BANCO DE LA REPÚBLICA COLOMBIA

INFLATION REPORT

March 2008

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Banco de la República
CENTRAL BANK OF COLOMBIA
Bogotá, D. C., Colombia

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The Inflation Targeting Strategy in Colombia

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is mainly intended to keep inflation low and to ensure stable long-term growth in output. Accordingly, the objectives of monetary policy combine the goal of price stability with maximum sustainable growth in output and employment. In this respect, monetary policy complies with the constitution and contributes to the well being of the Colombian population.

HORIZON AND IMPLEMENTATION

The Board of Directors of the Central Bank of Colombia (BDBR) sets quantitative inflation targets for the current year and the next. BDBR policy initiatives are designed to meet each year's target and to provide for long-term inflation at around 3%. The annual variation in the consumer price index (CPI) is the inflation measurement used.

THE DECISION-MAKING PROCESS

Monetary-policy decisions are based on an analysis of the current state of the economy and its prospects for the future and on an assessment of the inflation forecast in light of the targets. If the assessment suggests, with enough certainty, that inflation will deviate from its target under current monetary-policy conditions, and that the deviation would not be due to temporary shocks, the BDBR modifies its policy stance. This is accomplished mainly by changing the intervention interest rate (charged by the Central Bank of Colombia on short-term liquidity operations).

COMMUNICATION AND TRANSPARENCY

Decisions on monetary policy are announced after meetings of the Board of Directors, through a press bulletin posted immediately on the Bank's website (www.banrep.gov.co). Inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and help to enhance its credibility. Specifically, these reports i) let the public know how the Board of Directors and the Technical Governor of the Bank view the recent and anticipated changes in inflation and its short and medium-term determinants; ii) explain the implications of those determinants for monetary-policy management within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions made during the quarter; and iv) provide information that helps economic agents to form their own expectations about future developments with respect to inflation and growth in output.

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The consumer price index (CPI) registered an annual increase of 5.93% in March 2008. This surpasses the rate witnessed the quarter before and is 143 basis points (bp) above the top of the inflation-target range for 2008. Nearly half the CPI build-up (45%) during the quarter was due to higher food prices, particularly for foods affected by the increase in international commodity prices.

Non-food inflation in March 2008 (4.67%), which was up by 24 bp with respect to December 2007, explains the other 55% of the rise in inflation during the quarter. Most of this increase originated with hikes in the price of regulated goods and services, particularly the spike in fuel prices and, to a lesser degree, the adjustment in rates for public utilities such as water and electricity.

There were, however, other factors that suggested the presence of inflationary pressure, mostly due to the momentum in local demand. They are described below.

1. The various core inflation measurements, which leave out the price of goods and services affected by temporary supply shocks, while including those affected by monetary policy measures, remained high throughout the first quarter of 2008 and showed no signs of declining.

2. Non-tradable inflation without food and regulated prices, which is determined largely by the force of local demand, declined between January and March 2008, but continued to exhibit annual rates above the target range for inflation this year.

3. The Colombian peso appreciated 14% (annual average rate) during the first quarter of 2008. This situation was accompanied by a major influx of foreign direct investment, mostly in oil and mining, with specific investments in companies in other sectors. However, revaluation of the peso is not been reflected in less inflation in goods and services that

are affected by the exchange rate. In fact, the first quarter saw a slight upward trend in tradable inflation, excluding food and regulated prices.

4. The increases in gross domestic product (GDP) (8.1%) and local demand (10%) during the fourth quarter of 2007 far surpassed the Bank's forecasts and the market's expectations, and continue to outpace growth in the productive capacity of the economy. The accumulated increase in real GDP was 7.5% in 2007. Growth in demand eased somewhat between the first and third quarter of last year, but accelerated in the fourth quarter due to the added momentum in investment and consumption.

5. As to the first quarter of 2008, the figures on economic activity show that aggregate demand has slowed, but remains robust. Between January and March, the average Fedesarrollo consumer confidence indicator was close to the average registered in 2007. By February 2008, commercial retail sales had experienced a sizeable increase (6.9% in real terms) and imports of consumer goods also registered high growth rates.

6. On the supply side, industrial growth rates remained low in February 2008, but registered an annual variation above their historic average (even when the 1999 recession is excluded from the average). The indicators of installed capacity continued to slow, but are still high and close to those reported at the start of 2006. The inventory, order-volume and industrial-confidence indexes show signs of a moderate slowdown, but are still at favorable levels.

7. The inflation expectations implicit in government debt paper rose during the first two months of 2008, before declining sharply in March and early April. However, the level of this indicator and that of expectations reported in various surveys remained above the target for inflation.

8. Monetary aggregates declined between January and March of this year, following an upward trend during the last quarter of 2007. Nevertheless, the annual expansion in base money and the broader monetary aggregate (M3) continued to exceed the nominal increase in GDP estimated for the current year. March witnessed the continuation of more moderate growth in local currency loans, primarily due to less of an increase in the retail loan portfolio.

9. Nominal lending and deposit rates continued to climb during the first three months of the year. In real terms, interest on preferential loans was above its historic average, while total interest and interest on retail and ordinary loans was near or slightly below average.

10. On the external front, the news in late 2007 and early 2008 signaled the possibility of a slowdown in the United States economy during the first quarter of this year. The latest information suggests the slowdown in GDP in the US might not be as pronounced as was anticipated at the start of the year. However, the crisis in the financial system and the increase in risk levels and restrictions on credit indicate the United States economy may be in for a longer period of low growth, including 2009. Commodity prices remained high, bringing inflationary pressure to bear on that country's economy. Given this outlook, the markets expected less of a decline in the interest rate set by the US Federal Reserve Bank and forecast a possible pause at around the 2% level.

11. The large emerging economies, such as China and India, which require an enormous amount of commodities, continued to report high economic growth rates. Coupled with other factors (such as the increased demand for bio-fuels), this has helped to maintain the upward trend in international prices for a number of commodities exported by Colombia (oil, coffee, coal, gold).

Considering all these factors, Board of Directors raised the Central Bank's benchmark rate by 25 bp in February and held it steady at 9.75% in March. That same month, the Board also decided to purchase foreign exchange through auctions of put options to accumulate international reserves. This decision was in response to the uncertainty derived from the world economy. These auctions will be held monthly with a quote of US$150 million, which means US$1.8 billion can be acquired in one year through this mechanism. The Board will continue to keep a close eye on the international situation, as well as inflation, economic growth and their forecasts. It reiterated that monetary policy in the future will depend on whatever new information becomes available.

Board of Directors
The Central Bank of Colombia

INFLATION REPORT

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I. Recent inflation developments

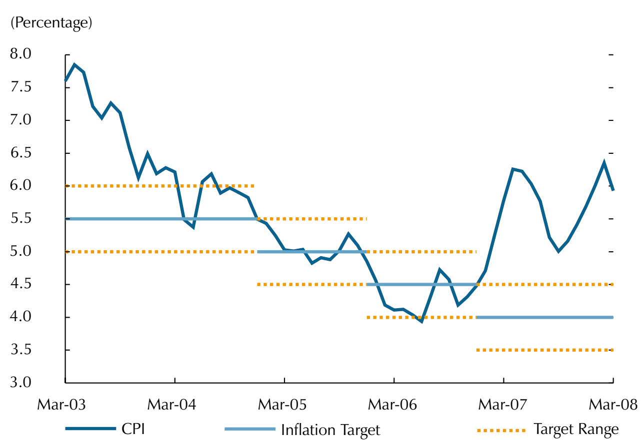
Annual inflation in March (5.93%) was more than forecast by the market and by the Bank's technical team, having exceeded the rate observed the quarter before and the target range for 2008.

The rise in inflation so far this year is explained largely by processed foods and regulated prices. The latter were affected by the increase in fuel prices and public utility rates, while processed food inflation was bolstered by international commodity prices.

GDP growth in the fourth quarter of 2007 was more than what was anticipated by the Central Bank of Colombia and by the market.

The restraint in growth reported between January and September 2007 reversed during the final quarter of the year. Private consumption and civil works construction were the items that increased the most.

Graph 1
Annual Consumer Inflation



Source: DANE and the Central Bank of Colombia

Annual consumer inflation was 5.93% by the end of the first quarter of 2008. This is 24 basis points (bp) above the annual rate reported in December 2007 by the National Bureau of Statistics (DANE) and 143 bp over the upper limit of the target range set by the Board of Directors of the Central Bank of Colombia (BDBR) for inflation in 2008 (between 3.5% and 4.5%). In February, after five months of steady increases, inflation reached a maximum of 6.4%, before declining in March, as the market and the Central Bank had expected (Graph 1).

Nevertheless, annual inflation in the first quarter of 2008 far surpassed the Central Bank's forecast in

Inflation at March exceeded the predictions of the Central Bank and the market.

December 2007 (5.1%). This underestimation is explained largely by the way food inflation behaved; it was 8.6% as opposed to a forecast of 6.7% in the last quarterly report. The figure reported for non-food inflation (4.7%) also was over the Central Bank's forecast (4.4%). Although non-tradable inflation, excluding food and regulated prices, coincided with what was predicted (5.1%), the figures for tradables, excluding food and regulated prices, and for regulated prices surpassed the estimate in the December report (Table 1).

Inflation during the first quarter continued to be affected by rising international fuel prices and by the impact those hikes had on food prices. Likewise, at local level, the rapid expansion in demand in Colombia and from Venezuela, coupled with less cyclical growth in the supply of several perishable foods items, also brought inflationary pressure to bear. These effects were manifest primarily in more inflation in food and public utilities, including transportation. Activation of the indexing mechanisms applied to public utilities would have contributed to higher prices for those items in March (Table 2).

Table 1
Observed Annual Inflation and the Forecast for March 2008
(Percentage)

	Forecast in September 2007	Forecast in December 2007	Observed
Total Inflation	**4.5**	**5.1**	**5.9**
Non-food Inflation	**4.3**	**4.4**	**4.7**
Non-tradables	5.4	5.1	5.1
Tradables	1.2	2.0	2.6
Regulated Prices	6.9	7.1	7.7
Food Inflation	**5.0**	**6.7**	**8.6**

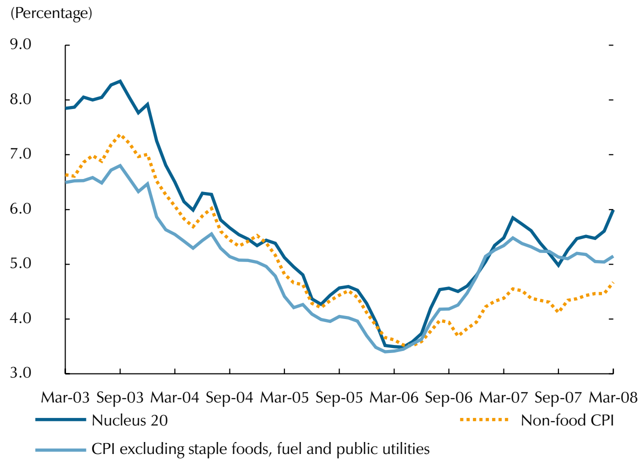
Source: DANE, calculations by the Central Bank of Colombia

Table 2
Annual Inflation Breakdown According to Upward Pressures
(Percentage)

Description	Weight	Annual Growth: Dec-07	Jan-08	Feb-08	Mar-08	Year-to-date Participation in the Build-up
Total	**100.00**	**5.69**	**6.00**	**6.35**	**5.93**	**100.00**
Non-food	**70.49**	**4.43**	**4.46**	**4.47**	**4.67**	**55.55**
Tradables	24.67	2.28	2.09	2.18	2.36	4.21
Non tradables	36.77	5.19	5.23	5.27	5.09	(19.38)
Regulated	9.04	6.42	6.81	6.57	7.71	70.72
Food	**29.51**	**8.51**	**9.39**	**10.47**	**8.61**	**44.45**
Vegetables, fruits, tubers and milk	7.15	6.66	10.44	13.68	6.59	19.69
Cereals, oils and others	5.35	9.12	8.62	9.15	11.13	50.68
Food Outside the Home and Others	9.52	7.65	7.43	7.02	6.77	(33.03)
Beef and substitutes	7.48	11.12	11.27	12.14	11.36	7.11

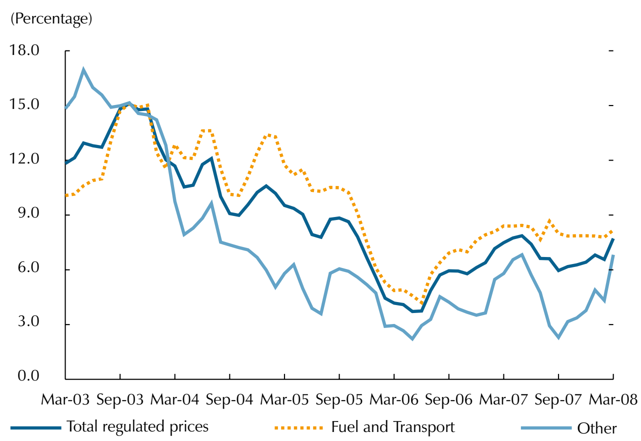
Fuente: DANE, cálculos del Banco de la República.

