,589	227	(91.2)
B. Net domestic credit	5,525	7,282	31.8
Disbursements	8,075	10,322	27.8
Repayment	2,549	3,041	19.3
C. Banco de la República's profits	1,415	819	(42.2)
D. Privatizations	23	793	3,354,.9
E. Others	(6,672)	(8,684)	30.2
V. Deficit as a percentage of GDP	**(0.0)**	**(0.6)**	

(pr) Preliminary
n.a. Not applicable
a/ The floating debt does not include the change in budgeted reserves.
b/ Does not include financial-restructuring costs.
Source: Ministry of the Treasury and Public Credit.

Central government revenue and spending, coupled with the cost of financial restructuring, led to a quarterly deficit of Col$3,688 b. It was financed with internal and external loans, the transfer of Banco de la República's profits and proceeds from the privatization of several electrical power companies. Net internal indebtedness was Col$7,282 b as a result of Col$10,322 b in disbursements and Col$3,041 b in debt repayment. Col$8,773 b in long-term TES were placed on the market, including Col$4,342 b in agreed and forced operations and Col$4,431 b sold through auctions. Net external financing came to Col$3,479 b, with Col$3,706 b in disbursements and Col$227 b in debt repayment. Profits transferred from Banco de la República came to Col$819 b. Col$793 m were provided from the privatizations, namely the sale of electric power companies in Santander, Norte de Santander and Cundinamarca.

Central government revenue and spending, together with the cost of financial restructuring, resulted in a quarterly deficit of Col$3,688 b. It was financed with internal and external loans, the transfer of Banco de la República's profits and proceeds from the privatization of several electrical power companies.

As in the first quarter of 2008, the bulk of the surplus in the decentralized public sector originated from the social security sector (0.4% of GDP) and the territorial entities (0.2% of GDP). FAEP, in contrast, posted a deficit equivalent to 0.2% of GDP, given the funds transferred to the national government, as stipulated in the National Development Plan.

2. Fiscal Outlook for 2009

The *2009 Mid-term Fiscal Framework*, which was presented in June, forecasts a fiscal deficit for the consolidated public sector equivalent to 2.4% of GDP. It represents an increase equal to 0.6 pp of GDP from to the deficit target

The 2009 Mid-term Fiscal Framework, which was presented in June, forecasts a fiscal deficit for the consolidated public sector equivalent to 2.4% of GDP. It represents an increase equal to 0.6 pp of GDP from to the deficit target announced by the government at the start of 2009.

announced by the government at the start of 2009. This adjustment was due to the revised annual figure for estimated tax revenue, given the slump in economic activity observed since the last quarter of 2008. The central government is expected to show a deficit equivalent to 3.7% of GDP, while the decentralized public sector is expected to post a surplus of 1.4% of GDP. A cash balance near equilibrium is forecast for Banco de la República and a surplus equivalent to 0.2% of GDP, for Fogafin. The cost of financial system restructuring will come to 0.2% of GDP (Table 21).

According to current estimates, the national government will see a 7.4% build-up in revenue and 15.4% in expenditure. Tax revenue is expected to increase 6.0% and capital income, 21.8%. Growth in income tax would come to 15.1%,

Table 21
Consolidated Public Sector
Fiscal Balance: 2008 and 2009

Item	Billions of pesos		Percentage of GDP	
	2008	2009 (proj)	2008	2009 (proj)
A. Total nonfinancial public sector (NFPS) (1 + 2)	**342**	**(11,604)**	**0.1**	**(2.3)**
1. National government	**(11,067)**	**(18,799)**	**(2.3)**	**(3.7)**
2. Sector subtotal decentralized	**11,409**	**7,195**	**2.4**	**1.4**
Electric	500	270	0.1	0.1
Emcali (Cali municipal utility company)	89	105	0.0	0.0
EPM (Medellín municipal utility company)	(93)	(301)	0.0	(0.1)
FAEP (Oil Stabilization Fund)	(1,898)	(988)	(0.4)	(0.2)
Other entities	2,471	899	0.5	0.2
Social security	5,139	4,345	1.1	0.9
Regional and local governments	5,201	2,865	1.1	0.6
B. Banco de la República quasi-fiscal balance	1.306	(25)	0.3	0.0
C. Fogafin (balance	502	890	0.1	0.2
D. Financial restructuring costs	(1,270)	(1,085)	(0.3)	(0.2)
E. Adjustments	(1,557)	0	(0.3)	0.0
F. Total consolidated public sector (A+B+C+D+E)	(678)	(11,824)	(0.1)	(2.4)

(proj) Projected
Note: deficit (-) or surplus (+)
Source: Ministerio de Hacienda y Crédito Público.

The momentum in capital income can be attributed to the transfer of Col$8,003 b in Ecopetrol profits (1.6% of GDP), mostly from the boom in oil prices up until mid-2008.

thanks to the payment from Ecopetrol, which will amount to 0.8% of GDP as opposed to 0.4% of GDP in 2008. Likewise, the momentum in capital income can be attributed to the transfer of Col$8,003 b in Ecopetrol profits (1.6% of GDP), mostly from the boom in oil prices up until mid-2008.

As for national government expenditure, interest will increase 6.1% and operating costs, 21.4%. However, investment will be down 3.3%, given the postponement of several programs and projects that were announced by the national government at the start of the year. In terms of operating expenses, personal services will be up 15.1% and transfers, 24.6%. Payments for the General Revenue Sharing System will come to Col$21,364 b, with an increase of 13.9 %, and pension expenses will reach Col$20,403 b. This last figure represents an increase of 21.3% with respect to 2008. As customary since 2004, these draws include a budget line for the Social Security Institute, which will be Col$7,400 b this year. It should be noted that transfers also include the fuel price subsidy, which amounts to Col$4,896 b (1% of GDP).

The national government deficit, which will come to Col$19,884 b including the cost of financial restructuring, will be funded through loans, privatizations and Banco de la República's profits. Net external financing will come to Col$8,388 b, with Col$11,130 b in disbursements and Col$2,742 b in repayment. It should be noted that Col$4,000 b of the all the TES-B scheduled for placement during the year correspond to pre-financing for 2010. Banco de la República'sprofits will come to Col$818 b and privatizations to Col$4,093 b.

As for the decentralized sector, the official figures show a surplus equivalent to 0.9% of GDP in the social security sector and 0.6% of GDP in the public sector at regional and local level. As noted in the March report by the Board of Directors, FAEP will distribute an amount equivalent to 0.2% of GDP, given the required transfer of funds to the national government.

Box 1
BROAD INFLATION TARGETING: TOWARDS A NEW MONETARY-POLICY MODEL

The normal performance of a market economy implies cyclical phases of booms and recessions. This occurs because of the pro-cyclical nature of how agents perceive risk in a context of limited rationality and incomplete information, and in some cases as a result of external shocks. Economic authorities in general and central banks in particular face the challenge of having to deal with these phases of the economy. These are challenges that go beyond simple answers to a crisis once it is manifest, because the central bank is obliged to prevent a deeper crisis and to cushion its impact by taking opportune action to prevent the economy from going down a path towards unsustainable growth. As is often stated, but frequently ignored, the seeds of economic and financial crisis are always planted during times of growth.

In addition to the pro-cyclical nature of market economies, there is the fact that policy measures adopted by central banks work their way through to the economy mostly via the financial system.[1] Moreover, central banks have a responsibility as lenders of last resort, and participate actively in the development and operation of payment systems. The task of crisis-prevention by the monetary authority has at least three basic elements:

- The pursuit and preservation of a financial system that is stable and effectively fulfills its basic functions.

- A focus, by the central bank, on the macroeconomic aspects of financial stability and particularly on instances of systemic risk, which complements the traditional task of regulation and oversight of individual entities on by the competent authorities.

- The prudent nature of its measures, seeking to avoid excessive risk taking and to accumulate assets during periods of growth, which can be used when the economy unwinds.

This means that central banks must perform a macro-prudential role. The importance of this role is one of the lessons of the current global financial crisis, in which excessive exposure to risk of financial systems played a leading role.[2] This new monetary policy and financial model, which has begun to be known as broad inflation targeting (BIT),[3] implies a break with two of the principles that characterized the U.S. Federal Reserve's monetary policy in the recent past.[4]

The first is the assumption that financial stability is obtained simultaneously and with the same instruments as monetary and price stability. This leads the monetary authority to respond with interest rate hikes only in the event of undesired pressures or deviations in consumer inflation. Consequently, it does not act in response to asset price bubbles, partly because they are considered impossible to identify *ex ante,* nor in response to upward momentum in lending and monetary aggregates, or external deficits. However, all these elements may indicate the existence of financial imbalances and may require active policies of the economic authorities.

The second principle is that policy action by central banks must be asymmetrical in dealing with the phases of the economic cycle. Accordingly, in the upward phase of the cycle, provided there are no inflationary pressures for the consumer, one does not "swim against the current". However, when things change and the economy enters a phase of rapid deterioration, central banks respond aggressively with sharp interest rate cuts to cushion the effects of the fall. In contrast to this vision, with the BIT strategy, monetary policy responds symmetrically to deviations from the projected target for inflation, but also to factors that jeopardize financial stability.

In the emerging countries, the BIT scheme must take additional considerations into account, such as the particular links these economies have with international financial markets, the limited development of local financial markets and the particular characteristics of price formation processes, among

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1 The financial business, by definition, is a risky one. Commercial banks receive deposits for the short term and lend for the long term. As a counterpart, they create debt that promises to have high liquidity; yet, at the same time, they have few liquid assets. Added to this is the fact that financial markets have shortcomings in the way they operate, due to the asymmetry of information. However, the role of financial systems is extremely valuable for an economy, because they channel savings to finance the investment projects required for economic growth. Nevertheless, they also require regulatory schemes that seek to alleviate the shortcomings that occur in financial markets.

