

# INTRODUCTION

*The crisis in the world economy will go down in history as the most severe one since the Second World War. In an environment as difficult as this, the growth of the GDP in Colombia was 0.4% in 2009, which is better than the registers of developed economies (-3.2%) and than the average for Latin America (-2.3%). Reaching a low inflation in Colombia is a historical event. It is an asset that must be preserved for the future.*

The crisis in the world economy which started in the last quarter of 2008 and hit its worst point in the first half of 2009 will go down in history as the most severe one since the Second World War. In the first half of last year, the global economy shrank 4.3%, the total volume of trade fell 18.4%, industrial production plunged 20.4% and unemployment in developed economies rose close to 2.4 percentage points (pp) in comparison to the levels prior to the crisis. However, in spite of the intensity that the international crisis had developed around March, 2009 after the bankruptcy of important financial entities, the general collapse of confidence and the sharp fall in the prices of assets, the worse scenario that many analysts feared would not have materialized: an economic crisis similar in magnitude to the Great Depression of the Thirties, which it took ten years for the world to recover. Actually, in the second half of 2009, production and world trade reversed their trend, financial and real market confidence returned, the prices for assets rose and final demand was strengthened. Thus, the fall in the gross domestic product (GDP) for the world in 2009 turned out to be less than what had been forecast by the International Monetary Fund (IMF). As a result, its projections for 2010 are now more optimistic.

The basic reason for the significant change in the trend for the world economy in the second half of 2009 was a policy of unprecedented macroeconomic stimulus. The monetary policy in the majority of the advanced countries and in many of the emerging ones was broadly expansionary with reductions in the interest rates to historically low levels and an sharp increase in the balance sheets of the central banks of the main developed countries. The fiscal policy also played a definitive role in supporting the world economy with expenditure expansion programs and, in some cases, reductions in taxes, all of which significantly widened the fiscal deficit and public debt in developed

countries and in some emerging countries. Specifically, the timely support that the monetary and fiscal policy successfully supplied to the financial sector in the United States and in some European countries was a crucial ingredient in detaining the vicious negative cycle between the real and the financial sectors that threatened to create a second Great Depression.

In a world environment as difficult as this, the Colombian economy had a GDP growth of 0.4% in 2009, a performance that is relatively favorable if it is compared to the fall seen in advanced economies (-3.2%) or to the Latin American average (-2.3%). Of course, Colombia was not immune to the crisis since, if its growth last year is compared to the average growth in 2007 and 2008, the slowdown in 2009 was 4.6%. The main channels through which the international crisis affected the economic performance of Colombia were the contraction in foreign demand for our exports products along with the deterioration on the domestic level in consumer and business confidence. This slowed down household consumption and caused a sharp drop in investment. The effects of the international crisis on the Colombian economy which began to be strongly felt in the last quarter of 2008 –with a 1% shrinkage in the GDP– continued to seriously affect the economic performance during the first half of 2009 when a 0.4% fall in the GDP in annual terms was registered. This contraction, although significant, turned out to be lower in magnitude than that observed in the last quarter of 2008. This showed the strength of the Colombian economy compared to the external crisis which was going through its worst period during those months. The slowdown in growth was reflected in an increase in the unemployment rate which reached 12.3% for the 13 main metropolitan areas in the last quarter of 2009 compared to 10.7% for the same period in 2008. For the national total, unemployment figures were 11.3% compared to 10.5% for the same periods. As is discussed in this *Report*, the higher unemployment was the consequence of a rise in the labor supply in 2009 which was not offset for by an increase in the demand for workers.

In the second half of 2009, some signs of reactivation linked to the recovery of the world economy, the effects of the expansionary monetary policy that have been in effect since the end of 2008, the counter-cyclical management of fiscal policy, particularly investment in civil works projects and the improvement in available household income resulting from the fall in inflation began to become evident. In spite of the above, the shrinking sales to Venezuela associated with sharp drop in their domestic demand and the trade restrictions that country imposed worked against the reactivation and the performance of the local economy in the second half of the year.

Just like the handling of the crisis in the rest of the world, in the case of Colombia, macroeconomic policy supplied a strong stimulus which was undoubtedly a fundamental element in preventing a more serious deterioration in the Colombian economy. On one hand, the monetary policy acted decisively and in a timely fashion with a reduction of 650 basis points (bp) –from 10% to 3.5%– in the intervention interest rate. It started on December, 2008 (50 bp) and became more intensified in the first half of 2009 (500 bp) when the GDP registered the largest annual falls and inflation declined beyond what was expected. This was possible thanks to the fact that Banco de la República's policies prevented an excess in private debt and of inflation expectations

between 2006 and 2008. On the other hand, the fiscal policy acted counter-cyclically by keeping the government's level of expenditure, which had been established previously in the Financial Plan for 2009, unchanged in spite of the imminent fall in tax revenue. Thus, a cutback in governmental expenditure was avoided at a time in which private demand was shrinking. This fiscal posture was possible thanks to the fact that the government started from a level of moderate debt and maintained access to the foreign and domestic financial markets. This made it possible for them to finance the larger deficit.

The results of the effort by monetary and fiscal policy to buffer the effect of the international crisis on the Colombian economy were evident over the course of 2009. As is explained in detail in this document, the reduction in Banco de la República's intervention interest rate was almost fully transmitted to the interest rates on deposits and even more than proportionally to the majority of the lending rates. This led the financial system's gross loan portfolio in national currency to reach a growth of 4.9% in 2009 in spite of the sharp contraction that the demand for credit suffered as a result of the economic slowdown.