Graph 2
Core Inflation Indicators
Annual Variation



Source: DANE, calculations by the Central Bank of Colombia

Graph 3
Regulated CPI
Annual Variation



Source: DANE, calculations by the Central Bank of Colombia

A. CORE INFLATION

Most core inflation indicators continued to climb during the first quarter of 2008, maintaining the tendency observed since September 2007. In March, the average of the three indicators was 5.3%, having been 5.0% in December and 4.7% in September 2007. The increases were important, particularly in the non-food consumer price index (CPI) and in nucleus 20 inflation, which was 6.0% by the end of the quarter. At that point, the three indicators were over the top of the target range set by the BDBR. CPI excluding staple foods, fuel and public utilities remained relatively stable, but was above 5% (Graph 2). A fourth indicator that excludes food and regulated price CPI was even more stable, closing out the quarter at 3.9%, which is near the central point of the target range for 2008.

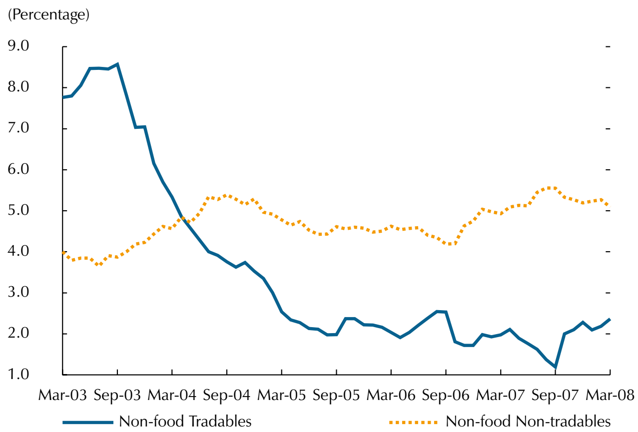
In general, the various core inflation indicators continued to be pressured by prices for non-perishable foods, public utilities and fuel (i.e. regulated prices) and, to a lesser degree, by prices for a number of tradable goods.

Regulated price inflation went from 6.4% in December 2007 to 7.7% in March. This explains more than 70% of the build-up in inflation during the first quarter of the year. Throughout 2007, this group was affected by constant hikes in local gasoline prices, which is why regulated price inflation was far over the Bank's inflation target. These pressures have continued so far during 2008 and will likely be present for the rest of the year, if oil prices remain high, which could affect the price of gasoline and transportation inside the country.

Regulated price inflation was responsible for 71% of the build-up in inflation during the quarter.

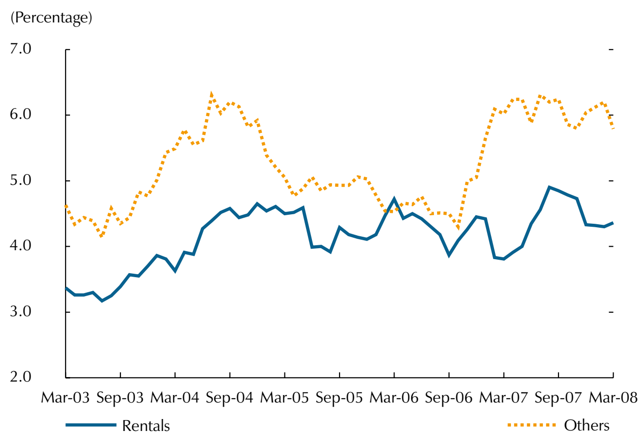
Price indexation for public utilities, especially water and electricity, is another factor that influenced regulated prices (Graph 3). The formulas used to determine regulated prices contemplate a revision in rates whenever a three (3) percentage point build-up in inflation occurs. The authorized hikes are normally of a similar proportion and begin to be charged approximately two months later. Given the increase in inflation at the start of the year and the forecast for inflation, these rates are likely to be indexed again in the coming quarters. If so, the build-up in inflation in recent quarters, due largely to exogenous shocks to the country's monetary policy (external fuel and food

Graph 4
Tradable and Non-tradable CPI Excluding Food and Regulated Prices



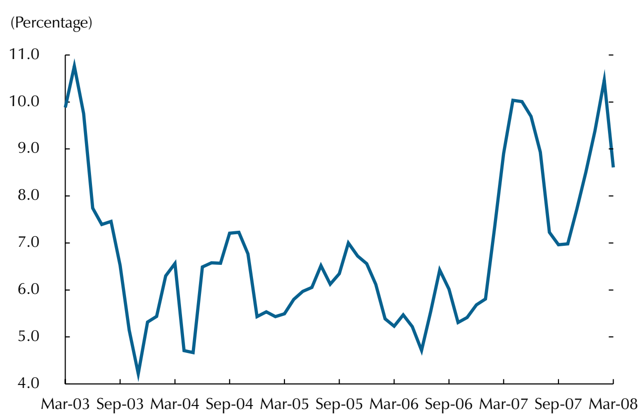
Source: DANE, calculations by the Central Bank of Colombia

Graph 5
Non-tradable CPI: Rentals and All Others
Annual Variation



Source: DANE, calculations by the Central Bank of Colombia

Graph 6
Food CPI
Annual Variation



Source: DANE, calculations by the Central Bank of Colombia

prices), would have a permanent effect as a result of indexation.

Tradable inflation, excluding food and regulated prices, went from 2.3% in December 2007 to 2.4% in March. Although inflation in this group is still under the bottom of the target range, it has exhibited an upward trend since October 2007 that is inconsistent with the high amount of peso appreciation observed since the end of last year and, particularly, during the first quarter of 2008. This group seems to have been affected by high international prices for raw materials, which continue to climb and have influenced local prices for certain products, such as cleaning supplies, batteries, medicines, airline tickets and jewelry, among others. Residential telephone rates also made an important contribution to the increase in tradable CPI inflation in recent months, excluding food and regulated prices (Graph 4).

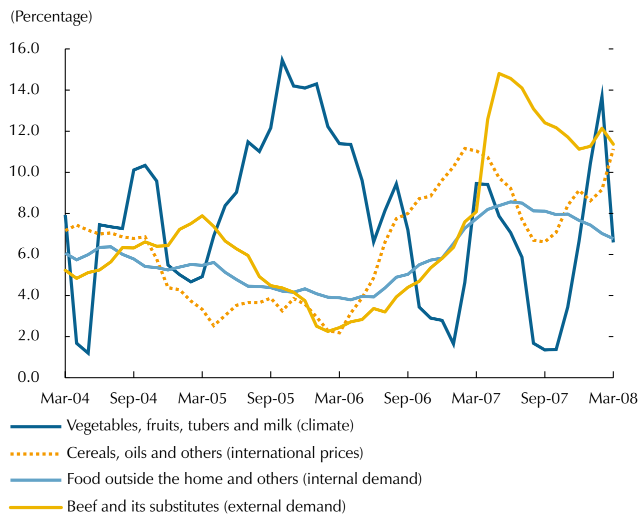
The non-tradable CPI, excluding food and regulated prices, was only sub-basket not to exert upward pressure on consumer inflation at the start of the year. In fact, inflation in that group declined slightly between December and March (Graph 4 and Table 1), but it is still over the top of the target range. Within the non-tradable group, rental inflation was around 4.3%, after declining at the end of last year. The rest of the group remained at around 6% during the last twelve months (Graph 5).

B. FOOD INFLATION

As anticipated, annual food inflation fell sharply between February and March (Table 2 and Graph 6), interrupting the upward trend in this variable observed since September 2007. However, compared to December, a slight rise was still evident and kept food inflation well above total inflation.

The high rate of food inflation observed so far this year is due primarily to the internal items most directly related to international prices; namely, imported foods such as cereals and oils, among

Graph 7
Food Inflation Breakdown
Annual Variation



Source: DANE, calculations by the Central Bank of Colombia

others. In fact, inflation in cereals and oils went from 9.1% in December to 11.1% in March. Staple foods (vegetables, fruits, tubers and milk) also pushed up inflation during the first quarter of the year, as did beef and its substitutes, but less so (Graph 7).

As shown in the last edition of this report, the surge in food inflation during 2007 and 2008 to date is not exclusive to Colombia. Its scope is global and includes both emerging and developed countries.

At the international level, it is associated with the sharp rise in international fuel prices, which has bolstered the substitution of food crops for crops used to produce fuel. It also has raised freight rates and prices for a number of agrochemicals.

High food prices at the international level also reflect the sharp rise in world demand, which is concentrated particularly in the large emerging economies such as China and India. Added to this is bad weather, which has contributed to a short supply on the world market, and speculation associated with a weaker dollar worldwide. On the one hand, the tendency among investors has been to seek refuge in the commodity markets, given increased risk perception in the developed markets. On the other, because the prices for raw materials are set in dollars, they tend to rise when the dollar goes down. Lastly, a number of grain-producing countries have begun to place restrictions on their farm exports. This will aggravate the food shortage on the international market.

In addition to these pressures, it is possible that food prices in Colombia also have affected by exports to Venezuela and the eventual consolidation of a cattle retention phase.

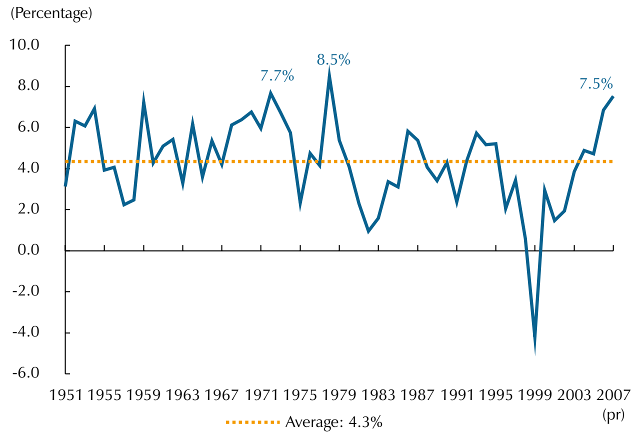
C. FACTORS THAT DETERMINE INFLATION

1. Aggregate Demand

Non-tradable CPI, excluding food and regulated prices, was the only sub-basket not to exert pressure on inflation.

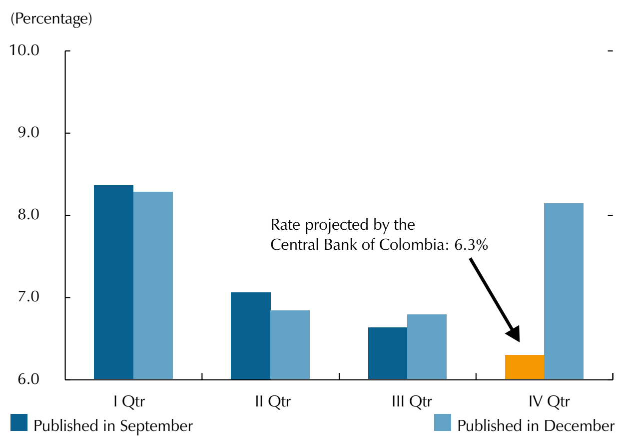
During the fourth quarter of 2007, GDP growth and local demand far exceeded the Bank's forecasts and the market's expectations, maintaining levels above those of the productive capacity of the economy. According to DANE, in annual terms, the increase in GDP between August and December 2007 was 8.1%, while the increase in internal demand was 9.7%. With this new figure, economic growth for all of 2007 was 7.5%, which is 0.2 pp over the top of the range projected in the last report. This is the third largest annual variation since 1951 (Graph 8) and the second, if GDP per capita is taken into account.

Graph 8
Annual GDP Growth



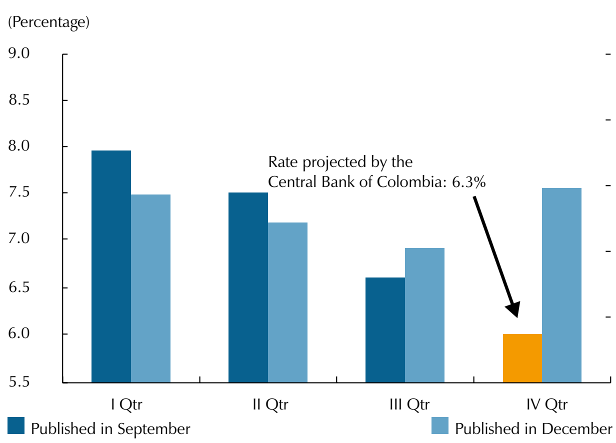
(pr) Preliminary
Source: DANE, calculations by the Central Bank of Colombia

Graph 9
GDP Growth in 2007



Source: The Central Bank of Colombia

Graph 10
Growth in Household Consumption during 2007



Source: The Central Bank of Colombia

In addition to the fourth-quarter figure, DANE also revised the increase in GDP for the three preceding quarters. Specifically, growth during the third quarter was estimated at 6.8%, following an initial estimate of 6.6%. When the new figures are taken into account, one sees that the gradual economic slowdown forecast for the second half of the year and contemplated in past editions of this report did not occur (Graphs 9 and 10).