2 This goes far beyond the central banks' response to asset price bubbles, which are only one of several ingredients that lead economies with financial imbalances to end up in more serious crises. The other elements include, for example, the momentum in credit and monetary aggregates, as well as external and output gaps.

3 For a detailed explanation of this model, see "Respuesta del banco central frente a una crisis financiera global y a una burbuja en el mercado de activos," a paper presented at "Más allá de la crisis financiera," an international seminar held on May 28, 2009 (available at www.banrep.gov.co).

4 A scheme that inspired the inflation-targeting monetary policy now applied in more than 20 countries over the world, including Colombia.

others. For that reason, besides contemplating the need to raise interest rates in situations where there are no obvious inflationary pressures, the BIT strategy must give special emphasis to the macro-prudential aspects mentioned earlier and to accumulating assets during boom periods; later, during the downward phase of the economic cycle, those assets can be used as a "cushion".[5]

In Colombia, the response by the Central Bank in terms of its monetary policy in the recent past is an example of the application of a BIT scheme, with peculiarities derived from the country's situation. Although low and stable inflation always has been the basis of the response from monetary policy, the Board of Directors of the Central Bank, as of April 2009, responded to the sharp increase in spending and indebtedness (nurtured by sizeable inflows of foreign capital and a highly dynamic lending market) to curb future pressure and to contribute to the stability of the financial system by pursuing three lines of action.

1) An effort was made to reduce the pace of private sector borrowing by directly restricting agents' risk taking and accelerating the pass-through of monetary policy on lending and expenditure. The idea was to combat inflationary pressures and to prevent financial imbalances from becoming more pronounced. To do so, in addition to a 400 basis point increase in rates between April 2008 and July 2008, the marginal reserve requirement was established and supplemented with reactivation of the deposit required for external loans.

2) To discourage residents from taking excessive exchange risk, the flexibility of the exchange rate was maintained and international reserves were accumulated at the same time.[6]

3) In addition, measures were taken to protect the financial system against exchange and counterpart risks in the market for foreign exchange derivatives. Those measures helped to control the exaggerated increase in lending and reinforced the soundness of the banks. Colombia has regulations that set high capital requirements for the branches of foreign banks. As happened in many Latin American countries, regulations of this type shielded the country from pass-through of the foreign bank crisis, preventing situations as chaotic as those witnessed in the emerging European countries. Moreover, for a number of years, Colombia has had regulations that limit the foreign-currency-exchange and term mismatches of financial intermediaries. On that basis, complementary measures were taken in 2007 when the economy was in a stage of strong growth and experiencing a considerable inflow of capital. The Financial Superintendence of Colombia established the credit risk management systems that exist today and raised the amount of provisioning required of banks. In 2009, at the suggestion of that same agency, banks and other financial institutions reinforced their capital adequacy ratios and prepared for the downward phase of the cycle by creating an equity reserve with some of the profits obtained in 2009.

Thus, measures were taken jointly that helped to preserve financial and price stability. The results of this series of monetary and macro-prudential measures have helped to minimize the impact of the external shock produced by the global financial crisis. Excessive growth in spending and indebtedness was contained, inflation expectations in the presence of sharp negative supply shocks were controlled, currency and term mismatches were limited, and the financial system was reinforced. Furthermore, because of those actions, the country's monetary policy also was able to act in a timely counter-cyclical way after the financial panic unleashed by the subprime crisis in the United States during August 2007 and particularly by the failure of Lehman Brothers in 2008. This was possible in an environment with a free floating exchange rate, partly offsetting the adverse effects of the world economic downturn on revenue from exports and remittances. The policy interest rate has been cut by 550 bp since December 2008 and the marginal reserve requirement was suspended in the second half of 2008, as was the required deposit on foreign borrowing. All of this was possible thanks to the adoption of measures consistent with the new monetary-policy scheme.

In the future, the Central Bank of Colombia and its Board of Directors will continue to assess the preventive measures and the macroeconomic guidelines that were adopted successfully during the upward phase of the economic cycle. Just as traditional inflation targeting made it possible to respond to and absorb the relative price shocks witnessed in recent years, the new BIT method will allow for important steps in the direction of a monetary strategy that better contributes to the stability and sustainability of the country's economic growth.

To be able to move to progress in the desired direction Colombia's institutional framework must be improve, since the prevention of systemic risk and ensuring a stable economy go beyond the reach of monetary policy. This does not inevitably demand laws that revise and limit functions or introduce bans. Above all, it requires good coordination between Banco de la República and the national government, specifically coordination that makes it possible to consolidate the progress achieved to date in terms of financial stability of the economy, while guaranteeing low and stable inflation.

5 For example, by trying to prevent excessive risk taking, even with regulatory measures.

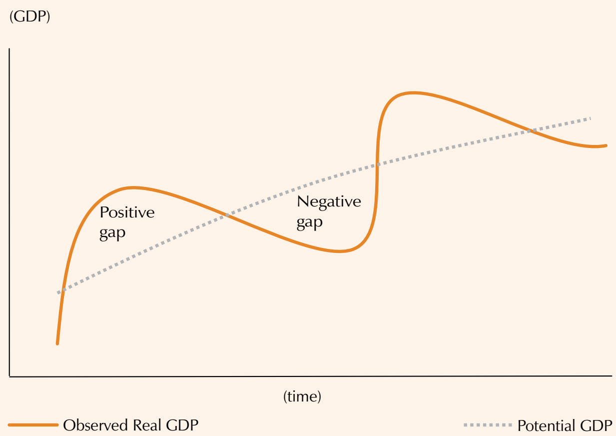
6 The purchase of reserves, particularly in 2008, might have combated the persistent misalignments between the exchange rate and what could be considered an equilibrium level. The non-interest bearing deposit on flows of borrowing and portfolio investment (a requirement imposed by the Colombian government) operated in the same line. These misalignments prompt economic agents to behave in a way that leads to exchange mismatches on their balance sheets, excessive foreign indebtedness and short-sighted consumption and investment decisions by consumers and producers, all of which imply an inefficient inter-temporal allocation of resources in the economy.

Box 2
GDP, POTENTIAL OUTPUT AND THE OUTPUT GAP

Nominal GDP measures the value of the production of goods and services in an economy during a particular period of time. Discounting the evolution of prices from this value gives us *GDP at constant prices or the real GDP*, an indicator that measures the amount of output that was generated during the same lapse of time. The percentage change in this last measurement is referred to as *real economic growth*.

Potential output, in the broadest sense, refers to the maximum capacity of an economy to produce goods and services if all its resources (human resources, capital and technology) are used fully, without bringing inflationary pressures.[1] Growth in potential output is due mainly to population growth, to better levels of education, to more investment in capital goods, to available natural resources, [2] and to an improvement in technological processes and knowledge.[3] Accordingly, this indicator can be understood as an economic concept related to the evolution of real variables and to the long-term performance of aggregate supply (B2.1 Diagram)

Diagram B2.1
GDP, Potential Output and Output Gap



The *output gap* is calculated as the percentage change between actual and potential gross domestic product (GDP).

A positive output gap reflects demand-side inflationary pressures to the extent that the economy is generating levels of output beyond what be sustained in the long term. In contract, a negative output gap indicates the economy can grow more without implying higher inflation. Developments in lending, consumer confidence and actual consumer consumption, business confidence to undertake productive projects and to hire personnel, and government spending are some of the elements, among others, that affect the output gap.

Despite the importance of the concepts of potential GDP and output gap, since they are *nonobservable* variables, there is no consensus in economic literature on how to calculate them. Consequently, a variety of statistical and econometric techniques must be used to shed light on how these variables evolve.[4] Moreover, today's complex international economic scene implies more uncertainty in estimates of output gap and potential output than in other economic situations. There are two elements in particular that will be vital to analyze the evolution of potential output this year and the next:

- *Evolution of the economy's investment cycles*. 2006 and 2007 were highly favorable years for investment in Colombia, which accelerated potential growth. Nevertheless, the current international economic situation can lead to the developing countries to experience high financing costs, smaller capital flows and a reduction in external demand, all of which would be to the detriment of investment. Accordingly, less economic growth in the future, if accompanied by less investment, could mean a slowdown in potential growth.

- *The effects of the international financial crisis*. These can be seen as a supply shock to potential world growth, which would take several years to recover. Colombia would not be the exception.

1 This is a definition of full-employment output. One that is more consistent with modern macroeconomic theory would be to consider the output that would be possible if all prices and wages in the economy were flexible and there were no nominal or real rigidities.

2 Their rational and best possible use.

3 For an introduction to modern economic theory on economic growth, see *Economic Growth*, 2nd edition, Robert Barro and Sala-i-Martin, 2003.

4 Banco de la República currently calculates five different estimates of the output gap and the potential output implicit in that gap.

Box 3
THE PRIVATE CORPORATE SECTOR

The drop in demand as a result of the economic crisis has placed companies in a difficult situation. The indicators of returns, liquidity and indebtedness registered a downward trend in 2008, leading the business climate to reflect a level of uncertainty with respect to the immediate future.