In turn, the fiscal policy stimulus for economic activity was mainly given through the expansion of civil works projects (34%) which, along with other items, includes the construction of roads, ports, dams, pipe lines, etc. that for the most part are public projects. This led the construction sector to exhibit a growth of 12.8% in spite of the contraction that was seen in buildings (housing, shopping centers and warehouses). From the demand side, the growth civil works partly offset the drop that occurred in the rest of gross fixed capital formation (-12.4%) thus easing the fall in investment (-1.6%). Furthermore, a moderate expansion in government consumption (2.9%) and an almost zero growth in household consumption (0.1%) was also seen. This allowed the total consumption to rise 0.7%. Therefore, the expansion in public demand and the monetary stimulus described, helped to support the aggregate demand of the economy which had been acutely weakened by the contagion of the international crisis and the reduction in trade with Venezuela. If it had not been for that, there is no doubt that the figure for GDP growth would have been negative and unemployment higher than what was seen.

In the context of a reversal of the food and fuel price shocks and a reduction in the inflation expectations experienced in 2009, the expansionary macroeconomic policy did not generate inflationary pressures. Thus, at the end of the year consumer inflation stood at 2%, which is much lower than that registered in December, 2008 (7.7%) and the lowest since November, 1955. As a result, inflation's rising trend in 2007 and 2008 was broken and it was at the floor of the long term target range (between 2% and 4%). The drop in inflation was associated with the international recession which led to a significant reduction in the international prices for fuel and regulated goods, raw materials and food. In Colombia, the strongest effect was felt in the prices for food, which, after having hit 13.2% inflation in 2008, registered -0.3% in 2009. However, in addition to food, the weakening of domestic demand resulted in a decline in inflationary pressures on many other items in the consumer basket. Consequently, core inflation also declined over the last year. Thus, the average of the four indicators that are regularly estimated by Banco

de la República was 3.1% at the close of 2009 compared to 5.6% at the end of 2008. Among these, the drop from 5.1% in 2008 to 2.9% at the end of 2009 that was registered for the consumer price index (CPI) excluding food should be mentioned.

Reaching an inflation as low as it was in 2009 is a historic event. When the 1991 Constitution gave the Board of Directors of the Banco de la República (JDBR) the mandate to preserve the purchasing power of the currency, annual inflation was 30.5%. Almost two decades went by before the country achieved price stability and inflation reached its long term target established as a range of between 2% and 4%. This is an asset that should be maintained in the future. That is why this Report has dedicated a box that emphasizes the importance of keeping low, stable inflation. Being aware of this, the Board decided as of 2010 to adopt the long term target by means of which inflation expectations will be anchored and the country will enter a stage of price stability.

The outlook for the world economy for 2010 is the continuation of the recovery process that started in the second half of 2009. However, it is expected that this will be very unequal between countries and regions around the world since it will depend on the initial conditions before the shock, the responses of the monetary policy, and the particular characteristics of each economy. For the advanced economies, the IMF predicts that after the 3.2% contraction in 2009, there will be an expansion of 2% in 2010. This is a recovery that is still very weak since it will continue to be affected by the high rates of unemployment and public debt, a financial system that is still weak and in some cases, a level of household indebtedness that is still high. Emerging economies have a more encouraging outlook. This is a rate of growth that in 2010 could reach 6% thanks to the strength of their economic fundamentals and the rapid response of the economic policy to the crisis. Within this group, the developing economies in Asia will lead the recovery with an expected growth of 8.4% in 2010. In the case of Latin America, an average growth of 3.7% in 2010 is estimated. The countries for which better performance is expected are Brazil, with a growth of 5.6%, Chile (4.8%), and Peru (4.8%).

For the Colombian economy, the technical staff at Banco de la República estimates that the growth in 2010 will be within a range of 2% to 4%. The boost in emerging economies and some developed ones will promote Colombian growth since it will stimulate the demand for our exports. Likewise, the expected increase in the price of commodities as global demand strengthens will favor Colombian exports. Nevertheless, the favorable outlook for Colombia in international trade will be overshadowed by the drop in the trade with Venezuela due to the trade restrictions imposed by that country, the devaluation of the bolivar and the slow growth that is estimated for that economy. Another factor that could contribute to the growth of the output in Colombia would be the recovery of household consumption stimulated by the low interest rates and the positive effect on disposable income that the sharp fall in the interest rates has meant. However, the high rate of unemployment will continue to hinder the increase in household consumption. Still, even though public demand is expected to continue supporting growth, it is likely that its contribution will be lower in magnitude than what was seen in 2009 given the austerity in government expenditure intended to prevent an unsustainable

increase in public debt. Finally, other factors that will exercise a positive influence are foreign direct investment (FDI) targeting the mining sector as well as investments other than civil works that will be stimulated by the low interest rates and the recovery of business sector confidence.

This *Report* contains four chapters. The first one describes the world economic situation and its outlook for 2010. The second discusses the situation of the Colombian economy and highlights the results in 2009 and the outlook for this year. The third chapter analyzes the international reserves with regards to their composition and the recent performance of the investments. The fourth chapter gives the financial situation of the Banco de la República. Furthermore, the *Report* includes various boxes that delve into specific topics that are considered important.