From the standpoint of spending, the major discrepancies between what was forecast and actually reported centered on final consumption and investment in civil works. As to the first of these aggregates, most of the increase was in government consumption, which exceeded expectations; however, private consumption was more dynamic than anticipated, perhaps because households had more available income due to the increase in terms of trade and the receipt of more remittances, among other reasons. Civil works exceeded the forecasts, due to added highway investment associated with the national government's Plan 2,500.

Broadly speaking, the significant momentum in local demand continued throughout 2007, similar to the extent registered in 2006. Growth slowed somewhat between the first and third quarters, particularly because of investment. However, this weak tendency did not continue during the fourth quarter when local demand accelerated again (by 10%), thanks to investment in civil works and consumption. The same was true of household consumption, which dipped slightly during the first three quarters of the year. However, that slump reversed itself during the fourth quarter (Table 3).

As to external demand, the fourth quarter also witnessed a great deal of momentum with respect to exports in pesos, which grew by 9.2% as opposed to 7.7% during the previous quarter. Growth for 2007 as a whole was 7.5%, which is slightly less than the figure reported a year earlier. Imports in pesos accelerated as well at the end of 2007 (16%), although their growth rate for the entire year (16.4%) was less than in 2006 (20.8%) (Table 3).

Table 3
Real Annual GDP Growth by Type of Expenditure: 2006 and 2007
(Percentage)

	2006	2007				
		Mar-07	Jun-07	Sep-07	Dec-07	Total
Final Consumption	**5.6**	**5.6**	**6.0**	**6.7**	**6.9**	**6.3**
Households	6.6	7.5	7.2	6.9	7.6	7.3
Government	2.1	(0.4)	1.9	5.7	4.6	2.9
FGross Capital Formation	**26.9**	**33.4**	**19.3**	**14.4**	**19.7**	**21.2**
Gross Fixed Capital Formation (GFCF)	18.3	29.7	13.8	11.8	19.2	18.2
GFCF without civil works	18.5	25.6	12.1	9.8	17.0	15.8
Civil works	17.2	45.2	20.5	20.2	28.6	28.2
Variation in inventories	201.2	71.0	68.2	33.2	23.2	44.4
Local demand	**9.8**	**11.5**	**9.0**	**8.5**	**10.0**	**9.7**
Total exports	**7.8**	**7.5**	**5.6**	**7.7**	**9.2**	**7.5**
Total imports	**20.8**	**21.0**	**14.8**	**14.3**	**16.0**	**16.4**
GDP	**6.8**	**8.3**	**6.9**	**6.8**	**8.1**	**7.5**

Source: DANE, calculations by the Central Bank of Colombia

Table 4
Colombian Exports and Imports
(Percentage of annual variation in dollars)

	Exports: FOB	
	2006	2007
Total	16.6	23.0
Traditional	13.9	20.3
Non-traditional	19.3	25.6
	Imports: CIF	
	2006	2007
Total	23.4	25.7
Consumer goods	32.8	28.4
Raw materials	21.1	22.9
Capital goods	21.3	27.7

Source: DANE, calculations by the Central Bank of Colombia

Foreign sales in dollars experienced an annual increase of 23.0% during 2007, which is 6.4 pp more than in 2006. As a matter of fact, non-traditional exports grew by 25.6% and traditional exports, by 20.3%. The annual variation in imports was 25.7%, up 2.4 pp from the year before. A breakdown of sales according to the CUODE classification (use and destination of goods and services) shows an increase of 28.4% in imports of consumer goods, 22.9% in raw materials and 27.7% in capital goods (Table 4).

On the supply side, the sectors that contributed the most to the rise in output during 2007 were construction (particularly civil works), transport, the manufacturing industry and commerce (including restaurants and hotels) (Table 5).

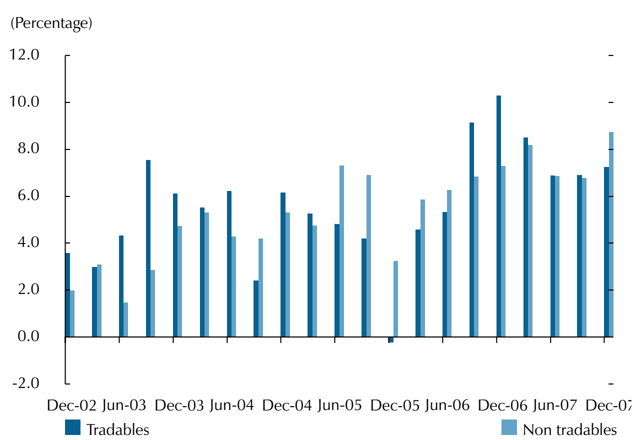
A look at the non-tradable and tradable sectors shows the first registered the best performance during 2007, above all in the last quarter, when non-tradables were up by 8.7%, primarily as a result of construction and commerce (including repairs, restaurants and hotels). The annual increase in tradable activities stabilized at rates near 7.0% as of the second quarter of 2007, following a tendency to accelerate as of the first quarter of 2006 (Graph 11). Despite less momentum, the pace of growth in tradables during 2007 was the second highest since 1994; the first was in 2006. This suggests that real peso

Table 5
Real Annual GDP Growth by Sectors
(Percentage)

	2006	2007				
		I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Total
Agriculture, forestry, hunting and fishing	2.3	1.4	2.5	3.1	3.3	2.6
Mining and quarries	0.1	0.3	5.2	3.6	9.2	4.6
Electricity, gas and water	3.0	3.9	1.8	2.0	1.7	2.3
Manufacturing industry	10.8	14.4	12.1	8.1	8.3	10.6
Construction	14.8	30.5	6.9	2.7	16.0	13.3
Buildings	13.3	19.9	(2.2)	(8.8)	7.3	3.2
Civil works	17.2	45.3	20.5	20.3	28.6	28.2
Commerce, repairs, restaurants & hotels	11.1	12.3	10.1	10.0	9.4	10.4
Transport, storage & communication	10.3	10.4	12.5	12.4	14.4	12.5
Financial, insurance, real estate and business service companies	1.4	4.9	15.7	3.6	9.5	8.3
Social, community and personal services	2.2	0.5	2.1	5.1	4.7	3.1
Financial intermediation, measured indirectly	(6.7)	9.0	81.9	1.7	20.2	22.5
Sub-total: Aggregate value	6.4	7.6	6.2	6.2	7.7	6.9
GDP	**6.8**	**8.3**	**6.9**	**6.8**	**8.1**	**7.5**

Source: DANE, Calculations by the Central Bank of Colombia

Graph 11
Annual GDP Growth in Tradables and Non-tradables



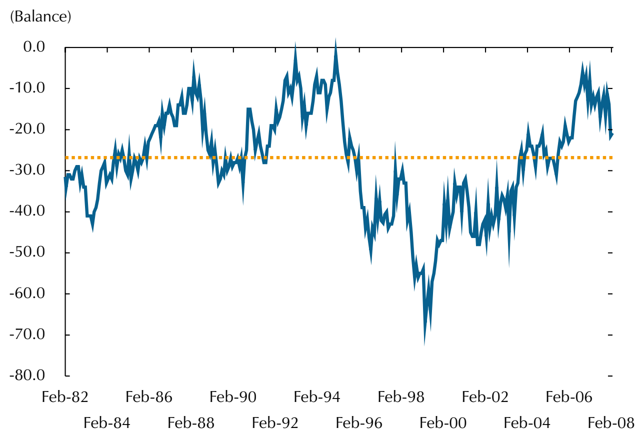
Source: DANE, calculations by the Central Bank of Colombia

revaluation did not have a substantial effect on the good performance of these sectors during 2007.

2. Surplus Production Capacity

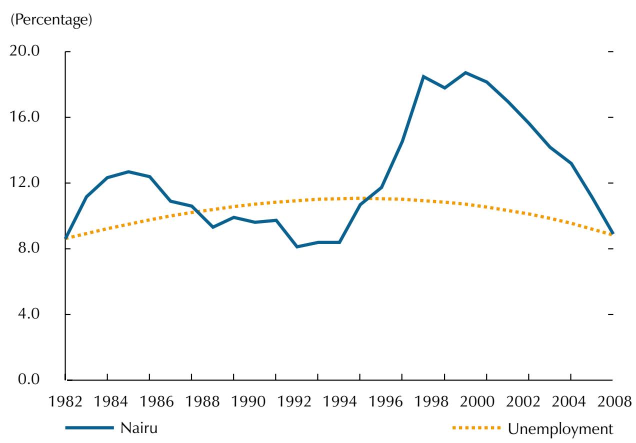
The various indicators of production capacity for the first quarter of 2008 suggest the positive momentum in economic activity continued. However, the build-up in pressure from demand did not continue and even may have declined. Variables such as the percentage of businessmen who believe their installed capacity is insufficient to supply the demand anticipated for the next twelve months have declined since the second half of last year (Graph 12). The same occurred with measurements of installed capacity utilization (ICU); namely, those of the National Association of Industrialists (ANDI) and the measurements taken by Fedesarrollo.

Graph 12
Demand Expected in the Next Twelve Months Compared to Installed Capacity



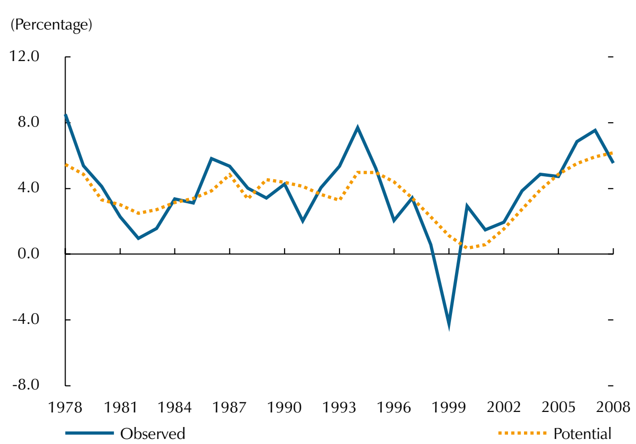
Note: The series is seasonally adjusted.
Source: Fedesarrollo, calculations by the Central Bank of Colombia

Graph 13
Unemployment Rate and Nairu



Source: DANE, calculations by the Central Bank of Colombia

Graph 14
Observed and Potential GDP Growth



Source: DANE, calculations by the Central Bank of Colombia

Despite less capital utilization, as suggested by the changes in ICU, the use of manpower is growing, as indicated by the narrowing gap between observed unemployment and the Nairu (non-accelerating inflation rate of employment) estimated by the Bank (Graph 13). This closing gap is indicative of a gradually tightening job market and, if this tendency becomes more pronounced, it could exert pressure on wages and prices.

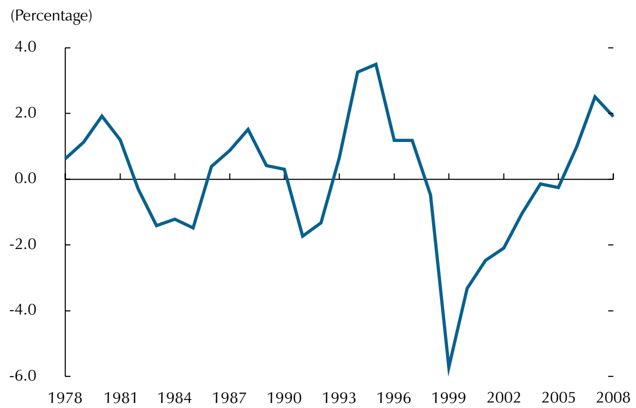
The latter is coherent with the acceleration in the wage indicators presented in the following section. Apparently, those pressures have not been fully contained by the gains in productivity or by the sharp rise in investment. Nevertheless, there continues to be a substantial increase in labor productivity (output/man hour) in industry and commerce. The rise in urban labor productivity was confirmed by other indicators as well. It should be noted that this growth cycle has gone on for nearly five years.

The central scenario for this report takes into account the fact that most indicators of productive capacity utilization show a change in trend as of late 2007 or early 2008. However, it also is important to point out that the extent of productive capacity utilization remains high.

The breakdown of growth between productive factors and productivity in 2008 is expected to show less intensive capital utilization and a more pronounced use of labor than in 2007. By the same token, potential output is expected to increase by about 6% (Graph 14), which is more than was forecast in the last report. In other words, more growth in 2007, compared to the forecast, was matched by an increase in the productive capacity of the economy.

Even so, the output gap in 2007 remained high and was similar to the estimate in the December report (Graph 15). This ratifies the existence of inflationary pressures in 2007 and at the start of 2008. However, if the economy grows by less than 6% in 2008, one would expect the output gap to continue to close and inflationary pressures to subside.