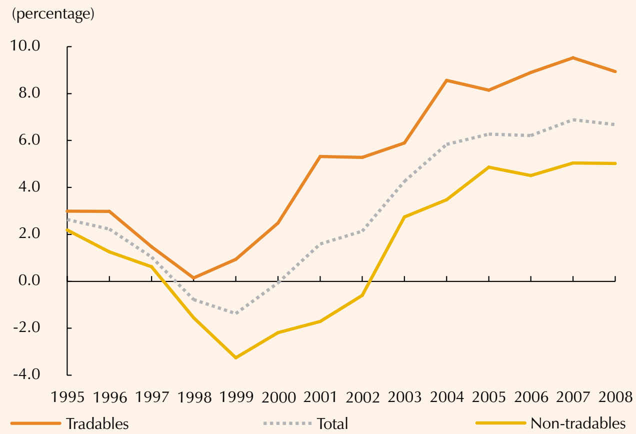
According to the combined industrial opinion survey (EOIC) conducted by the National Colombian Business Association (ANDI), the business community has designed strategies to take advantage of the opportunities of the moment. The main ones are: optimization of costs, market intelligence, and improvements in new product innovation and development (for local and international markets). Also, according to the EOIC, most companies have made it a policy this year to avoid dismissing personnel .

An analysis of the situation in the private corporate sector, based on accounting information reported to the Superintendence of Corporate Affairs, is presented in this section.

1. Profitability

Return on assets (ROA), which is defined as profits before taxes on total assets, declined from 6.9% in 2007 to 6.7% in 2008 (Graph B3.1). The ROA of companies producing tradable goods[1] dropped from 9.5% to 8.9% during that period. However, performance within this group was not uniform. In other words, while the agricultural and industrial sectors reported less profit, the fishing and mining sectors increased their profits (Table B3.1). The ROA of companies producing non-tradable goods remained constant at 5.0%.

Graph B3.1
Return on Assets
(Profits before taxes /Total assets)



Source: Office of the Superintendence of Corporate Affairs; calculations by Banco de la República

Table B3.1
Financial Indicators (Percentage)

		Tradables				Non-tradables		
	Year	Agriculture	Fishing	Mining	Industry	Construction	Commerces	Services
ROA	2007	11.2	2.8	36.1	25.0	12.3	36.9	15.0
	2008	10.6	9.0	38.2	22.5	12.4	34.8	16.1
Total Indebtedness	2007	34.9	58.1	40.3	37.7	64.2	57.8	21.3
	2008	34.5	62.4	41.2	40.2	61.8	57.5	22.0
Financial Indebtednes	2007	13.6	31.8	4.0	13.7	21.0	19.9	7.6
	2008	13.9	31.0	4.0	16.8	20.8	20.9	7.9
Sector Share a/		3.0	0.1	7.0	32.4	5.9	16.8	33.9
Number of companies at 2008a/		1,440	43	412	4,423	2,045	7,029	6,771

a/ As a percentage of total assets at December 2008.
Source: National Office of the Superintendent of Corporate Affairs; calculations by Banco de la República.

2. Liquidity

The liquidity indicator, measured as the ratio of assets to current liabilities, was 136.0% in December 2008, which suggests the companies analyzed have enough liquid assets to cover their

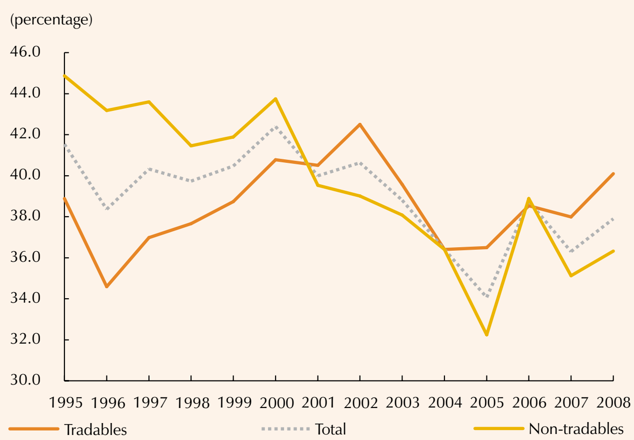
1 Companies producing tradables are those in the agriculture, cattle, hunting, fishing, mining - quarrying and industrial manufacturing sectors. Those producing non-tradables are in the other sectors.

short-term liabilities. This indicator declined 2.5 pp between December 2007 and the same month in 2008, due to a greater increase in current liabilities (6.8%) than in current assets (8.8%). Contrary to the performance observed since the end of 1998, in December 2008 the companies producing tradables had lower liquidity indicators (132.6%) than those producing non-tradables (138.6%).

3. Indebtedness

The total indebtedness ratio, defined as the ratio of total liabilities to total assets, rose from 36.3% to 37.9% between December 2007 and the same month in 2008 (Graph B3.2). This is explained by an increase in both short and long-term financial liabilities.

Graph B3.2
Total Indebtedness
(Total liabilities /Total assets)



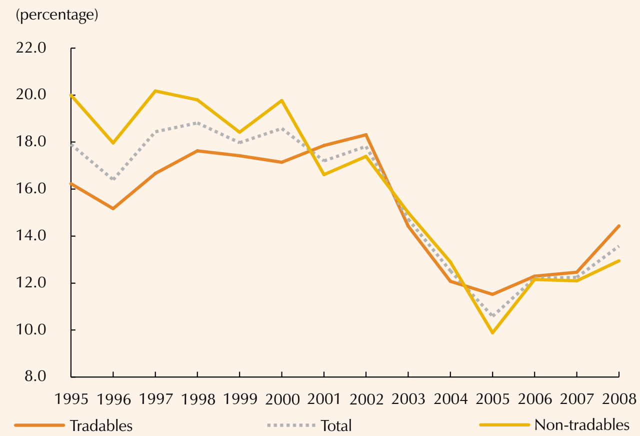
Source: Financial Superintendence of Colombia; calculations by Banco de la República.

As for the different sectors, companies producing tradables showed more indebtedness compared to those producing non-tradables (40.1% as opposed to 36.3%, respectively). The former raised their indebtedness level by 2.1 pp between 2007 and 2008, while the latter increased theirs by 1.2 pp. The performance of the tradable sector is explained by industry, fishing and mining (Table B3.1), while the service sector is responsible for the higher level of indebtedness for the group of companies producing non-tradables.

The results shown in this table were obtained from a uniform sample comprised of companies that reported accounting information for both 2007 and 2008.

The rise in corporate financial liabilities generated an increase in the financial indebtedness indicator (ratio of financial liabilities to total assets), which went from 12.2% to 13.6% in 2008 (Graph B3.3). This indicator for the companies producing tradables increased by 2.0 pp during the past year to 14.4%,, while the indicator for non-tradable producers rose 0.9 pp, to 12.9% at December 2008.

Graph B3.3
Financial Indebtedness
(Financial liabilities /Total assets)

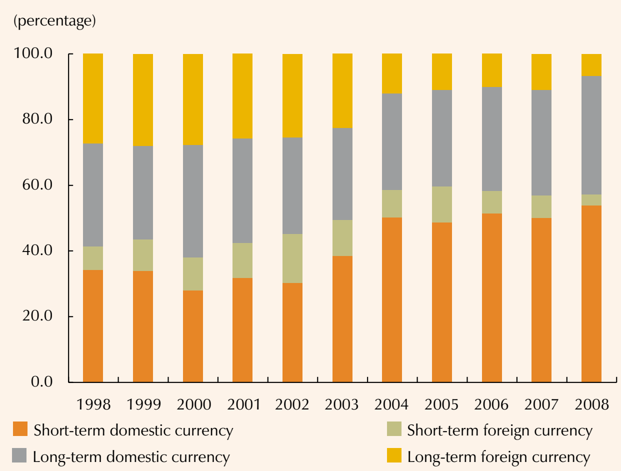


Source: Financial Superintendence of Colombia; calculations by Banco de la República.

As for the composition of financial liabilities in terms of maturity and currency, the share of short-term debt increased between 2007 and 2008 . At December 2008, it accounted for 57.2% (56.9% a year earlier). According to classification by type of currency, the share of the debt denominated in domestic currency was up from 82.0% by December 2007 to 89.9% a year later (Graph B3.4).

By groups, companies producing tradables increased their share of short-term financial liabilities by 4.1 pp, to 58.7%, while the share for companies producing non-tradables declined 2.8 pp to 55.9% at December 2008.

Graph B3.4
Indebtedness by Currency and Term



Source: Financial Superintendence of Colombia; calculations by Banco de la República.

With respect to composition by type of currency, the group of companies producing tradable goods increased its share of financial liabilities in domestic currency by 7 pp, to 90.6%, while the group of companies producing non-tradables increased theirs by 8.5 pp, to 89.4%.

4. Exports

The same set of companies (5,676) that exported during 2006, 2007 and 2008 registered an 18.7% increase in the amount of exports in dollars between 2007 and 2008 (less than reported in 2006: 19.6%) (Table B3.2).

Table B3.2
Exports of Companies in the Sample

	Exports		
	2006	2007	2008
Amount (USD millions)	23,685	28,330	33,625
Growth (percentage)		19.61	18.69

Source: DANE; calculations by Banco de la República.

The share of exports to the United States increased from 34.7% to 39.0% between 2007 and 2008, while the share of exports to Venezuela declined from 16.4% in 2007 to 13.4% in 2008 (Table B3.3).

5. Imports

Using a uniform sample of 13,965 companies that registered imports during 2006, 2007 and 2008, it was found that purchases in dollars increased 19.0% between 2007 and 2008 (less than the increase reported a year earlier: 25.2%) (Table B3.4).

The share of imports from the United States gained 2.3 pp between 2007 and 2008, while the share of imports from Venezuela continued to decline (Table B3.5).

Table B3.3
Share of Exports by Companies in the Sample, According to Destination (Percentage)

Year	United States	Venezuela	Ecuador	Other
2006	39.82	10.98	5.08	44.11
2007	34.72	16.42	4.42	44.43
2008	39.00	13.44	4.30	43.25

Source: DANE; calculations by Banco de la República.

Table B3.4
Imports of 13.965 Companies in the Sample

	Imports		
	2006	2007	2008
Amount (USD millions)	23,489	29,416	35,013
Growth (percentage)		25.23	19.03

Source: DANE; calculations by the Central Bank of Colombia.

