

# I. INTRODUCTION

*The macroeconomic policies applied in Colombia since late 2003 have been decisive to preventing the change in the prospects for international financial markets from jeopardizing the vigorous growth now characterizing the Colombian economy.*

The report presented to the Congress of the Republic of Colombia describes the state of the Colombian economy in the early months of the year and prospects for the remainder of 2004. Economic activity continued to expand. According to the National Bureau of Statistics (DANE), gross domestic product (GDP) rose by 4.08% during the first quarter of the year. If illegal crops are excluded, the increase was 4.24%. Sectors such as construction (12.1%), commerce (5.8%) and industry (4.4%) were particularly important in terms of their evolution. Agriculture (illegal crops not included) grew by 4.03%. The external environment remained favorable for Colombia and the region, thanks to the trend in the demand for export products, better terms of trade and the influx of capital. Nevertheless, there were recent changes on the international financial markets, anticipating a possible interest-rate hike by the United States Federal Reserve Bank (Fed). This was manifest in high stock, financial and exchange market volatility in Colombia.

Chapter II of this report contains a brief description of the exchange intervention strategy Banco de la República is using as part of the inflation-targeting scheme. It is important to note that the combination of macroeconomic policies applied in Colombia since late 2003 has been decisive to preventing the change in prospects for international financial markets from jeopardizing the vigorous growth now characterizing the Colombian economy. The monetary and exchange policies adopted by the Board of Directors of Banco de la República (the Board) during those months were based on the assumption that low external interest rates were only temporary. Therefore, the possibility of a reverse in capital flows sometime in the future justified intervention in the exchange market to accumulate international reserves and to make the exchange rate less volatile. The strategy to this end called for purchasing substantial amounts of foreign currency, coupled with moderate reductions (on two occasions) in the Bank's intervention rate, as permitted by the tendencies in inflation.

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On the fiscal front, accounts have evolved as planned at the start of the year, and the end of 2004 should see a consolidated deficit in the public sector equal to 2.5% of GDP. This would be on target. Further adjustments will be required in the medium term to achieve fiscal sustainability for the country and to reduce the public debt as a share of GDP. The approval of proposed pension and tax reforms would be of considerable help in this respect, as would passage of the bill to modernize the Budget Act.

Chapter III discusses the positive outlook for the economy during the remainder of the year. Economic growth is expected to be around 4.0%, exceeding the forecast in the last *Report by the Board of Directors to the Congress of the Republic* (3.8%). Despite the volatility on financial markets, the external environment should continue to be favorable. As a result, external demand should continue to increase and terms of trade are expected to remain high. In addition, external financing for the public sector during the current year is ensured by the national government's recent decision to use US \$500 million in international reserves made available by Banco de la República as of November 2003 to substitute the foreign bond issues scheduled for this amount. Under these circumstances, actual projections for the balance-of-payments current account deficit are lower than those indicated in the March 2004 *Report to Congress*, since the current account deficit is expected to equal 1.8% of GDP and not 2.6%. This is due to an increase of 11.9% in imports and a growth of 14.5% in exports. Chapter III also shows that, despite a possible increase in the annual rate of inflation in the third quarter, projections are favorable, as annual inflation will surely be somewhere in the 5%-to-6% target range by the end of 2004.

*The rate of employment in Colombia continues to depend on the recovery in production.*

Employment in Colombia remains tied to the recovery in productive activity. In fact, economic growth has allowed for an increase in both the extent and quality of employment, as suggested by the recent decline of almost 1.0 percentage point (pp) in unemployment in the 13 major cities for the month of May. Yet, further economic expansion is essential for increased recovery in employment and an even bigger decline in unemployment.

The findings of a study conducted by Banco de la República on how the minimum wage affects income distribution in Colombia are discussed at the end of Chapter III. The existence of a minimum wage has a positive impact on minimum-wage earners, but is negative for those who earn less. This last group includes the unemployed and the underemployed, who face fewer possibilities for formal employment.

Chapter IV discusses how Colombia's international reserves were managed in the early part of the year. Despite an accumulation of reserves, indicators of the country's external vulnerability are still near their critical values.

Chapter V lists projected profits for 2004 at 140.3 billion pesos, which is less than the profits reported for 2003 and the projection in March 2004.

This is due to depreciation of the international reserve portfolio in June, owing to the rise in international interest rates, a stronger dollar against currencies such as the euro and the yen, and the decline in gold prices on the international market. Although the projected return on reserves in 2004 points to a low yield on the portfolio, unanticipated movement in the value of other currencies against the dollar or in the price of gold pose certain risks that could affect the Bank's financial statements by the end of the year.

Banco de la República has a reserve to absorb an eventual exchange loss provoked by changes in the dollar compared with other currencies. This reserve expands with the profits generated by an increase in the net value of assets and liabilities in foreign currency due to exchange variations between the U.S. dollar and other reserve currencies, or declines in the event of losses registered for this item. Therefore, even if Banco de la República were to suffer exchange depreciation losses in 2004, they could be offset with existing reserves.

*Despite an accumulation of reserves, indicators of the country's external vulnerability are still at levels near their critical values.*