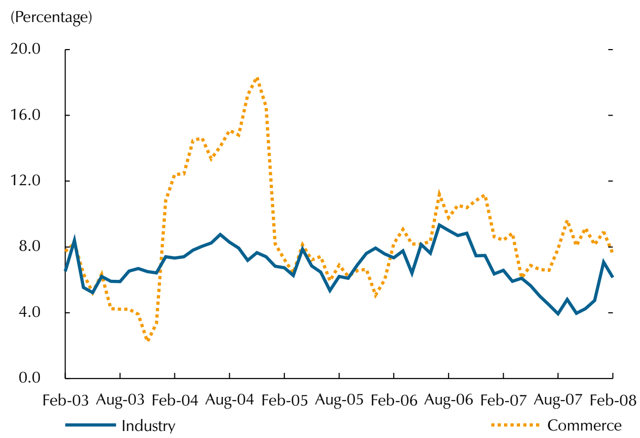
Graph 15
Output Gap



Source: The Central Bank of Colombia

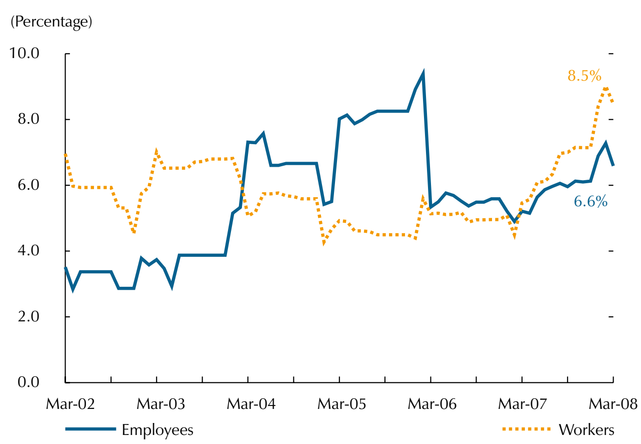
Graph 16

A. Nominal Wage Index for Industry and Commerce: Annual Variation



Source: DANE-Monthly Retail Trade Sample – Monthly Manufacturing Sample

B. Heavy Construction Wage Index: Annual Variation



Note: Laborers: foremen, manual workers, craftsmen and factory hands.
Employees: chief engineers, assistant engineers, clerks, accountants and watchmen
Source: ICCP-DANE

3. Wage Costs and the Job Market

In early 2008, a number of wage indicators in different sectors showed mounting increases that exceeded the target for inflation (Graph 16). There was an important build-up in the average annual industrial wage hike during the first two months of the year compared to the second half of 2007. During the same two months, wages in commerce continued to rise at high annual rates above 7.0%. Wages in the construction sector remained on an upward course during the first three months of the year, registering an average annual increase of 7.3% by March. The wage hikes for unskilled manpower (laborers) were larger than for skilled workers (employees).

As to employment, the first three months of the year continued to see reductions in the unemployment rate in all areas of the DANE Household Survey, although less so than at the end of last year. By March, quarterly unemployment was 12.0% nationwide and 12.4% for the thirteen major urban areas. This represents respective reductions of 0.8 pp and 0.9 pp compared to the same quarter in 2007. As occurred in 2007, these reductions in unemployment at the start of 2008 were more the result of a significant rise in job creation than a standstill in the labor supply. The annual increase in the employment rate by March was 4.8%, with approximately 840,000 new jobs created in the past year. This figure is more than the growth rate for the economically active population (3.8% or about 770,000 personas) (Table 6).

However, job creation in recent quarters has been concentrated among the self-employed, with an annual increase of 10.3% during the first quarter of the year. In contrast, the number of salaried employees during the same period declined by 2.5% (Graph 17). The standstill in salaried (and probably permanent) employment may be a normal phase in the cycle of this job market, which is particular to high economic growth periods such as the one at present. Given how costly it is to

At the start of 2008, a number of wage indicators registered increases above the inflation target.

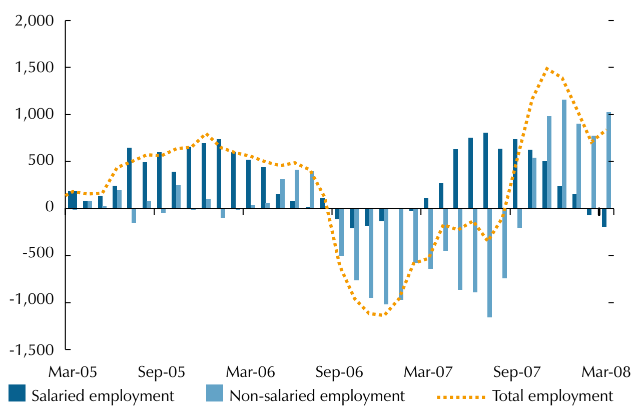
Table 6
Job Market Indicators (Quarterly moving average)

	Quarter (January-February-March)					
	2004	2005	2006	2007	2008	Difference between 2007 and 2008
Global participation rate						
National	61.6	59.6	59.7	56.9	58.0	1.1
Rural area	59.3	56.7	55.7	51.1	53.2	2.1
Municipal areas	62.4	60.6	61.1	59.0	59.7	0.7
Thirteen Cities	63.6	62.3	62.4	60.6	61.6	0.9
Occupation rate						
National	52.1	51.6	52.2	49.6	51.0	1.4
Rural area	53.1	51.8	51.1	46.7	48.7	2.0
Municipal areas	51.8	51.5	52.6	50.6	51.8	1.2
Thirteen Cities	52.8	52.5	53.6	52.6	53.9	1.4
Unemployment rate						
National	15.3	13.4	12.6	12.8	12.0	(0.8)
Rural area	10.3	8.6	8.3	8.5	8.4	(0.1)
Municipal areas	17.1	15.0	14.0	14.1	13.1	(1.0)
Thirteen Cities	17.1	15.8	14.1	13.3	12.4	(0.9)

Source: DANE - Chief Integrated Household Survey (GEIH in Spanish)

Graph 17
Job Creation

(Thousands of persons in the national total, third order moving average)



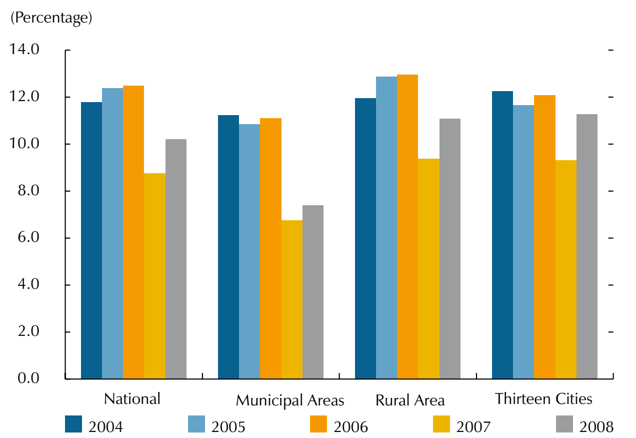
Source: DANE

hire manpower, employers may prefer to recruit independent workers on a scaled basis, with pauses, until possibilities for expanding their companies can be confirmed.

There has been an increase in objective underemployment rates, which measure the proportion of employed workers who are not satisfied with their jobs and continue to look for work. This is due mainly to the increase in workers who regard their jobs as inadequate in terms of pay (Graph 18). Nonetheless, this indicator does not necessarily reflect a downturn in the quality of employment, since it may be associated with an increase in the perception of opportunities for better wages in other jobs. This is compatible with the positive situation on the job market in Colombia.

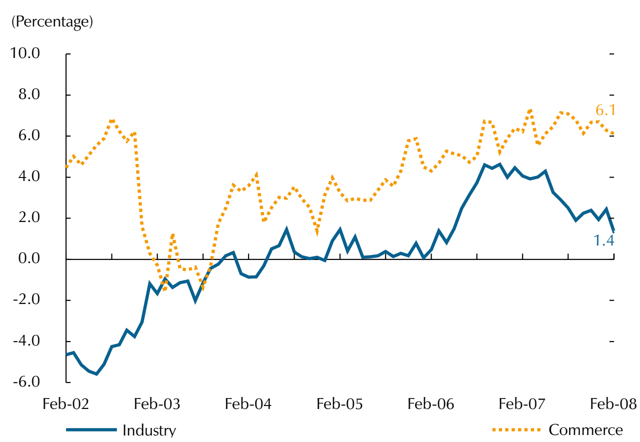
The sector surveys confirm the fact that the momentum in job creation during the first two months of the year was good, although slightly less than last year (Graph 19). According to the Monthly Manufacturing Sample (MMS), the annual increase in industrial employment by February was 1.4%. That

Graph 18
Objective Underemployment Rate
(January-February-March)



Source: DANE

Graph 19
Employment in Industry and Commerce
Annual Variation



Source: DANE-Monthly Retail Trade Sample – Monthly Manufacturing Sample.

same month, for the first time during the current decade, permanent employment increased more than temporary employment. Employment in commerce rose in February at an annual rate of 6.1%, rounding out twelve months of growth above 6.0%. In turn, the figures for social security show a sharp increase in affiliates by January. This is true of family subsidy and pension funds alike, suggesting the jobs being created are in the formal sector and of good quality (Table 7).

The pace of wage hikes and the sizable increase in the main job indicators during the first quarter point to a tightening market. This raises the risk of pressure on labor costs that eventually may be passed on to inflation. In an inflationary situation like the one at present, with high expectations that exceed the targets for inflation, that risk is mounting. Whether or not those pressures persist will depend largely on the pace at which the job market continues to tighten in the next few quarters.

4. Other Costs

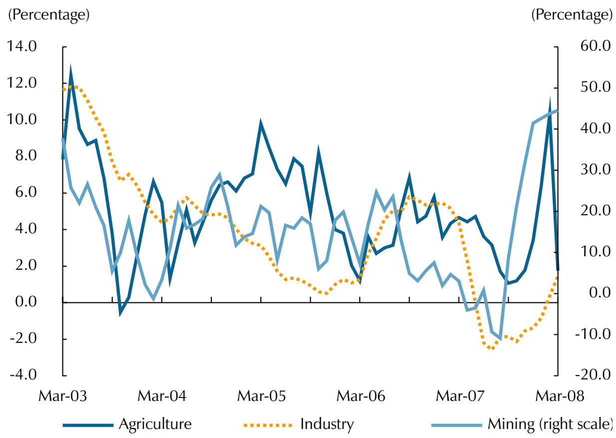
The producer price index (PPI) and other cost indexes suggest there was a moderate increase in non-wage pressure during the first quarter of 2008, which would have been larger had it not been for appreciation of the peso with respect to the dollar. Producer inflation measured with the total PPI accelerated during the first two months of the year

Table 7
Social Security Indicators in the National Total

Sub-systems	Dec. 2006 a/	Dec. 2007 a/	Variation between Dec. 2007 and Dec. 2006 a/	
			Absolute	Percentage
Workers Affiliated with Family Subsidy Entities	4,796,797	5,246,554	449,757	9.4
Professional Risk Management Affiliates	5,637,676	5,945,653	307,977	5.5
Active Pension Fund Contributors (ISS + AFP)	4,893,144	5,364,326	471,182	9.6
ISS Pension Contributors	1,949,204	1,842,270	(106,934)	(5.5)
Mandatory Pension Fund Contributors	2,943,940	3,522,056	578,116	19.6

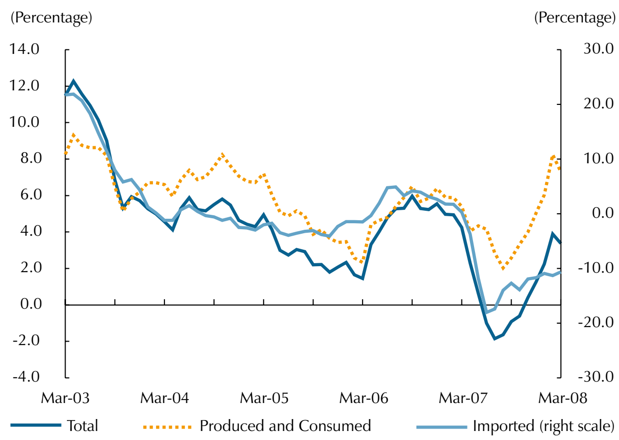
a/ The figures for family subsidy fund affiliates pertain to January of the following year.
Source: Ministry of Social Protection, with data from the Professional Risk Office, ISS, the Superintendent of Finance and the Family Subsidy Superintendent.