Table B3.5
Share of Imports for the Sample, by Origin

Year	United States	Venezuela	Ecuador	Other
2006	36.51	5.16	5.02	53.30
2007	35.52	3.67	5.66	55.15
2008	37.81	2.53	5.22	54.43

Source: DANE; calculations by Banco de la República.

Box 4
A FLEXIBLE CREDIT LINE WITH THE INTERNATIONAL MONETARY FUND

On April 20, 2009, Colombia asked the International Monetary Fund (IMF) for access to a line of contingency financing (flexible credit line: FCL) for approximately US$10.4 b with a term of one year. This borrowing facility was created to support countries that have positive economic fundamentals and policies and need a safe mechanism to address an eventual deepening or expansion of the current international crisis[1].

The flexibility of the FCL stems from its access, with long repayment terms, the fact that it is renewable, and its dual use for balance of payment needs, both actual and contingent (of a precautionary nature). The principal feature of this borrowing facility is the absence of conditionality, which makes it very different from traditional IMF loan agreements. Moreover, its objective is to send a signal of IMF confidence regarding the policies of the country in question and its ability to take corrective measures.

1 Although the country's economic authorities do not expect to use these resources, they believe it is wise to have them as insurance against a possible abrupt cutback in external financing.

Once approved, the loans may be completely disbursed, or when they are needed, and are not subject to policy commitments, as happens with the traditional programs backed by the IMF. If used, the resources would be part of the country's international reserves and used as such. The annual cost of the agreement is 0.267% on the amount of available resources, which would be repayable if the country makes use of the agreement. Once the loan is disbursed, the interest rate would vary according to the repayment period.

Access to the FCL would reduce the economic and social costs of a more intense or prolonged external shock than the one at present. Because it was done in advance, the announcement in April was not accompanied by a loss of reputation. Since Colombia was expected to be an ideal candidate to access the agreement, it resulted in a reduction in the country's sovereign risk premium, which helps to lower the cost of external borrowing. Since as this facility is extended to countries with sound economic fundamentals, having it sends a positive signal that Colombia possesses resources and its economy is being managed appropriately. This minimizes or tones down the effects of "contagion" if the current world crisis sharpens. Lastly, the agreement will make it easier to continue with counter-cyclical monetary and exchange policies, and with financing for government spending.

III. International Reserves

Banco de la República has taken steps to reduce the financial risks associated with international reserve management and, therefore, to address the international financial crisis. As a result of these measures, Colombia obtained a high return on its reserves during 2007 and 2008. Limited exposure to the different types of financial risk and the historically low interest rates of the leading central banks forecast low return on international reserve investment in 2009.

Banco de la República adopted a series of measures at the start of the international financial crisis to address and reduce the financial risks associated with international reserve management.

Banco de la República adopted a series of measures at the start of the international financial crisis to address and reduce the financial risks associated with international reserve management. These measures were taken in view of the Bank's constitutional mandate to manage investments in strict compliance with the criteria of security, liquidity and return. The most important decisions adopted in 2008, as emphasized in the last *Report to Congress,* involved: i) suspension of the securities lending programs with securities held in custody by JP Morgan Chase and the Bank of New York Mellon; ii) no new investments in asset-backed securities (ABS) and a reduction in exposure to asset-backed commercial paper (ABCP)[60]; iii) an increase of three levels in the minimum credit risk rating for bank and corporate issuers from A- a AA-; iv) an increase in the share of securities backed by the treasuries of the governments of developed economies; and v) a reduction in the average term of investments

60 ABS are securities with cash flows that depend on payments received from a pool of loans (e.g. automobile, credit card, etc.) and tend to mature beyond a year. ABCP are fixed-rate securities that mature in less than a year and are backed by a set of assets. These two types of assets are different from mortgage-backed securities (MBS). Banco de la República stopped any new investments in ABS and ABCP, but still has investments in MBS backed by agencies, since they have the effective support of the United States government.

The measures adopted in 2008 were complemented with other provisions adopted during the current year to lower credit and market risk even further.

(modified duration[61]) from 1.46 to 1.27. These provisions are explained, in detail, in the March 2009 edition of the *Report to Congress* and in *Foreign Reserve Management*, a document published that same month.

The aforementioned measures were complemented with others adopted during 2009 to reduce credit and market risk even further. For example, there was i) the suspension of investments in asset-backed commercial paper (ABCP); ii) the decision to sell off all investments in asset-backed securities (ABS) before November 30, 2009; iii) suspension of the securities lending program with securities held in custody by Euroclear; and iv) the additional reduction in the modified duration of the portfolio. The measures adopted by Banco de la República to deal with the external crisis not only helped the country to obtain a higher return from the management of its international reserves in 2007 and 2008, as government bonds increased in value, they also led to a situation where international reserves currently have very little exposure to the various financial risks. However, this means the return on international reserve investment is expected to be low as well, considering the interest rates of the leading central banks are set at historically low levels and the direct relationship that exists between investment risk and return. In other words, less risk means less return, and vice versa.

The actual situation of the country's international reserves is described in this chapter, along with the measures that have been adopted and their impact on return. The current status of the claims against Lehman Brothers and Bank of New York Mellon is discussed as well.

A. THE COMPONENTS OF COLOMBIA'S INTERNATIONAL RESERVES

The country had US$23,729.0 m in gross international reserves at June 30, 2009 and US$5.6 m[62] in short-term external liabilities, which comes to US$23,723.4 m in net international reserves. Compared to December 2008, gross reserves were down by US$312 m, primarily because of US$320 m in profits transferred to the government.

The country had US$23,729.0 m in gross international reserves at June 30, 2009.

International reserves are divided into four main components: i) the portfolio of investments in financial instruments on international markets (US$22,416 m, 94.5%); ii) shares in the IMF (US$647 m, 2.7%) and in LARF (US$393 m, 1.7%); iii) investments in gold (US$208 m, 0.9%), and

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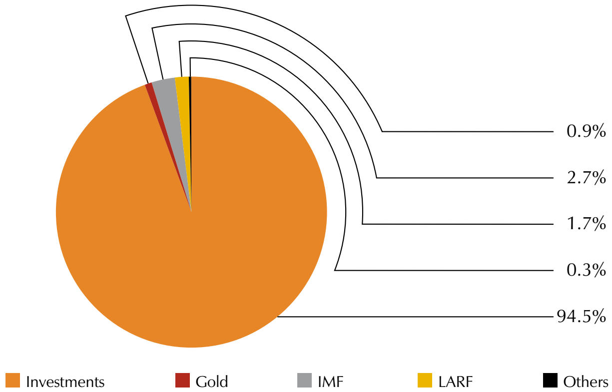
61 Modified duration is a measure of the sensitivity of the value of the portfolio to interest rate movements. For example, a modified duration of 2 implies the portfolio will reduce 2% in value if there is a 1% increase in external interest rates. Therefore, a lower modified duration leads to less market risk.

62 These liabilities correspond largely to the amounts payable on contracted investments.

Graph 56
Composition of Gross International Reserves
(June 30, 2009)



Fuente: Banco de la República.

iv) contributions to the de ALADI international agreement (US$61 m, 0.3%) (Graph 56).

1. The Components of the Investment Portfolio

Banco de la República has reduced credit risk exposure significantly in response to the situation caused by the international financial crisis. Most of the country's reserve portfolio investments are in extremely safe securities issued by the treasuries of the governments of developed countries or by entities backed by those governments, repurchase agreements with the Federal Reserve Bank of the United States, and securities issued by supranational institutions (e.g. the Inter-American Development Bank [IDB], the World Bank and the Andean Development Corporation [CAF]). As a whole, these investments account for 85.2% of the portfolio, which is far above the 55.3% registered in June 2007, before the international crisis began.

Most of the country's reserve portfolio investments are in extremely safe securities.

The increase in the portion of investments in governments, in the United States Federal Reserve and in supranational institutions has offset the sharp reduction in investments in asset-backed securities and bank and corporate securities (Table 22 and Graph 57). Securities issued by banks and corporations in the industrialized countries now account for 14.4% of the investments (as opposed to 33.8% in June 2007), and are rated AA- or higher. On the other hand, investments in asset-backed securities account for 0.4% of the portfolio (in contrast to 10.9% in June 2007). These investments have to be sold or will have matured before November 30, 2009. The reduced share of this set of instruments in the investment portfolio is the result of Banco de la República's decision to lower credit risk and to deal with the international crisis.

The increase in the share of investments in governments, in the United States Federal Reserve and in supranational institutions has offset the sharp reduction in investments in asset-backed securities and bank and corporate securities.

To limit credit risk, Banco de la República sets minimum ratings for issuers of securities. In the case of bank and corporate issuers, these long-term required ratings were increased in 2008 by three levels. The required minimum for the short-term[63] is A-1/P-1/F-1, which is the highest rating possible. The required minimum long-term ratings are AA- for bank and corporate issuers and A- for supranationals and government-backed entities. The minimum long-term rating required by Banco de la República is at least three steps above the

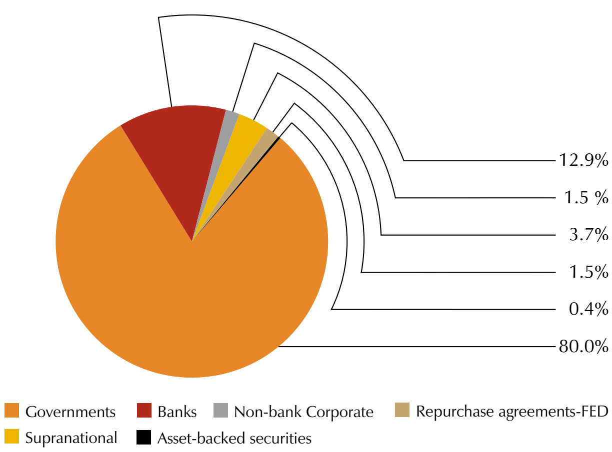
63 Investments that mature in less than 397 days are considered short term. Investments with longer maturities are considered long term.

