Presentation, Summary and Conclusions

A. The Economic Situation and Inflation

✠ In April of this year the Board of Directors of the Bank of the Republic (BDBR) decided to raise the Bank's intervention rates by 100 basic points (bp) in response to greater inflationary pressure observed during the first quarter, deriving principally from a high level of accumulated devaluation to date and an increase in expectations for inflation. This increase was added to the one carried out in January, in the same proportion, and was complemented by an auction to diminish accumulated reserves in the months of March, April and May for a value of US$200 million (m) each time.

✠ These changes in monetary policy had the following consequences:

- ✠ Interbank interest rates rose in the same proportion.
- ✠ It contributed to a decrease in TES rates, which dropped by about 80 bp on average in a context of a diminishing country risk premium.
- ✠ There were no increases in DTF or the majority of the placement rates.
- ✠ It contributed to a stabilization of the exchange rate (also affected by the behavior of the country risk premium and by external flows, mainly remittances abroad).

✠ Thus, policy actions contributed to moderating inflation expectations and reducing depreciation in the exchange rate. In spite of increases in rates, monetary policy positions continue to be loose and favorable to growth, to judge by real levels of exchange and interest rates and by growth in the monetary base.

✠ During the year, economic activity has developed within a propitious domestic and foreign environment, and growth has accelerated with respect to the second semester of 2002, driven mainly by private internal demand. Domestically, interest rates continue at low real levels, which together with improvements in private sector balances and greater levels of confidence shown by entrepreneurs and consumers have allowed credit to turn upward. Abroad, there has been continuing and even increasing availability in capital markets for emerging markets, allowing country risk premiums to drop and making greater exchange stability possible in the case of Colombia.

✠ It is expected that in coming months both domestic and foreign conditions will continue to favor growth. Both private investment and to a lesser degree household consumption are perceived as prime sources of growth. Exports will be driven by non-traditional products aimed at the U.S. and by coal exports for the most part. However, other sales abroad, and particularly, those that are aimed at the Venezuelan market could show less than satisfactory performance. In this context, and taking into account the positive performance of several indicators in June, it is considered feasible that growth for 2003 will surpass the goal of 2% set by the government.

✠ In the second quarter, there was a change in the rising tendency of inflation recorded since mid-year 2002. Nevertheless, this reduction depended exclusively on a drop in food inflation and not basic inflation, which showed an increase for the third consecutive quarter. In June, annual inflation without food was at 7.0% and the average of the three basic inflation indicators was 7.3%, surpassing the established goal in all cases for this year by a wide margin.

✠ It is unlikely that the increase in basic inflation in the second quarter was due to demand pressures. Even though loose monetary policy and recovery of confidence in the private sector have lent impetus to acceleration in economic growth and a closing of the production gap that was quicker than expected, the level of the latter continues to be negative. Installed capacity usage indicators and those for the labor market, as well as the calculations made by the Deputy Manager for Economic Studies (SGEE) indicate that production is still to be found below its "potential" level.

✠ Over the last months, peso depreciation has continued to be transmitted to inflation in the consumer price index (CPI). Likewise, thanks to exchange stability, the effect of devaluation on inflation in the producer price index (PPI) for imported goods is beginning to recede. In the second semester, inflationary pressure from devaluation could continue to drop if the exchange rate does not register any new peaks.

✠ Although policy actions undertaken up until last April seem to have moderated inflation expectations, available indicators show that they remained at levels above the target.

✠ In the second quarter, inflation without food was also affected by shocks to supply (energy and fuel), the impact of which was; nevertheless, lower than in the first quarter.

✠ In brief, acceleration in basic annual inflation during the second quarter was due to pressures from the exchange rate and expectations. Although the effect of devaluation on inflation in imported goods would begin to give way, continued transmission of depreciation to consumer prices and the persistence of inflation expectations above 6% are the main risks that fulfillment of 2003 and 2004 goals face.

B. Forecasts

✠ For the rest of the year, Bank of the Republic models indicate a significant reduction in consumer inflation, which will depend largely on a deceleration in food inflation. On the other hand, inflation without food could record additional rises until the third quarter, driven by supply shocks (energy and fuel) and by a lag in the effect of devaluation. Only during the fourth quarter would there be a sustained drop in this indicator.

- In general terms, inflation forecasts for 2003 are less than those shown in the March report. However, there are difficulties comparing the two forecasts, due to changes made in the central model (transmission mechanisms model – TMM). Particularly, in its most recent version, the TMM used shows figures for the end of the year, while in the previous version, used for the March Report, showed forecasts for the average of the fourth quarter.

- The central path of the TMM shows that consumer inflation in December, 2003, will be near 6%. This result, however, is particularly uncertain given that it depends, largely, on an important correction in food prices. The level of inflation without foodstuffs is projected in the range between 6.2% and 7.2% for December, that is, less than the figure presented in the March report, but above the target range announced.

- For 2004, the Bank model forecasts an additional reduction in consumer inflation explained basically by the drop in inflation without foodstuffs. For the coming year foodstuffs inflation would converge with basic inflation.

- Previous forecasts were calculated under the assumption that the average exchange rate for the second semester would not show any significant recovery. In 2004 some exchange pressure could be expected due to a drop in petroleum income resulting from diminishing international prices. Within this scenario, it can also be assumed that public debt spread will remain stable.

- Given the foregoing, predicted reduction in inflation without foodstuffs during the coming year and a half, to levels compatible with the 2003 target and with the announced range for 2004, depends for the most part on the absence of renewed inflationary pressure from devaluation. Furthermore, it depends on greater growth not generating significant pressure on prices, which assumes that the economy will continue to count on sufficient productive capacity to attend to greater production without the appearance of any sector bottlenecks.

- As usual, the foregoing forecasts are subject to several risk factors:

    - There are risks of a rise in the exchange rate, both in the short run (due to both domestic and regional factors), as well as in the medium term (due to a drop in petroleum prices). In the recent past, acceleration in devaluation has been followed by increases in the expectations for inflation.

    - Credibility in achieving the inflation target for this year is low, and if inflation in December is greater than 6%, it would be the second consecutive year in which the inflation target has not been fulfilled, in spite of having been defined in the form of a range (5%-6%).

- Closure in the production gap is occurring more rapidly than projected in previous reports. Even though a reduction in the production gap has been one of the objectives of monetary policy over the last few years, closure of the gap can lead to future increases in basic inflation when it is not accompanied by strong credibility in inflation targets.

- Inflation in foodstuffs is projected at 5.0% on the average for 2004, which contributes significantly to the fact that forecasts for total inflation are fluctuating in the range of 3.5%-5.5% for that year. It is obvious that there is a lot of uncertainty as to the expected performance of this variable, given the high variance that characterizes it.

- Finally, in the medium term, one of the main risks is associated with the evolution of fiscal variables, which affect the perception of agents as to macroeconomic stability, and therefore, their expectations for devaluation.

C. Monetary Policy Decisions

- Taking into account that inflation to the consumer has begun to descend and that forecasts for inflation suggest that this tendency can be maintained over the coming year and a half, that the exchange rate has maintained a stable level, and that the present foreign and domestic environments do not lead us to foresee any inflationary pressures arising that would compromise a long term price stabilization policy, the Board of Directors at its July 25th Meeting decided:

- To keep Bank of the Republic intervention interest rates unaltered, which will continue thus: minimum expansion 7.25%, Lombard expansion 11%, maximum contraction 6.25% and Lombard contraction 5.25%.

- Not to carry out option auctions in the month of August intended to accumulate or reduce accumulation of international reserves, given recent performance of the exchange market.