Graph 20
PPI, by Branches: Annual Variation



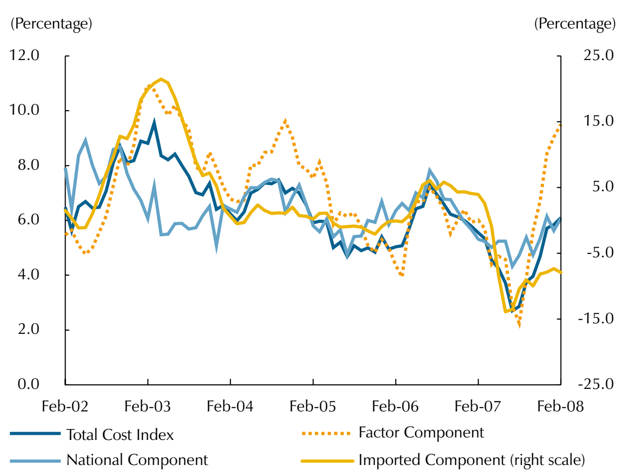
Source: Prior to December 2006: the Central Bank of Colombia. After December 2006: DANE and calculations by the Central Bank of Colombia

Graph 21
PPI: Total and by Components Annual Variation



Source: Prior to December 2006: The Central Bank of Colombia. After December 2006: DANE and calculations by the Central Bank of Colombia

Graph 22
Cost Indexes Based on SAM Annual Variation



Source: DANE, calculations by the Central Bank of Colombia

before declining slightly in March (to 3.4%). These rates are higher than those observed in the second half of 2007.

The behavior of the total PPI during the last two quarters was largely determined by mining inflation, which increased due to pressure from oil prices. The agricultural PPI, which also exerted upward pressure until February, ceased to do so in March, thanks to the favorable tendency in prices for meat and a number of short-cycle farm products. The rise in manufacturing PPI inflation is also an important factor, even though it has been slow. This index exhibited negative rates throughout much of last year (Graph 20).

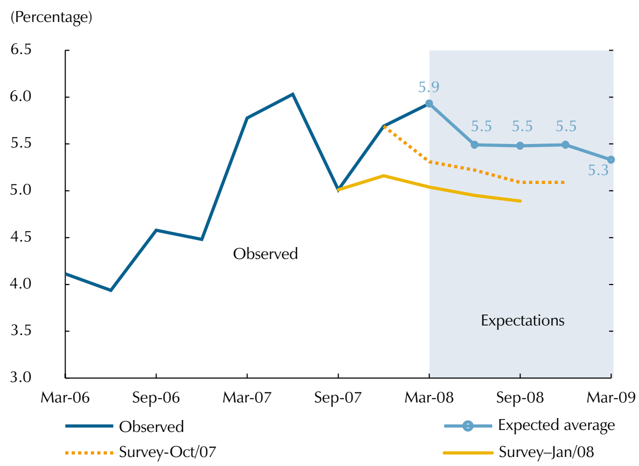
High adjustments in the PPI for produced and consumed goods were reported in the first quarter, based on the origin of goods. The result was an annual variation of 7.3% by March. Inflation in imported goods remains in negative terrain and has been relatively stable due to the effect of appreciation (-10.6% at March) (Graph 21).

Cost indexes weighed according to the social accounting matrix continue to show a steady rise in total costs since midway through last year. By February their inflation was 6.1% compared to a minimum of 2.7% in June 2007. As to components, the indexes that represent internal cost pressures are the ones that reported the most build-up, ending the quarter with increases on the order of 9.5%, while costs of imported origin continued to decline in annual terms (Graph 22). As to the different branches, the cost indexes that contributed the most to the build-up in the global index were mining, public utilities and industry, which registered respective annual variations of 7.6%, 13.2% and 6.2% by February.

5. Inflation Expectations

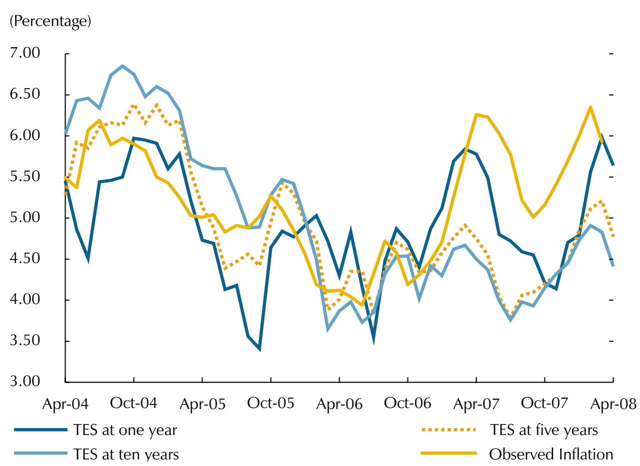
During the first quarter of 2008, inflation expectations tended to increase or remained high in

Graph 23
Observed Inflation and Inflation Expectations
(At three, six, nine and twelve months)



Source: The Central Bank of Colombia –Quarterly Expectation Survey

Graph 24
Inflation Expectations
(Monthly Average)



Source: The Central Bank of Colombia.

Inflation expectations remained above the target set for this year.

relation to the target range set for this year by the BDBR. The inflation forecast for December 2008, according to the quarterly survey done at the start of April, is 5.5%, which is above the figure registered three months ago (5.1%) (Graph 23). Expectations for the end of the year, as reported in the monthly survey of banks and brokers in April, point to 5.2%, which is similar to the level registered in the fourth quarter of 2007.

The indicators based on interest rates for fixed-rate TES and TES UVR (break even inflation) also show a considerable rise in expectations at different horizons during the fourth quarter of last year and at the start of 2008. However, these tendencies reversed in March and early April, particularly in the case of expectations based on ten-year securities (Graph 24).

It is worth noting that expectations are an important way for monetary policy to work its way through to the economy. With expectations anchored in inflation targets, shocks that are exogenous (and one time only for certain prices) have a temporary impact on inflation. However, if expectations mount and monetary policy is not sufficiently credible, those shocks tend to cause permanent changes in inflation, which make the price stabilization policy more costly.

Mounting expectations in the last two quarters increase the risk of this second scenario occurring in Colombia, as well as the risk of second-round effects on prices due to indexation or wage and price renegotiations, which would raise inflation permanently in the long run. Under these circumstances, a slowdown in growth does not necessarily result in less inflation. In fact, the experience of the seventies in Colombia and throughout most of the world is proof of that.

II. Financial Markets

Doubts about the soundness of the US financial system increased during the first quarter of this year, generating risk aversion in capital markets.

Restrictions on loans have been extended to different types of portfolios and to other developed countries, such as the United Kingdom and the Euro Zone.

However, the outlook for investment in the developing economies, particularly in Latin America, remained positive, with considerable appreciation in the currencies of the region's main economies.

Growth in monetary aggregates and in the loan portfolio slowed during the first quarter of 2008.

Interest rates on lending and deposits were up.

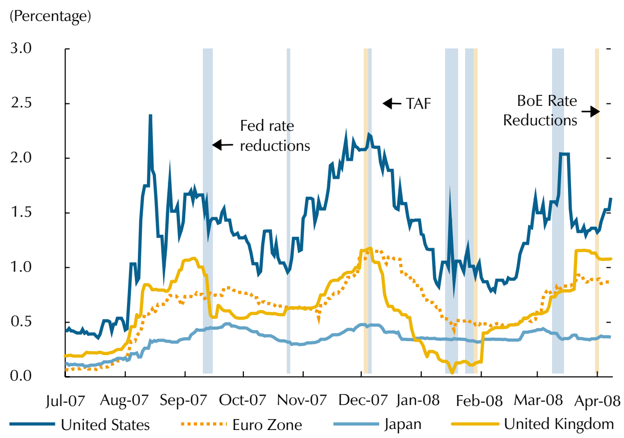
A. INTERNATIONAL CONTEXT

Consumer confidence in the United States fell to levels similar to, or even below those witnessed during the recession in 2001.

As in past quarters, the way the developed capital markets performed continued to depend on the economic situation in the United States. The figures on the US economy indicate that GDP continued to weaken during first quarter of 2008. In fact, by March, consumer confidence was down to levels similar to, or even below those observed during the 2001-2002 recession. This was due, among other factors, to negative job creation in recent months, coupled with the prospect of a further decline in housing prices, the increase in prices for crude oil and other commodities, valuation losses on the stock market, and more restrictions on loans, even for borrowers with good credit ratings.

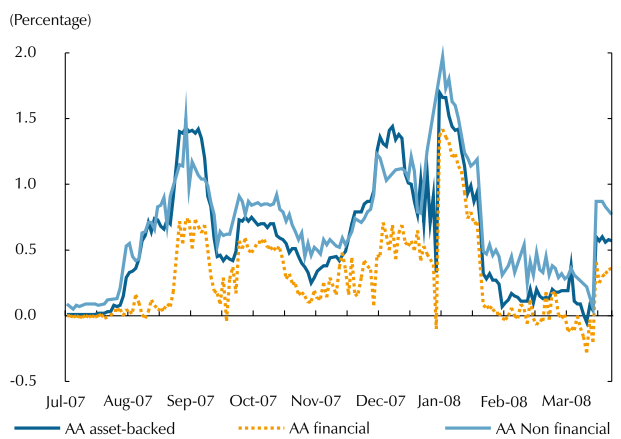
During the early months of 2008, the financial system continued to be affected by the crisis in the subprime market (mortgage loans with higher risk), as mirrored in the sharp losses registered on the balance sheets of major banks. In this context, doubts about the soundness of the financial system added to the risk of less output, creating a vicious circle. [1]

Graph 25
Interbank Market: Comparison between the Libor and Three-month Treasury Bill Rates



Source: The United States Federal Reserve Bank

Graph 26
Rates on 90-day Commercial Paper in the United States (Difference in Percentage Points Compared to the Fed's Benchmark Rate)



Source: The Fed

In response to those risks, the United States Federal Reserve Bank (The Fed) continued to lower its benchmark rate, doing so by 200 bp in the last quarter, which placed it at 2.25%. Market projections signaled further reductions.[2] The Fed also reduced the difference between its benchmark rate and the discount rate on window operations,[3] and applied mechanisms to deal with financial market liquidity and funding problems. To begin with, liquidity flows to institutions that receive deposits were maintained through the term auction facility (TAF). The Fed also extended direct overnight credit to primary dealers with investment grade collateral and, eventually granted them an extension on the term and collateral for Fed treasury loans to reduce funding problems associated with mortgage-backed assets.

However, interbank market data show the Fed's efforts to bolster the economy through lower interest rates and innovations in its liquidity tools have been only partly successful. In fact, the interest rate on interbank credit (Libor) has dropped less than the rate on US treasury bills, reflecting problems with confidence among the agents in the financial system (Graph 25). Moreover, in March, the difference between the interest rate on the market for commercial paper, which companies need for working capital, and the Fed's benchmark rates increased again (Graph 26). The same occurred with the medium and long-term corporate debt in both the United States and Europe.

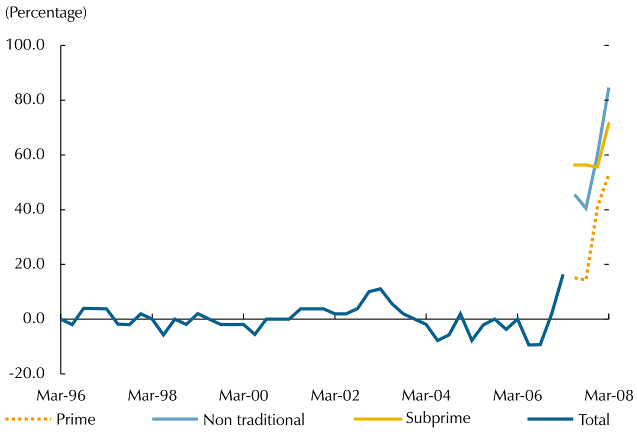
Although there is more risk of a weakening world economy, the outlook for investment in Latin America remains positive.

1 The difficulties facing investment banks in the United States and particularly the Bear Stearns crisis have fed those fears.

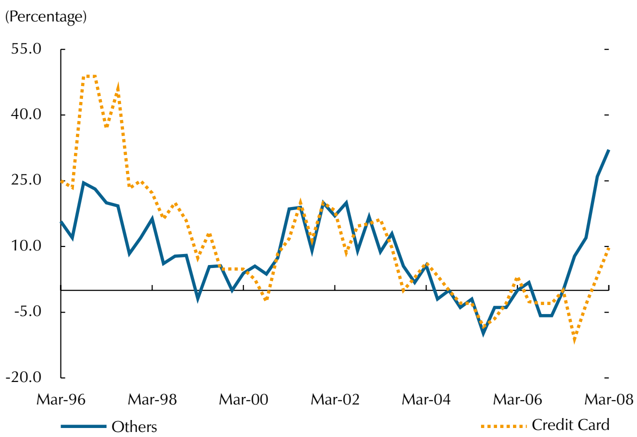
2 In fact, when this report was being written, the Fed lowered its rates again, by 25 bp, leaving the benchmark rate at 2%.