Table 22
Developments in the Components of the Portfolio by Issuer

	June 2007		December 2008		June 30, 2009	
	Components	Minimum credit rating	Components	Minimum credit rating	Components	Minimum credit rating
I. Investment Portfolio (In USD millions)	18,835		22,669		22,416	
Governments (percentage)	52.0	A-	80.3	A-	80.0	A-
Banks (percentage)	30.8	A-	12.6	AA-	12.9	AA-
Non-bank corporate issuers (percentage)	3.0	A-	0.7	AA-	1.5	AA-
Supranational (percentage)	2.1	A-	3.5	A-	3.7	A-
Asset-backed securities (percentage)	10.9	AAA	1.7	New investments are restricted	0.4	New investments are restricted
Repurchase agreements with the Fed (percentage)	1.1	n.a.	1.3	n.a.	1.5	n.a.
II. Others [a/] (In USD millions)	1,164		1,342		1,312	
III. Total Gross Reserves (In USD millions)	19,999		24,041		23,729	

n.a. Not applicable
a/ Includes gold, contributions to the International Monetary Fund, Andean pesos and international agreements.
Source: Banco de la República.

Graph 57
Composition of the investments, by issuer



Source: Banco de la República.

required minimum rating for an investment to be considered investment grade.[64]

Currently, 100% of the short-term portfolio investments have the highest possible credit rating and 99.5% of the long-term investments are rated AA- or higher. Consequently, the likelihood of default by the issuer is extremely low (Table 23).

The foreign exchange composition of the investment portfolio is shown in Graph 58. Banco de la República determines the foreign exchange composition reserves as a replica of the outflows in the country's balance of payments. Currently, the

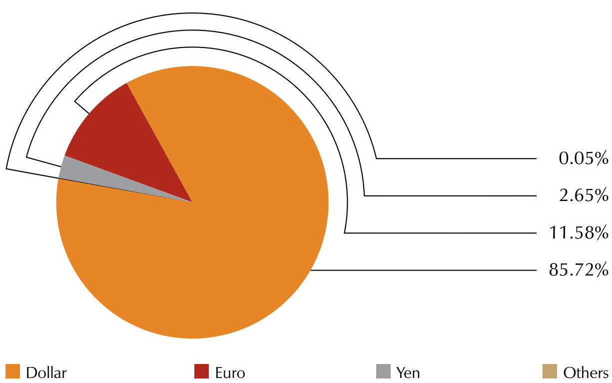
64 To limit credit risk, Banco de la República uses as a reference the credit ratings published by the most recognized international rating agencies (S&P, Moody's and Fitch Ratings). Their highest short-term rating is A-1+/P-1/F-1+ and the lowest is D. The highest long-term rating is AAA and the lowest is D. An investment in investment grade paper; that is, with a rating equal to or above A-3/P-3/F-3 in the short term and BBB- in the long term, is considered safe for the average investor.

Table 23
Distribution of Investments by Credit Rating

Long-term Investments		Short-term Investments	
Rating	Share (%)	Rating	Share (%)
AAA	93.2	P-1	100.0
AA+	0.6	Total	100.0
AA	1.2		
AA-	4.4		
A+	0.3		
A	0.2		
Total	100		

Source: Banco de la República

Graph 58
Foreign Exchange Composition of the Investment Portfolio



Source: Banco de la República.

Table 24
External Portfolio Management Program

Company	Amount Managed (US$ millions)
Deutsche Bank Advisors	920
Goldman Sachs Asset Management	2,048
Wellington Management	953
Barclays Global Investors	2,592
Western Asset Management	908
BlackRock Financial Management	1,039
Total	8,460

Source: Banco de la República.

foreign exchange composition is 85% U.S. dollars, 12% euros and 3% yen. The current foreign exchange composition is slightly different from the target structure, since minor deviations are permitted within strict limits, as are investments in other developed-country currencies, such as the British pound, the Swiss franc and the Canadian dollar.

In short, the Banco de la República's response to the international financial crisis has substantially reduced the credit risk of the reserve portfolio, which is invested largely in securities issued by governments, the Fed and supranational entities, with top credit ratings for both long-term and short-term investments.

2. The External Management Program

Banco de la República, like most central banks of its kind, delegates the management of a portion of its portfolio to external financial institutions of recognized prestige and experience. Since international reserves have grown and financial markets have become more specialized, Banco de la República believes it is appropriate to use the services of companies with considerable experience in third-party asset management, abundant resources and information, a sound capacity for analysis and a highly sophisticated technological and human infrastructure. Thanks to this program, it has been possible to train internal staff members and to supplement the information that is required to adopt policies and to monitor the Bank's investments internally.

The following are the firms currently under contract to participate in this program: Barclays Global Investors, Western Asset Management, Deutsche Bank Advisors, Goldman Sachs Asset Management, Blackrock Financial and Wellington Management (Table 24). Currently, they manage 35.7% of the country's international reserves pursuant to clearly-defined investment guidelines established by Banco de la República. These asset managers were selected on the basis of their high technical standards, and

The lending program with securities held in custody by JP Morgan Chase and Bank of New York Mellon was suspended in March 2008. This was one of several measures adopted to lower credit risk and to deal with the international financial crisis.

their permanence in the program is assessed regularly. The last three firms mentioned have been engaged by the United States Federal Reserve Bank to manage several of the programs being implemented to deal with the financial crisis, such as management of some of the assets belonging to AIG and Bear Stearns, participation in the PPIP[65] and, until the end of 2009, the purchase of US$1.25 b in mortgage-backed securities (MBS) issued by agencies.

Banco de la República defines the parameters to evaluate the performance of asset managers, which are reviewed regularly.[66] Decisions are taken depending on the success of their performance. For example, the amount being managed may be changed or the contract may be cancelled.

3. Securities Lending Programs

Securities lending is usually done by central banks to cover the cost of holding securities in custody and to increase the return on international reserves. Central banks authorize firms to hold securities in custody so they can be loaned through a repurchase agreement. A detailed explanation of how the program operates is provided in *Administración de reservas internacionales*, a document published in March 2009 by the Central Bank of Colombia (http://www.banrep.gov.co/documentos/publicaciones/Reserve_inter/2009/Marzo.pdf). The lending program with securities held in custody by JP Morgan Chase and Bank of New York Mellon was suspended in March 2008. This was one of several measures adopted to lower credit risk and to deal with the international financial crisis.

In May 2009, Banco de la República decided to suspend the securities lending program with Euroclear[67] to further reduce credit risk. This program was different from those with JP Morgan Chase and Bank of New York Mellon and represented less risk for Banco de la República, since it was concentrated in Euroclear.[68] The loans made through this program were low compared to the securities in custody (1.9% or US$31 m a month, on average). However, as

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65 The Public-Private Investment Program (PPIP) is intended to buy up toxic assets the banks have on their balance sheets.

66 Monthly reports with information on portfolio performance are submitted to the Reserve Committee, which is the highest decision-making body within Banco de la República. The horizon for assessing external asset managers is three years, so as to have sufficient information to arrive at decisions in terms of modifying the amount or cancelling the contract.

67 Euroclear provides Banco de la República with security custody and transaction settlement services for one part of the directly managed portfolio. It is a financial services company with a low risk profile and specializes in the settlement of transactions involving securities, stocks and investment funds. It plays an essential role in international capital markets as a central securities depository. It also offers asset management services such as securities lending. Its credit rating is AA+.

68 The securities on loan were backed by securities, and there was no cash collateral that could be invested in new securities. The only credit risk to Banco de la República was the insolvency of Euroclear.

In May 2009, Banco de la República decided to suspend the securities lending program with Euroclear to further reduce credit risk.

part of its policy to reduce credit risk, Banco de la República recently decided to suspend the program.

The lending program with securities held in custody by JP Morgan Chase and Bank of New York Mellon declined from US$4,177 b in March 2008 to US$290 m on June 30, 2009. The securities lending with Euroclear comes to zero.

B. MEASURES ADOPTED AND INVESTMENT PERFORMANCE

1. Measures Adopted during the First Half of 2009

To supplement the provisions adopted in 2008, the Banco de la República has taken additional measures this year to further reduce credit and market risk of the international reserve portfolio. Specifically, it decided to:

a. *Suspend investment in asset-backed commercial paper (ABCP).* In May 2008, Banco de la República toughened the terms for investments of this type by lowering the quotas and being stricter about the type of issuers permitted. In May of this year, it decided to suspend all such investments indefinitely. At present, the balance is zero.

b. *Sell off all investments in asset-backed securities (ABS) prior to November 30, 2009.* These investments were suspended in April 2008, when it was agreed their balance would be reduced through maturity. In May of this year, Banco de la República decided to speed up the sell-off of ABS; therefore, the balance should be zero by next November.

c. *Suspend the lending program with securities held in custody by Euroclear.* As mentioned already, the program was suspended recently and its balance is zero.

d. *Reduce the modified duration of the portfolio from 1.27 to 0.51.* In June, Banco de la República decided to reduce the modified duration of the portfolio to reduce the adverse effect on the return of international reserves that would result from a possible normalization of monetary policy in the developed countries, where interest rates are at historically low levels, or simply because market interest rates increase. The international environment at present generates a significant market risk for the return of reserves. When interest rates are near 0%, accrued interest is minimal and securities could devaluate, since rates are not likely to fall even further. In contrast, there is a wide margin from them to increase in the future.

Banco de la República decided to reduce the modified duration of the portfolio, since the current international environment generates significant market risk for the return of reserves.