3 It is now only 25 bp, with a broader term and wider range of collateral.

Graph 27
A. Mortgage Loan Restrictionsa hipotecario a/



B. Retail Loan Restrictions a/



a/ Percentage of replies that mention tight credit conditions.
Source: The Fed

Liquidity constraints in the interbank credit markets, losses reported on the balance sheets of financial institutions due to the devaluation of mortgage-backed assets, and, in general, more of a perception of risk, given the economic and financial stress, have weakened bank capital adequacy ratios. This, in turn, has added to the restrictions on mortgage, retail and commercial loans in the United States (Graph 27) and on the European continent.

Consequently, the uncertainty and risks surrounding world economic growth increased significantly during the last quarter, owing to events in the developed financial markets. The high levels of risk aversion illustrate this fact and largely affect high yield assets in favor of safer options for investment[4] (Graph 28).

In spite of this outlook, the external environment for the developing economies and for Latin America in particular continues to be positive. This is due, in part, to favorable terms of trade, which have fueled exports from those countries, and to foreign direct investment (FDI) in sectors that produce raw materials.

The steady appreciation in the region's currencies with respect to the dollar (Graph 29) is evidence of this fact. The Colombian peso appreciated 8.24% against the dollar during the first quarter,[5] when the steady flow of FDI into the country, primarily in commodity-producing sectors, was the main reason behind that momentum. Although risk perception with respect to the sovereign debt of developing countries has increased compared to what is regarded as risk-free debt, that reaction is still less than during previous episodes of financial stress and is less than the reaction registered in similarly classified bonds in the developed countries. As to the corporate debt of companies in the developing economies, there are reports of risk premium increases above those exhibited by the debt of their governments, together with smaller amounts being floated, which suggests a more vulnerable outlook for bonds of this type (Graph 30).

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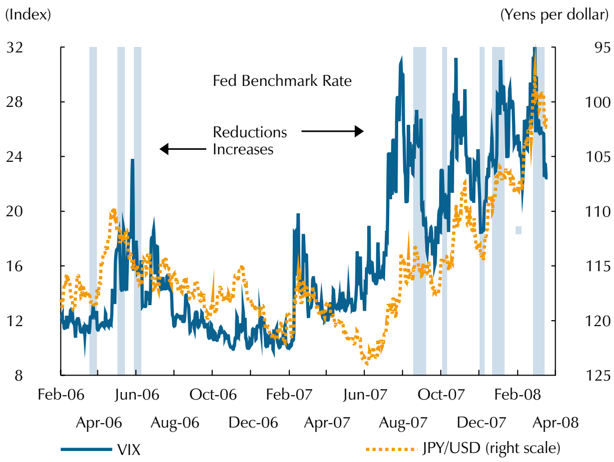
4 At the time this report was being written, the appetite for global risk improved due to less negative news about the US economy than what the market had forecast previously.

5 The percentage of change between the average in December 2007 and the average in March 2008.

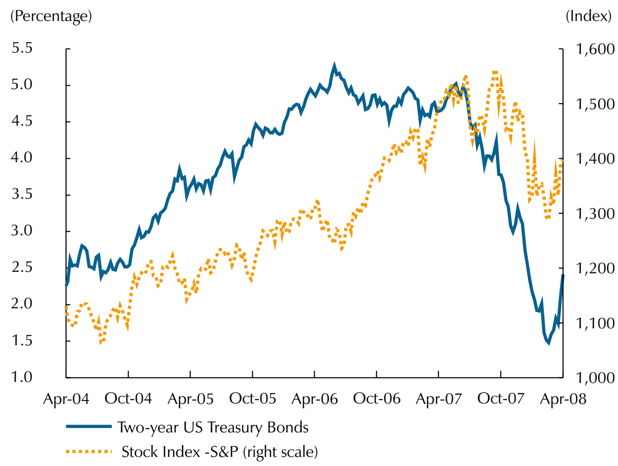
Graph 28

A. International Risk Aversion

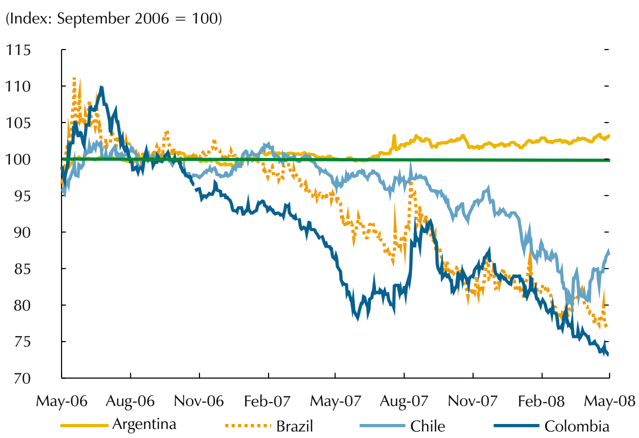


Note: Right scale in reverse order.
Source: Datastream

B. Stock and 2-Year Generic US Treasury Bond Market Index



Graph 29
Nominal Dollar Exchange Rate in Several Latin American Countries



Source: Datastream

B. FINANCIAL MARKETS

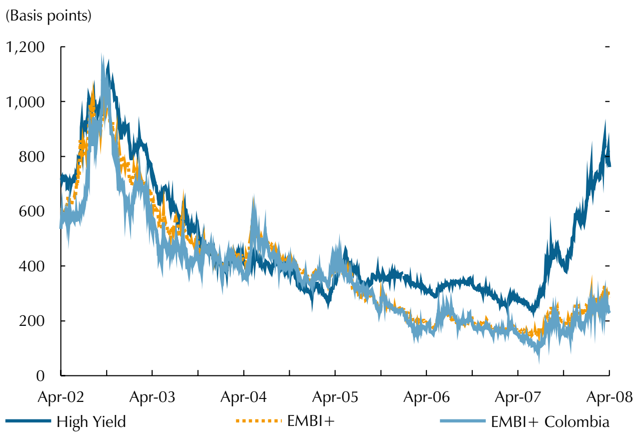
The interest rate hike in February and the reserve requirements adopted during 2007 continue to work their way through to interest rates in the market. Other factors, such as added government deposits with the Central Bank of Colombia, reduced the availability of resources in the market and contributed to the increase in deposit rates, particularly on time certificates of deposits (CDT), which surpassed the rise in the Bank's benchmark rate. Interest rates on loans also were up last quarter (except on mortgage loans). The rates on preferential and retail loans experienced the largest increases.

The upward trend in the annual variation in monetary aggregates observed since the last quarter of 2007 reversed between January and March 2008. Nevertheless, the base money and M3 growth rates were still higher than the increase in nominal GDP. The amount the government will have to pay on TES scheduled to fall due in the second quarter of 2008 is equal to nearly half the amount it had on deposit with the Central Bank of Colombia in March. Using those funds to honor that debt would create an expansionist factor that may favor the increase in financial system liabilities subject to reserve requirements (LSR)

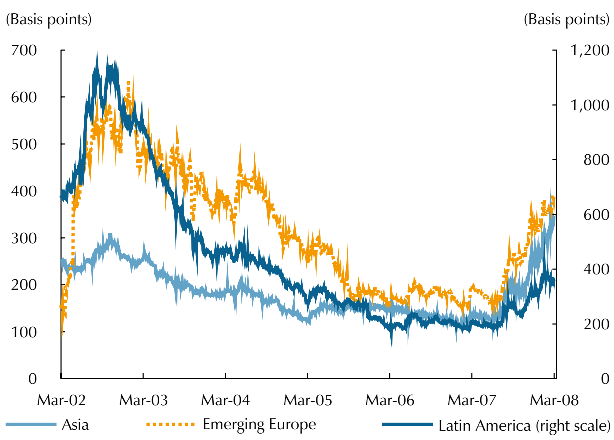
The increase in peso loans continued to slow, particularly with respect to retail loans. In the case of commercial and mortgage loans, statistical exercises suggest the portfolio may stabilize at rates similar to those registered at the

Graph 30

A. EMBI+ and Spread on US Corporate Bonds



B. Emerging Corporate Debt Spreads (Difference in bp)



Source: Bloomberg.

end of March. However, when the external debt of economic agents is added to the total loan portfolio in local currency, the global loan portfolio indicator reflects less of a slowdown.

1. Monetary Aggregates

The growth in monetary aggregates slowed during the first three months of 2008, contrary to their performance in the final quarter of 2007. The annual increase in base money declined from 19.4% in December 2007 to 13.2% in March 2008, due to less demand for cash and, particularly, to less growth in the bank reserve, which went from 38.3% to 21,1% during the same period (Graph 31).

As to the increase in cash, the average demand for cash during the quarter was consistent with the nominal increase in economic activity projected for this year. There are two factors that explain the slowdown in the bank reserve. One is seasonal. After the holidays at the end of the year, credit institutions tend to shift their deposits towards instruments that are not as liquid and have a lower reserve ratio. The second factor is the reduced reserve ratio on CDTs compared to checking and savings account, as a result of the measures adopted in 2007.[6]

The broader monetary aggregate (M3) also exhibited less of an annual increase, which declined from 17.8% in December 2007 to 15.1% in March 2008 (Graph 31). This tendency was determined by LSR, primarily the slowdown in savings deposits, which were up by 6.1% in March compared to 11.0% in December. The slowdown in LSR would have been greater had it not been for the sharp increase in CDTs; by March, they were up by 33.7% (Graph 32).

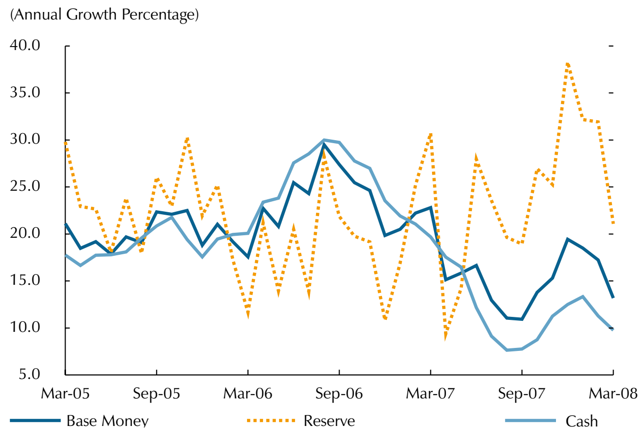
The growth in monetary aggregates has slowed.

Factors such as the normalization of interest rates and the changes in reserve requirements ordered by the Central Bank of Colombia helped to increase deposits in the form of CDTs during the first quarter. Another reason was the reduced availability of resources in the market, due to the increase in

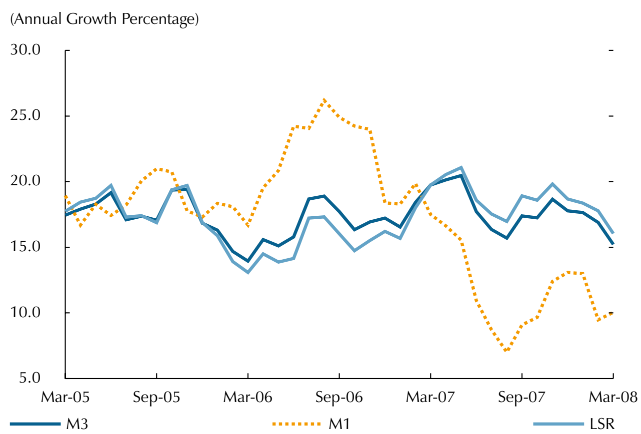
6 The marginal reserve ratio is 5% for CDT and 27% for checking and savings accounts. See the *Inflation Report*, June 2007, pg. 40, published by the Central Bank of Colombia.

Graph 31

A. Base Money by Use

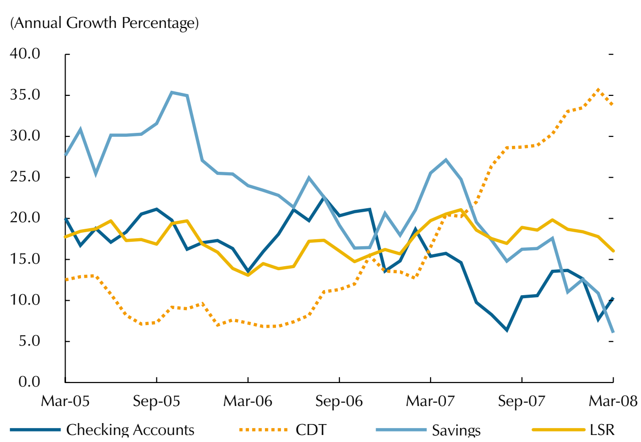


B. Monetary Aggregates and Deposits



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

Graph 32
Total Deposits and their Main Components



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

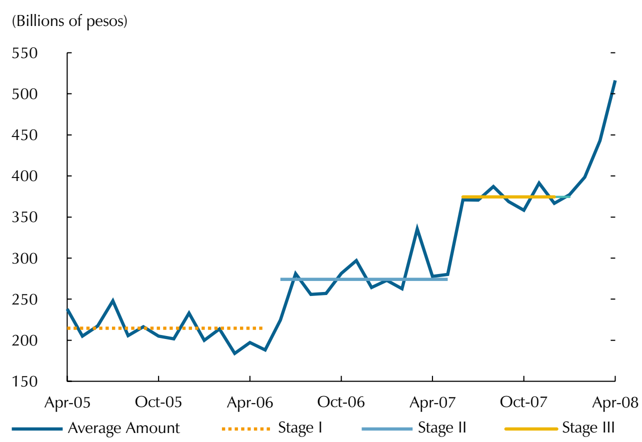
government deposits with the Central Bank.[7] Average daily deposit taking for CDTs was up by 21% between December 2007 and March 2008 (Graph 33), mainly because of corporate deposits. An increase in deposits from the general public was a contributing factor as well, but less so.