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When interest rates are low, as is now the case, a slight increase in interest rates can mean negative portfolio yield.

This being the case, when external interest rates increase the price of securities declines and negatively affects the return on reserves. In the long term, taking on more market risk; that is, having more tolerance to fluctuations in the price of investments, tends to generate higher returns. Nonetheless, the level of market risk that can be assumed is affected by the level of interest rates. When interest rates are high, more market risk can be taken, since accrued interest can compensate for devaluation in investments. On the contrary, when interest rates are low, as is now the case, a slight increase in interest rates can eliminate the return from accrued interest. For instance, if a portfolio has a 5% internal rate of return and a modified duration of 2, an increase of 1% in the one-year rates would mean an approximate return of 3% on the portfolio (5% from accrued interest and -2% from valuation). However, another portfolio with the same modified duration of 2, but a return of 1%, would have a -1% yield with the same movement of the curve.

Banco de la República decided to reduce the market risk on investments, because external interest rates are currently very low. Up until June 30, the modified duration of the investment portfolio was 1.27, which meant that reserves could lose US$280 m with a 1% rise in external interest rates. To lessen that risk, Banco de la República will have reduced the modified duration of the portfolio to 0.51 by July 31. As a result, potential losses from the same movement in the yield curve would be reduced to US$113 m. Although, the return on reserves is expected to be low as a result of less duration, the new composition of the investment portfolio will reduce the probability of negative returns in twelve months to 5% compared to an estimated probability of 29% before the measure was adopted. Less duration has costs in terms of less return, but it protects Banco de la República against the possibility of losses if market risk materializes.

2. Projected Performance

The return from reserves depends primarily on three factors: the interest rate earned on investments, the valuation or devaluation of securities, and the performance of the exchange rates for the euro, the yen and other currencies with respect to the U.S. dollar. The March 2009 edition of the *Report to Congress* forecast a sharp drop in return on reserves this year. The lower return, both current and anticipated, is due to three factors:

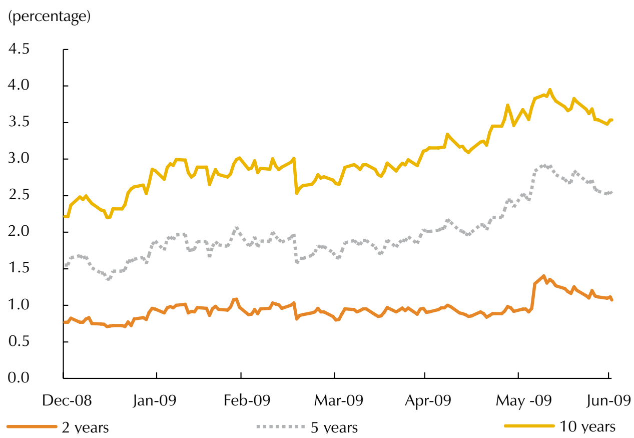
Although the return on reserves is expected to be low as a result of less duration, the new composition of the investment portfolio will reduce the probability of negative returns in twelve months to 5%.

- The decision to have a portfolio with a more conservative risk profile; that is, with a larger percentage of securities issued by the governments of the industrialized countries, implies receiving less return that what is offered by securities with more credit risk.

- Interest rates in the United States, Europe and Japan are at historically low levels because of the crisis and the decision of central banks to relax their monetary policy as a way to deal with the crisis. The rate on federal funds, which is the Fed's policy instrument, is in the 0% to 0.25% range; the European Central Bank's benchmark rate is 1% and that of the Bank of Japan, 0.1%. This translates into low returns from accrued interest on investments of reserves.

- The recent rise in interest rates on U.S. treasury bonds had a negative effect on the value of the portfolio, given the inverse relationship that exists between interest rates and asset prices. The market expects the Fed to raise its interest rates in the future, which has sparked the increase in the rates on bonds. This tendency has been reinforced at a time when risk aversion is less and investors have replaced demand for U.S. government securities with demand for higher-risk assets. Moreover, the U.S. government's need for greater financing, due to a high fiscal deficit and added expectations of future inflation, helps to explain the recent movement in interest rates on U.S. treasury bonds (Graph 59). As explained earlier, Banco de la República reduced the modified duration of the reserve portfolio to lower risk exposure.

Graph 59
Interest Rates on U.S. Treasury Bonds



Source: Bloomberg.

Table 25
Return on International Reserves

	Millions of dollars	Annual Rate of Return (percentage)
1992[a/]	319.3	4.5
1993[a/]	386.5	4.9
1994	503.0	6.3
1995	818.4	9.9
1996	200.8	2.2
1997	204.6	2.1
1998	728.9	7.8
1999	78.4	0.9
2000	505.3	5.9
2001	477.9	4.8
2002	810.5	7.7
2003	464.8	4.2
2004	324.5	2.7
2005	81.4	0.6
2006	815.2	5.5
2007	1.326.2	7.4
2008	1.004.5	4.5
2009 (proj)	**148.4**	**1.5**

a/ Exchange balance data.
Source: Banco de la República.

The projection for 2009 is a return of US$124.1 m or 0.52%. As illustrated in Table 25, the projected return for this year is less than what was obtained in the last three years, due to the aforementioned reasons, and is similar to the return in 1999 and 2005, when the euro depreciated sharply against the dollar and interest rates were up in the United States.

C. STATUS OF CLAIMS FOR CREDIT EVENTS

As outlined in detail in the March edition of the *Report to Congress* and in *Administración de las Reservas Internacionales,* a document published at the end of March 2008, two credit events occurred: a Lehman Brothers security for US$2.7 m and a Sigma Finance security for US$20 m in the lending program with securities held in custody by Bank of New York Mellon. Both of these events took place amidst the extreme conditions international markets faced that year.

Banco de la República's response to the credit events was diligent and in keeping with the legal framework in force.

In *Administración de las Reservas Internacionales* and in the various debates within the Third Standing Committees of the Senate and the House of Representatives, Banco de la República explained how its action in response to these credit events was diligent and in line with the legal framework in force. It is a known fact that investment decisions always involve uncertainty. In other words, there is no certainty as to the return on a particular investment or if the issuer of a security will honor its commitment. For that reason, Banco de la República has established a series of guidelines and procedures for assessing the risk of its international reserve investments, based on the information that is available at a given point in time. Like other central banks and first -rate financial institutions, the ratings assigned by credit risk rating agencies are the main way to measure the credit risk of an investment. As to the agreements with external managers and within the securities lending program, precise obligations are established, so that the external managers, who are expert fiduciary managers, conduct this monitoring.

When the payments were suspended, the investments in Lehman Brothers and Sigma had the minimum credit levels defined by the Reserve Committee.

When the external manager Blackrock, which is one of the world's largest asset managers and was hired by the U.S. Federal Reserve to manage the assets involved in the crisis, invested in Lehman Brothers, the security was rated A+, while Sigma had a AAA long-term credit rating and an A1+ short-term rating (Standard & Poors). When payments were suspended, both investments had the minimum credit levels defined by the Reserve Committee. In fact, the Lehman security was A- rated, while the Sigma security was A-rated for the long-term and A1 for the short term (Standard & Poors).

Banco de la República monitored the ratings on those investments daily.

Banco de la República monitored the ratings on those investments daily and, in the case of Sigma, since the information was more limited, it did so permanently with Bank of New York Mellon, which always stated that it had good information on Sigma and indicated repeatedly to Banco de la República that its investment was safe. In view of the credit ratings and the information supplied to Banco de la República by Bank of New York Mellon, no change was made in the policy to hold the investment to maturity, a policy that was adopted when the securities lending program was suspended in March 2008. Payments were suspended on September 30 and the security was due to mature that same year, on October 31.

Banco de la República has filed a suit with the Supreme Court of the State of New York against Bank of New York Mellon Corporation, Bank of New York Mellon N. A. and Bank of New York Mellon Asset Services B.V..

As reported to Congress and announced to the public, Banco de la República has filed a suit with the Supreme Court of the State of New York against Bank of New York Mellon Corporation, Bank of New York Mellon N. A. and Bank of New York Mellon Asset Services B.V.. According to a comprehensive review conducted by Banco de la República, with technical assistance from a specialized auditing company and the legal firm of Crowell & Moring, the firms in question breached the obligations entrusted to them by Banco de la República under a securities loan agreement.

Banco de la República is taking the necessary legal steps to recover its US$2.7 m investment in Lehman Brothers, as part of bankruptcy proceedings.

The suit that has been filed is going through the normal procedures, according to the provisions of U.S. law. The external lawyers have said it will be at least two years before an initial ruling is handed down.

Banco de la República is also taking the necessary legal action to recover its US$2.7 m investment in Lehman Brothers, as part of bankruptcy proceedings. According to the restructuring procedure outlined in Chapter 11 of the United States Commercial Code, the debtor is required to present a restructuring plan with a proposal to pay all of its creditors, based on priority determined with respect to loans and its assets. The plan in question will be presented next year, in March. Banco de la República is being represented in this suit by the law firm of Morrison & Foerster LLP.

IV. The Financial Situation of Banco de la República

The historically low external interest rates and the recent rise in interest rates on U.S. Treasury bonds explains the decline in the estimated return on the Central Bank's international reserves in 2009. This explains the sharp reduction in projected revenue on Banco de la República's income statement, which in turn balances the decline in expences anticipated for 2009.

As indicated in the *Report to Congress* presented last March, negative operating results are forecast for the end of 2009, due to a sharp reduction in income that far exceeds the anticipated reduction in expenses.

Basically, income is down because the return on international reserves will be less than in the last year. On the one hand, interest rates in the United States and Japan are at historically low levels. This means less return in the form of accrued interest on reserve investments. Moreover, there has been a recent increase in interest rates on U.S. Treasury bonds. This has a negative impact on the value of the portfolio, given the valuation at market prices and the inverse relationship that exists between interest rates and the prices of fixed-income securities.