The government has a debt of nearly Col$4.0 trillion (t) payable in the second quarter of 2008 for treasury bonds (TES) that mature during that period. It has enough on deposit with Central Bank to cover that debt. Coupled with the current expectation of peso revaluation shown in market surveys, this could favor the demand for deposits in pesos.

2. Loans

The indicator for the gross loan portfolio plus leasing in local currency continued to exhibit less growth during the first quarter of 2008. This tendency was first summarized in the June 2007 edition of the *Inflation Report.*. However, the pace of the slowdown eased during the past quarter, registering an annual increase of 21.9% by March.

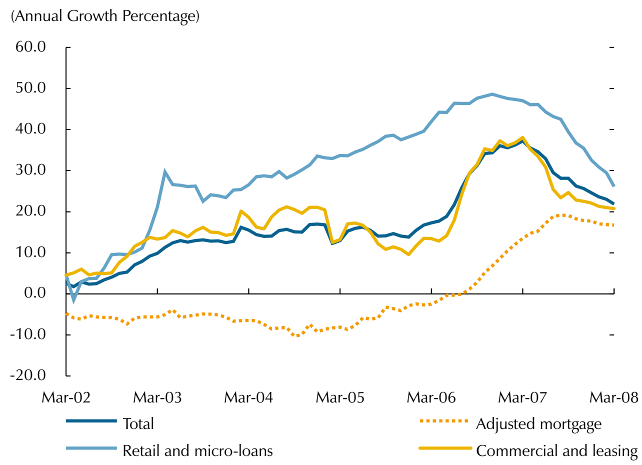
Graph 33
CDT Acceptance: Average Daily Amount



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

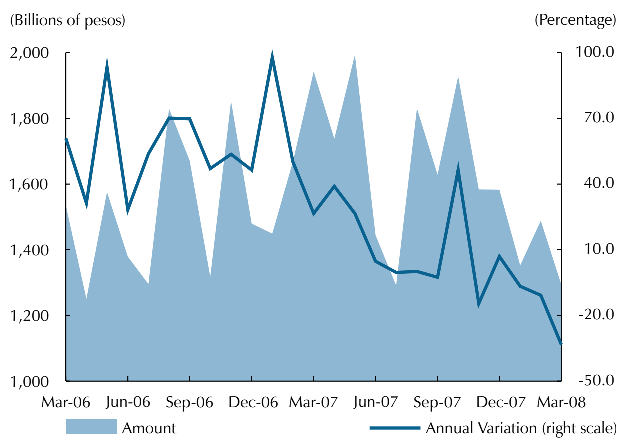
7 Average deposits increased from Col$3.1 t in December to Col$8.9 t in March.

Graph 34
Gross Loan Portfolio with L/C Leasing



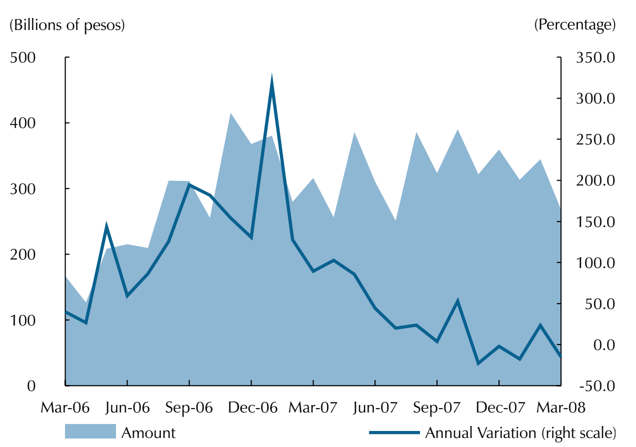
Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

Graph 35
Monthly Retail Loan Disbursements



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

Graph 36
Monthly Mortgage Loan Disbursements



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

The sharpest slowdown was in the retail portfolio (which includes micro-credit) and, to a lesser degree, in commercial and mortgage loans. Loans of this type registered respective annual increases of 26.1%, 20.7% and 16.7% at March 2008. These rates are 642 bp, 138 bp and 100 bp less, in that order, than the ones observed the quarter before (Graph 34).

The level of disbursements, as an indicator of marginal loan performance, also shows signs of a slowdown with respect to retail loans. Those amounts have declined since November 2007, both in absolute value and their annual variation. The share of retail loans extended for more than five years has increased (from 12% in March 2007 to 19% in March 2008) compared to shorter loans, suggesting less rollover in credit of this type (Graph 35).

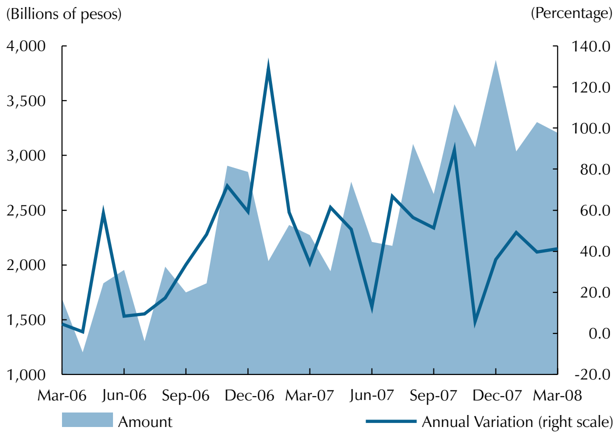
As to mortgage loans, the average for disbursements has been around Col$300 billion (b) since June 2006. However, because these are long-term loans for direct acquisition or for subrogation by builders, it is not possible to conclude that stability in disbursements is indicative of a slowdown in the mortgage loan portfolio (Graph 36).

With respect to commercial loans (including ordinary, treasury and preferential loans), the momentum in ordinary and treasury loans, with almost 40% annual growth, indicates an upsurge in lending of this type. The volume of disbursements on ordinary loans rose in the last three months and, since September 2007, the share of those contracted at more than five years has increased from 5% to 20% of all commercial loans. Moreover, treasury loans have been larger in amount, and three and four week loans were being replaced for one and two-week loans. The increased rollover in this last type of credit also would have occurred with preferential loans, since 85% of the disbursements were at a term of less than one year (Graph 37).

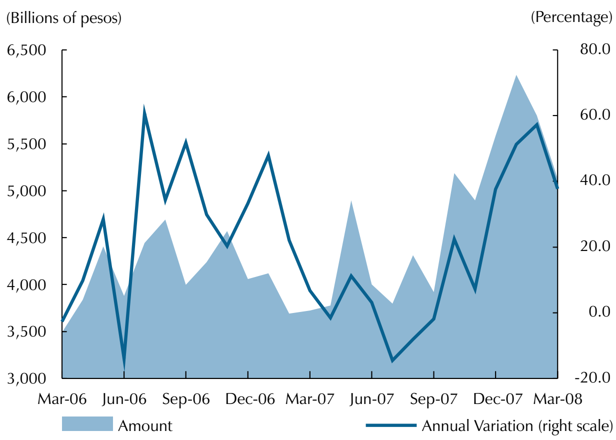
The forgoing loan analysis is consistent with the results obtained using different statistical methods to calculate the tendency in the series for the gross

Graph 37
Monthly Disbursements by Type of Loan:

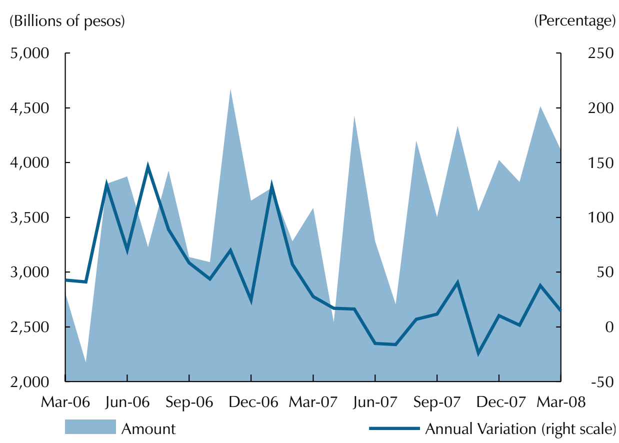
A. Ordinary Loans



B. Treasury Loans



C. Preferential Loans



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

loan portfolio in pesos.[8] The exercises indicate this variable is converging towards an annual growth rate between 17% and 23%. As to loan destination or use, the calculations show a stable rate of expansion in the commercial and mortgage loan portfolios at respective levels near 21% and 14%, and a downward trend in retail loans.

In terms of economic agents' external indebtedness, the calculation was obtained by adding the credit in foreign currency extended to Colombian residents (private and public) by the local financial system[9] to the credit obtained directly outside the country by the private sector.[10] Between March 2007 and February 2008, that variable increased by US$2 billion (b), which meant a build-up in the annual growth rate from zero to 10% (Graph 38). This is exactly opposite to the tendency demonstrated by the loan portfolio in pesos.

Consequently, when the increase in local currency loans and foreign borrowing is viewed as a whole, the aggregate reflects slower moderation as of March 2007, with a reduction in growth from 25% to 20% by February of this year (Graph 39).

3. Interest Rates

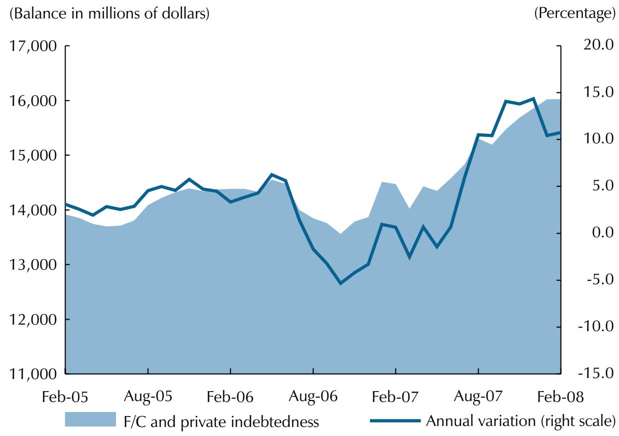
At a meeting on February 22 of this year, the Board of Directors agreed to raise the Central Bank's policy rate by 25 bp, after holding it steady for two months. This decision raises the number of rate hikes to fifteen since the end of April 2006, beginning with a reference rate of 6% in April 2006 and ending with the current rate of 9.75%. The interbank rate (TIB)

8 Using Hodrick and Prescott-200, order 12 moving average, exponential and band pass.

9 Does not include the loan portfolio acquired by Banco de Colombia when its branch in Panama purchased Banco del Comercio de El Salvador.

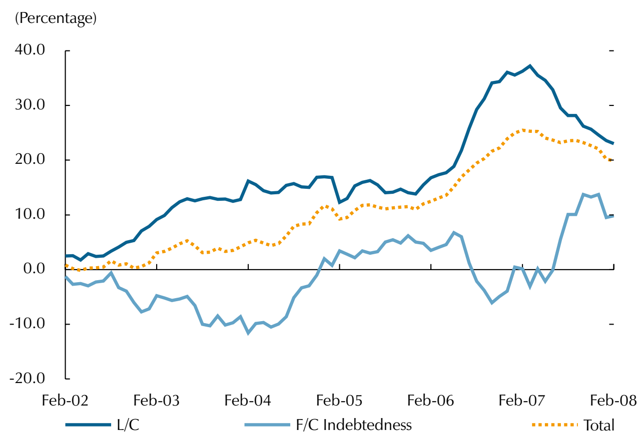
10 This refers to bank loans, commercial loans and placement of securities acquired by the non-financial private sector, including leasing.

Graph 38
F/C Loans and Foreign Borrowing by the Non-financial Private Sector



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

Graph 39
Financial Sector Loans and Private Sector Borrowing



Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

There was less of an increase in the loan portfolio in local currency. However, when considering local currency loans and foreign borrowing as a whole, the aggregate reflects slower moderation in growth as of March 2007.

remained near the contraction rate (9.65%), as it has since mid-October of last year (Table 8).

The increase in the Central Bank's reference rate and the reserve requirements decreed last year have affected interest rates in the market. In fact, all nominal interest rates were up during the first quarter of 2008, except for the rate on mortgage loans, which declined by nearly 14 bp. Nevertheless, the interest charged on loans of this type has increased (167 bp) since last year. This is similar to the rise in the policy rate (169 bp).