Negative operational results are forecast for the end of 2009, due to a sharp reduction in income that far exceeds the anticipated reduction in expenses.

On the other hand, the reserve management measures adopted by Banco de la República to deal with the international financial crisis, as explained in the preceding chapter, have created a situation where the exposure of reserves to the various types of financial risk is very limited. Consequently, the expected return on those reserves is low as well, given the direct relationship between risk and return.

During the first half of the year, Banco de la República reported Col$2.7 b in operational result, explained by Col$619.9 b in income and Col$617.3 b in expenses.

Finally, in the current year major valuations of the portfolio due higher asset prices are not expected, in contrast to what happened in 2008. This is due to the expansive monetary policies adopted by the major central banks to deal with the effects of the external crisis and the added demand for bonds issued by the governments of industrialized countries in response to the rise in risk aversion.

It is important to point out that Banco de la República has reported no negative profits since the early nineties. The losses posted during that period were due to the high amount of debt the Bank owed as a result of the policy on sterilization of international reserve accumulation, which was accomplished by placing securities issued by Banco de la República at high interest rates. During the last few years, reserve accumulation has been sterilized through the sale of TES from the Bank's portfolio, the reduction in the repo balance and the increase in deposits with Banco de la República by the government and financial institutions. This sterilization has meant fewer income and more expenses, which has affected the Bank's income statement.

The lower value of the position in international reserves is explained largely by the rise in interest rates on U.S. Treasury bonds during the first half of the year.

A. INCOME STATEMENT AT JUNE 2009

During the first half of the year, Banco de la República reported Col$2.7 b in operational income, as a result of Col$619.9 b in income and Col$617.3 b in expenses (Table 26).

The income originated mainly with:

- the return on international reserves (Col$233.6 b);
- short-term liquidity operations (Col$136.2 b);
- the exchange rate adjustment for assets denominated in foreign currencies other than those of the country's international reserves (Col$71.9 b); and
- the commissions Banco de la República charges in exercise of its functions as the bankers' bank and the government's fiscal agent (Col$78.7 b).

Net income on international reserves registered Col$233.6 b at the end of June 2009. This was due to: i) Col$530.5 b in accrued interest, ii) Col$298.6 b devaluation of the assets in which reserves are invested, and iii) Col$1.8 b from the exchange rate difference between the dollar and the euro, the yen and SDR.[69]

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69 The euro went from 1.3901 to 1.40265 dollars per euro between December 2008 and June 2009. The yen went from 90.650 to 96.4850 yen per dollar between December 2008 and June 2009. The SDR went from 1.5403 in December 2008 to 1.5522 SDR per dollar at the end of June 2009.

Table 26
Banco de la República – Income Statement: 2008-2009
(Billions of pesos)

	Performance at:	
	Dec. 2008 A	Jun. 2009 B
1. Income	**2,965,9**	**619.9**
A. Monetary income	**2,798,6**	**541.2**
1. Interest and returns	2,514,0	444.0
International reserves	2,119,8	233.6
Other interest	13.5	25.1
Liquidity operations	311.7	136.2
TES valuation	68.4	49.1
Valuation other securities	0.6	0.0
2. Exchange rate differences	224.9	71.9
3. Coins	47.3	7.8
4. Others	12.5	17.6
B. Corporate income	**167.3**	**78.7**
2. Expenditures	**1,644.1**	**617.3**
A. Monetary expenditures	**1,249,1**	**486.4**
1. Interest and returns	955.5	382.5
Deposit-account reserve requirements	163.2	60.4
Deposit-accounts, Finance Ministry-Treasury	708.3	247.1
International reserve management expenses	15.6	21.8
Expenses for monetary contraction operations	68.4	53.2
2. Exchange rate differences	175.9	68.3
3. Cost of issuing and distributing banknotes and coins	113.9	33.0
4. Others	3.8	2.6
B. Corporate Expenditures	**322.4**	**163.8**
1. Personnel expenses	206.3	110.2
2. General expenses	47.5	21.8
3. Taxes	7.2	3.7
4. Insurance	6.0	3.1
5. Contributions and membership fees	4.6	1.6
6. Cultural expenses	8.7	3.9
7. Depreciation, provisions, and others	42.2	19.5
C. Pension expenses	**72.6**	**(33.0)**
3. Operating Income (1 – 2)	**1,321,8**	**2.7**

Source: Banco de la República.

The devaluation in assets is explained largely by the rise in interest rates on U.S. Treasury bonds during the first half of the year, which has negatively affected the market value of the portfolio, given the inverse relationship that exists between interest rates and asset prices. This pattern in bond interest rates is due to the fact that the market expects the Federal Reserve to raise its interest rates in the future, and because risk aversion has declined and investors have replaced the demand for U.S. government bonds with a demand for higher-risk assets. The U.S. government's need for more financing, as a result of its high fiscal deficit, and the rise in expectations of inflation in the future also help to explain this increase.

Liquidity operations conducted through repos with the financial system produced Col$136.2 b in income, while the exchange rate differences generated Col$71.9 b.[70] Commissions paid to the Central Bank came to Col$78.7 b due to the volume of TES managed in the Central Securities Depository (DCV) and the increased number of transactions conducted through the electronic trading system (SEN).

The highlights with respect to expenditure include:

- interest paid on national government deposits (Col$247.1 b);
- interest on the reserve requirement for credit institutions (Col$60.4 b),
- exchange rate differences (Col$68.3 b),
- personnel expenses (Col$110.2 b) and
- expenses incurred in monetary contraction operations (Col$53.2 b).

70 This refers to the exchange rate adjustment for assets and liabilities denominated in foreign currency that do not affect international reserves, given the difference in the value of the peso with respect to the dollar. The closing accounting rate for these foreign currency operations at December 31, 2008 was Col$2,243.59. In June 2009, it was Col$2,145.21. The appreciation during the first six months was 4.4%.

Banco de la República reported Col$65,129 b in assets at June 30, 2009, which is Col$2,621 b (4.2%) more than at December 2008.

During the first half of 2009, the National Department of the Treasure kept Col$7,285.8 b on deposit with Banco de la República, an amount that earned 6.9% average interest rate in annual effective terms.

On the other hand, the personnel expenses show a controlled performance and basically reflect commitments acquired as part of the current collective bargaining agreement. The rise in public utility fees and the effect of the minimum wage increase on contracts that involve manpower were the highlights with respect to general expenses (Col$21.8 b).

Pension expenditure was negative by Col$33 b as a result of larger returns on the portfolio constituted with Col$121.2 b in pension liabilities. The foregoing was due to the behavior of the interest rates of TES during the first half of the year; This asset represent approximately 74.0% of portfolio. It was agreed, with the national government, that during 2009 no additional actuarial provisions would be made; they will be deferred until the years ahead.

B. THE BALANCE SHEET OF BANCO DE LA REPÚBLICA

The changes in Banco de la República's principal asset, liability and equity accounts between December 31, 2008 and June 30, 2009 (Table 27) are explained below.

1. Assets

Banco de la República reported Col$65,129 b in assets at June 30, 2009, which is Col$2,621 b (4.2%) more than at December 2008, when it registered Col$62,508 b in assets. The most important changes in the asset accounts are explained by:

- *International Reserves:* At the end of June 2009, gross international reserves, valued at market prices, were Col$50,904 b (US$23,729 b), declining by Col$3,035 b (-6%) during the first half of the year. Primarily, this was due to: i) fewer reserves because of the net sale of foreign exchange (Col$94.5 b); ii) the exchange rate adjustment as a result of the appreciation of the with respect to the dollar, which lowered the balance of gross international reserves, in pesos, by Col$2,215 b and iii) interest rate return and valuation of portfolio, which raised reserves by Col$232 b.

- *The domestic-currency denominated investment portfolio,* at market prices, came to Col$422 b at June 2009, down Col$478 b compared to the end of 2008. The drop was due primarily to: i) Col$499 b in net sales of TES B held by Banco de la República during February 2009; ii) Col$0.5 b and Col$20.5 b in principal and coupon payments, respectively; iii) Col$17 b in portfolio valuation due to lower interest rates of TES during 2009.

Table 27
Banco de la República Balance Sheet December 2008 to June 2009
(Billions of pesos)

	December 2008		June 2009		Variation	
	Balance	Percentage	Balance	Percentage	Absolute	Percentage
Assets	**62,508**	**100.0**	**65,129**	**100.0**	**2.621**	**4.2**
Gross international reserves	53,938	86.3	50,904	78.2	(3,035)	(5.6)
Contributions in international organizations	2,538	4.1	2,766	4.2	228	9.0
Investments	900	1.4	422	0.6	(478)	(53.1)
Public sector, consolidated debt	0	0.0	0	0.0	0	0.0
Public-sector, monetary regulation	864	1.4	392	0.6	(472)	(54.6)
Bonds: public bank capitalization and others	36	0.1	30	0.0	(6)	(16.6)
Loan portfolio	1	0.0	1	0.0	(0)	(9.3)
Public sector and national government	1	0.0	1	0.0	(0)	(9.1)
Financial corporations	0	0.0	0	0.0	0	n.a
Other loans	4	0.0	4	0.0	(0)	(2.5)
Provisions	(4)	(0.0)	(4)	(0.0)	0	(2.6)
Repurchase agreements – temporary liquidity support	1,547	2.5	7,225	11.1	5,678	367.0
Accounts receivable	37	0.1	30	0.0	(7)	(18.7)
Other net assets	3,547	5.7	3.781	5.8	235	6.6
Liabilities and equity	**62,508**	**100.0**	**65,129**	**100.0**	**2,621**	**4.2**
Liabilities	**43,460**	**69.5**	**49,113**	**75.4**	**5,653**	**13.0**
Foreign-currency liabilities that affect international reserves	25	0.0	12	0.0	(13)	(52.6)
Monetary Base	36,193	57.9	34,422	52.9	(1,771)	(4.9)
Banknotes in circulation	29,875	47.8	26,550	40.8	(3,326)	(11.1)
Coins	666	1.1	673	1.0	8	1.1
Bank reserve deposits	5,074	8.1	6,603	10.1	1,529	30.1
Current-account deposits rest of financial sector	577	0.9	595	0.9	18	3.1
Non-reserve interest-bearing deposits	1,624	2.6	166	0.3	(1,459)	(89.8)
Deposits from external borrowing and foreign-capital portfolio investment	15	0.0	0	0.0	(15)	(98.2)
Other deposits	108	0.2	126	0.2	18	16.2
National government: Department of the Treasury - n/c	2,487	4.0	11,205	17.2	8,718	350.5
National government – Department of the Treasury - f/c	151	0.2	74	0.1	(77)	(51.3)
Obligations with international organizations	1,940	3.1	2.171	3.3	231	11.9
Accounts payable	78	0.1	93	0.1	15	18.9
Other liabilities	838	1.3	846	1.3	8	0.9
Total equity	**19,049**	**30.5**	**16,017**	**24.6**	**(3,032)**	**(15.9)**
Capital	13	0.0	13	0.0	0	0.0
Reserves	2.393	3.8	2,867	4.4	473	19.8
Surplus	15,321	24.5	13,135	20.2	(2,186)	(14.3)
CEC liquidation	453	0.7	453	0.7	0	0.0
Foreign exchange adjustments from 1993 onward and surplus	13,623	21.8	11,408	17.5	(2,215)	(16.3)
Others	103	0.2	133	0.2	30	29.2
Property valuation (art, cultural, real estate)	1,142	1.8	1,141	1.8	(1)	(0.1)
Results	1,322	2.1	3	0.0	(1,319)	(99.8)
Profit/loss for previous periods	0	0.0	0	0.0	0	0.0
Profit/loss for the period	1,322	2.1	3	0.0	(1,319)	(99.8)

Source: Banco de la República.

Liabilities came to Col$49,113 b at June 30, 2009. This amount is Col$5,653 b higher than at the end of 2008.

Repo operations to provide temporary liquidity showed a balance of Col$7,225 b at the end of the first half of 2009. This amount represents an increase of Col$5,678 b (367%) with respect to the close of 2008.

2. Liabilities

Liabilities came to Col$49,113 b at June 30, 2009, or 13% more (Col$5,653 b) than at the end of 2008. The following were the main reasons for the variation:

- *Government deposits in domestic currency with the Banco de la República, constituted by the Department of the Treasury,* came to Col$11,205 b at the end of June 2009. This is an increase of Col$8,718 b (351%) compared to the balance at December 2008.

- *Monetary Base:* At the end of June 2009, monetary base came to Col$34,422 b, which is Col$1,771 b less (5%) than at the close of 2008.

3. Equity

The equity balance was Col$16,017 b at June 30, 2009. This is Col$3,032 b less than the figure registered at the end of December 2008.

The equity balance was Col$16,017 b. This amount is Col$3,032 b less (16%) compared to the end of December 2008, primarily because of the change in the exchange rate adjustment account. The latter was down by Col$2,215 b (16%), as a result of peso appreciation against the dollar, which —as mentioned earlier— lowered the peso balance of international reserves.

C. 2009 INCOME AND EXPENDITURE FORECAST

For this year, it is estimated a total income of Col$837.1 b and expenses of Col$1,262.4 b, which would leave a negative operational result of Col$425.4 b.

As indicated, the decline in income is explained primarily by the sharp drop in returns on international reserves due to: i) low external interest rates; ii) the limited exposure of reserves to the various financial risks, which also means low projected return, and iii) no significant valuations anticipated for the securities in which reserves are invested, as did occur the year before.

Total estimated income for 2009 is Col$837.1 b and expenditure, Col$1,262.4 b, which would leave a negative opperational result of Col$425.4 b.

Moreover, the accumulation of reserves in recent years was sterilized through the sale of TES from Banco de la República's portfolio, the decline in outstanding repos and the increase in government deposits and those of financial institutions with Banco de la República. This sterilization means less income and more expenditure, which has affected Banco de la República's result. The decline in income is due to several factors; namely, i) the interest rate at which acquired reserves are invested is lower than the interest rate earned on the TES the Bank sells to sterilize them; and i) the Bank's position

The projected operational loss is Col$188.4 b more than what was indicated in the March 2009 edition of the Report to Congress (Col$237.0 b). This was due to less return on international reserves and appreciation of the peso with respect to the dollar.

with the financial system as a creditor has declined, which means fewer repos and lower interest rate income. The rise in expenditure is the result of interest rate paid to the government and to financial institutions for deposits with Banco de la República, which contribute to sterilize the purchase of reserves.

The projected operational loss is Col$188.4 b more than what was reported in the March 2009 edition of the *Report to Congress* (Col$237.0 b). This was due to less return on international reserves and appreciation of the peso with respect to the dollar, which affects the balances in pesos, primarily the contributions with international organizations (Table 28).

The main sources of income would be the return on international reserves (Col$284.4b), income from liquidity operations (repos) (Col$191.2 b) and corporate income (Col$170.6 b).

The return on reserves in 2009 is expected to be US$148.4 m. This is the lowest it has been in the last three years, due to the aforementioned reasons, but is more than in 1999 and 2005, when the euro depreciated against the dollar and interest rates increased in the United States. However, this projection does not include the possible impact of changes in the exchange rates for the currencies in the portfolio. Therefore, the expected income from this item are subject to uncertainty concerning the behavior of the exchange rate for the dollar with respect to the euro, the yen and SDRs.

With respect to expected expenses, 69.4% are monetary and would come to Col$876.7 b. This is equivalent to an annual reduction of 29.8% with respect to 2008, as result of: i) lower remuneration on government deposits, given the cut in Banco de la República's intervention rate and fewer projected average deposits in 2009 than in 2008, and ii) the elimination of remuneration on the reserve requirement for current accounts, savings accounts and all other demand deposits as of February 2009. The cost of issuing and distributing currency is expected to reach Col$147.1 b, given the issue schedule established by the Mint and the Banknote Printing House. Corporate expenses would come to Col$364.7 b, due to Col$226.0 b in personnel expenses, Col$51.2 b in general expenses or overhead, and Col$87.4 b in other expenses. These expenses reflect the commitments outlined in the collective bargaining agreement and the increase in expenditure due to the reopening of the Gold Museum.

Lastly, it is projected a net expenditure on retirement pensions of to Col$21.0 b, which is Col$51.6 n lower than in 2008, as a result of: i) Col$161.5 b in estimated returns on the portfolio constituted with pension funds, as opposed to Col$142.6 b observed the year before, ii) no provision for the actuarial estimate, as explained already, and iii) Col$191.4 b in pension expenses.

Table 28
Banco de la República - 2008-2009 Income Statement
(Billions of pesos)

	December 2008 (A)	Projected 2009 (B)	Annual Variations	
			Percentage (B/A)	Absolute (B - A)
1. Income	**2,965,9**	**837.1**	**(71.8)**	**(2,128,8)**
A. Monetary income	**2,798,6**	**666.5**	**(76.2)**	**(2,132,2)**
1. Interest and returns	2,514,0	560.0	(77.7)	(1,953,9)
International reserves	2,119,8	284.4	(86.6)	(1,835,4)
Other interests	13.5	18.1	34.3	4.6
Liquidity operations	311.7	191.2	(38.7)	(120.6)
TES valuation	68.4	63.3	(7.5)	(5.1)
Valuation in other securities	0.6	3.1	438.7	2.5
2. Exchange rate differences	224.9	21.5	(90.5)	(203.4)
3. Coins	47.3	75.5	59.8	28.3
4. Others	12.5	9.4	(24.8)	(3.1)
B. Corporate income	**167.3**	**170.6**	**2.0**	**3.4**
2. Expenditure	**1,644,1**	**1,262,4**	**(23.2)**	**(381.7)**
A. Monetary expenditure	**1,249,1**	**876.7**	**(29.8)**	**(372.4)**
1. Interest and returns	955.5	635.5	(33.5)	(320.0)
Reserve requirements on deposit accounts	163.2	114.9	(29.6)	(48.3)
Deposit accounts - Treasury Department	708.3	394.9	(44.2)	(313.4)
International reserve management expenses	15.6	65.8	320.6	50.1
Expenses incurred in monetary-contraction operations	68.4	60.0	(12.2)	(8.4)
2. Exchange rate differences	175.9	78.9	(55.1)	(97.0)
3. Cost of issuing and distributing bills and coins	113.9	147.1	29.2	33.2
4. Others	3.8	15.2	302.5	11.4
B. Corporate expenditure	**322.4**	**364.7**	**13.1**	**42.3**
1. Personnel	206.3	226.0	9.6	19.7
2. General expenses	47.5	51.2	7.8	3.7
3. Taxes	7.2	8.3	15.8	1.1
4. Insurance	6.0	7.1	19.4	1.2
5. Contributions and memberships	4.6	4.8	5.1	0.2
6. Cultural expenses	8.7	10.0	15.4	1.3
7. Depreciation, provisions, amortization and others	42.2	57.2	35.4	14.9
C. Pension expenditure	**72.6**	**21.0**	**(71.0)**	**(51.6)**
3. Income **(1 - 2)**	**1,321,8**	**(425.4)**	**(132.2)**	**(1,747,1)**

Source: Banco de la República.