Interest rates on all CDTs rose by 65 bp, which is 40 bp more than the reference rate hike ruled by the Board of Directors last quarter. Accordingly, its level (9.79%) was 4 bp above the TIB, after lagging behind for 16 months. This is the first time the variation in the implicit savings rate (29 bp) is more than the change in the policy rate.

As to lending rates, the most important increases were in credit card loans (100 bp), preferential loans (88 bp) and retail loans (77 bp), coupled with the aforementioned decline in the rate on mortgage loans. Accordingly, the weighted average lending rate calculated by the Central Bank of Colombia [11] rose by 32 bp.

By March, real lending rates —pursuant to the method used by the Central Bank of Colombia (11.71%)— and the DTF (4.70%) had returned to levels below their historic averages calculated since 1986 (76 bp and 15 bp, respectively) (Graph 40). In terms of loan destination or use, real rates on ordinary and retail loans (12.15% and 20.35%, respectively) were down by 59 bp and 8 bp, respectively, compared to the historic averages calculated ever since information has been available (March 1998). The rates on treasury (8.01%) and preferential loans (9.57%) were 108 bp and 160 bp above their historic averages.

11 It includes rates for ordinary, preferential and treasury loans.

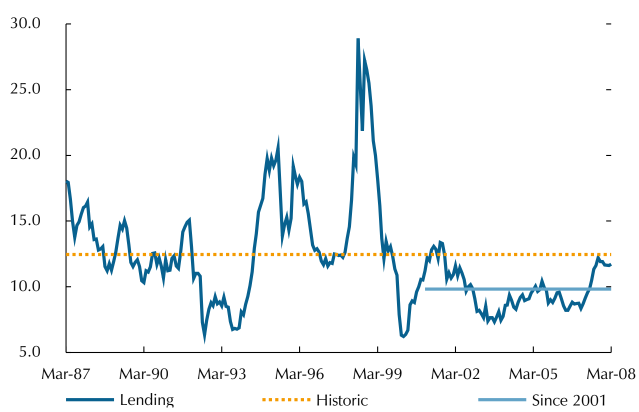
Table 8
Interest Rates
(Percentage)

	Nominal Rates							Real Rates						
					Variation							Variation		
	Apr-06	Dec-06	Sep-07	Mar-08	Quarterly	Annual	Abr-06 a Mar-08	Apr-06	Dec-06	Sep-07	Mar-08	Quarterly	Annual	Apr-06 to Mar-08
Deposit Rates														
Ordinary Savings	3.60	3.92	4.98	5.26	0.29	0.84	1.66	0.07	(0.03)	0.53	0.56	0.04	0.52	0.49
CDT	6.11	6.98	9.14	9.79	0.65	1.99	3.68	2.50	2.92	4.51	4.88	0.38	1.60	2.39
DTF	5.93	6.75	8.98	9.59	0.62	2.07	3.67	2.32	2.70	4.35	4.70	0.34	1.68	2.38
Lending Rates														
The Central Bank of Colombia lending rate	12.94	13.04	16.61	16.93	0.32	3.01	4.00	9.09	8.75	11.66	11.71	0.05	2.56	2.62
Retail	21.14	19.57	25.21	25.98	0.77	7.46	4.84	17.01	15.03	19.90	20.35	0.45	6.80	3.34
Ordinary	15.36	14.24	17.08	17.39	0.31	2.03	2.03	11.44	9.91	12.12	12.15	0.03	1.62	0.71
Mortgage	13.88	13.02	15.60	15.47	(0.14)	1.67	1.58	10.01	8.72	10.70	10.31	(0.39)	1.28	0.30
Preferential	8.73	10.22	13.88	14.69	0.82	3.48	5.97	5.02	6.04	9.05	9.57	0.52	3.02	4.55
Credit Card	24.01	21.94	30.23	31.24	1.00	11.08	7.23	19.79	17.31	24.71	25.38	0.67	10.26	5.59
Treasury	7.68	9.58	12.62	13.06	0.44	2.52	5.38	4.02	5.41	7.84	8.01	0.17	2.10	3.99
TIB (Inter-bank Rate)	5.89	7.36	9.35	9.65	0.30	1.65	3.76	2.28	3.29	4.71	4.75	0.04	1.28	2.47
Repo Auction	6.00	7.36	9.50	9.75	0.25	1.69	3.75	2.39	3.28	4.86	4.85	(0.01)	1.32	2.46
Usury Rate	25.13	22.61	31.89	32.74	0.86	12.00	7.62	20.86	17.95	26.30	26.82	0.52	11.13	5.95

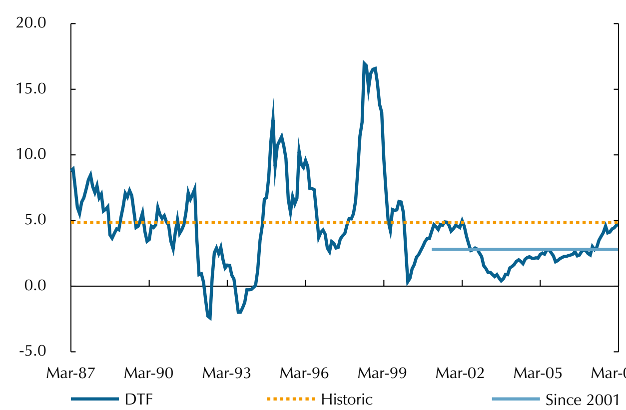
Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

Graph 40

A. Real Lending Rate a/



B. Real DTF a/



a/ Non-food CPI deflated series
Source: National Office of the Superintendent of Financial Institutions, calculations by the Central Bank of Colombia

Box
THE IMPACTOF A U.S. RECESSION ON THE COLOMBIAN ECONOMY

Ricardo Bernal
Luz Adriana Flórez*

The last three quarters have seen evidence of a sharp slowdown in the United States economy that may signal the start of its next recession. This raises some important questions: How vulnerable is the Colombian economy in the face of a possible U.S. recession? What implications would it have for future economic growth in Colombia?

There is evidence in literature of various channels through which a recession in the United States could affect the emerging market economies, including Colombia. Some of those channels are analyzed in this article.

1. Foreign Trade and Financing

Americans are the world's biggest consumers. Therefore, fewer imports into the United States would have serious implications for economic growth worldwide. To analyze this point, it is interesting to consider the correlation between economic growth cycles in the United States and those in other countries. As illustrated in Table B1, the countries that correlated the most with the US economic cycle during 1980-2007, based on annual data, are the European Union, Canada and the United Kingdom. The emerging market economies, with the exception of China and India, show coefficients under 30%.[1] In the case of Colombia, there was no correlation and, when the analysis is repeated with quarterly data for 1978 - 2007, the correlation coefficient is only 12%.

VAR was calculated for a series of countries and several of them were grouped according to growth: United Kingdom-Europe, Venezuela-Ecuador, China-Japan, Canada-Mexico, Colombia and finally the United States. The results are quite similar to those obtained with the previous exercise. For example, a shock to growth in the United States has a significant impact on the Europe-United Kingdom group and on Canada-Mexico. In the case of Colombia, only a shock to growth in Venezuela-Ecuador was significant. A 1% increase (decrease) in growth in Venezuela-Ecuador raises (reduces) GDP in Colombia by 0.42 percentage points.

Table B1
Correlation Coefficients Between the Economic Cycles of Each Country and the US Economic Cycle

	1980-2007	1990-2007
Euro Zone	**0.39**	**0.37**
France	0.19	0.42
Germany	0.19	(0.23)
Italy	0.46	0.12
Canada	0.80	0.77
Japan	(0.01)	(0.29)
United Kingdom	0.54	0.64
Emerging Economies	**0.21**	**0.14**
Emerging Asian Economies	**0.27**	**0.11**
China	0.34	0.13
India	0.33	0.35
Indonesia	(0.14)	(0.32)
Malaysia	(0.04)	(0.05)
Middle East	**(0.01)**	**(0.43)**
Latin America	**0.12**	**0.26**
Colombia	**(0.01)**	**(0.18)**

Source: IMF, calculations by the Central Bank of Colombia

However, this does not mean that a drop in imports into the United States would have no effect on the emerging market economies. There may have been other shocks during those periods, such as shocks to terms of trade or capital flows that might have lessened this effect. Moreover, some of those cycles would be determined by local factors as well.

Therefore, an additional exercise was done to quantify the impact of a reduction in US imports, excluding any other shock. According to Márquez (2000 and 2005), the income and price elasticities of US imports would be around 1.8% and -0.3%, respectively. Considering the pessimistic outlook for growth in the United States (forecast in this report at 0% for 2008), with devaluation of the dollar (against a basket of currencies) possibly being similar to what it was last year (8%, in real terms), US imports would be down by about 7%. Table B2 also shows the impact this would have on GDP for the main exporters to the United States, including Colombia. With a sharp slowdown in the US economy (the pessimistic risk scenario), GDP in Colombia would drop by 0.4 pp, while the reductions in countries such as Canada, Mexico and Venezuela would exceed 1 pp of GDP.

Only a drop in exports to the United States is analyzed in this exercise. However, it is important to point out that Colombia sells 17% of its total exports to the Euro Zone and 12% to Venezuela. Consequently, if those economies are affected by

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* Los autores son, en su orden, profesional líder en asuntos especiales, y profesional del Departamento de Programación e Inflación. Las opiniones expresadas en este documento no comprometen al Banco de la República ni a su Junta Directiva.

1 The Chinese growth cycle has been substantially less synchronized with that of the United States since the nineties. China's economic integration with emerging market economies, particularly India, Indonesia and Malaysia, among others, could be the reason why.

Table B2
US Imports in 2007

Origin	Percentage of Total US Imports	Percentage of Each Country's GDP	Percentage Impact on GDP
Canada	16.0	22.1	1.5
China	16.0	9.9	0.7
Euro Zone	14.0	2.2	0.2
Mexico	11.0	23.9	1.7
Japan	7.0	3.3	0.2
United Kingdom	3.0	2.0	0.1
Venezuela	2.0	16.9	1.2
Colombia	0.1	5.5	0.4

Source: IMF, calculations by the Central Bank of Colombia

less demand in the United States, Colombia's exports to the Euro Zone and to Venezuela would be affected as well. Accordingly, the total impact would be somewhere within a range of 0.42 pp to 0.7 pp of Colombia's GDP. This might suggest that a slowdown in the US economy would have a limited effect on the Colombian economy by way of exports. However, other effects that could act as amplifiers would have to be considered, such as less employment and fewer expectations of investment in the export sector. More complex estimates, such as those done by González and Moreno (2007),[2] show that a 1 pp decline in annual growth in industrial production in the United States would result in a maximum reduction of 0.8 pp in industrial activity in the developed economies and 0.7 pp in the emerging economies.

In an attempt to capture the impact of financing conditions as well as commerce, Abrego and Osterholm (2008) constructed a Bayesian VAR model for the Colombian case based on an important group of variables: world GDP (excluding Colombia), the short-term external interest rate, EMBI, the spread on US high-yield corporate bonds, foreign direct investment, government spending, the interest rate on lending in Colombia and the GDP in Colombia. The authors found that a decline of 1 pp in world growth during four quarters produces a 1.4 pp drop in Colombian economic growth during the same period. This outcome is a reflection of less world demand and changes in external financial conditions (such as EMBI and high yield, which also respond significantly to changes in world economic growth). For example, an increase of 100 bp in the EMBI would lower growth by 0.3 pp after one year, while an increase of 100 bp in high yield would have an impact of 0.2 pp on GDP.

2 This is a self-regressive vector exercise in a panel that uses variables such as industrial production in the United States, industrial production in each country, the real exchange rate, total exports and US imports for each country. The exercise was done for 1998- 2007 and applies to 17 emerging economic and five developed ones.

2. Terms of Trade

Terms of trade constitute the second channel and are very important for countries like Colombia that export raw materials. According to an IFM report (2008a), the recent boom in terms of trade has been different compared to previous boom periods in the developing economies. The current cycle is characterized by a sharp response in export volume (excluding oil exports), increased appreciation of the currency of exporting countries, large increases in capital flows (especially foreign direct investment), less external debt (particularly due to less government borrowing), less of an increase in government consumption compared to private consumption, and more investment. These factors have translated into far more growth for the developing economies than in previous booms periods and fewer symptoms of vulnerability.

The foregoing is evidence of the fact that terms of trade play a decisive role in the current growth cycle of the emerging economies. A VAR model with annual GDP for Colombia, the United States, Venezuela –Ecuador, and commodity prices was constructed to capture this effect for Colombia. It shows the Colombian economy responds significantly only to a shock to growth in Venezuela-Ecuador and to terms of trade. A drop (increase) of 1 pp in terms of trade produces a reduction (increase) of 0.21 pp in GDP for the Colombian economy; moreover, the result of a shock to Venezuela-Ecuador is similar to the outcome of the previous exercise.

Consequently, what happens with terms of trade is quite important to the Colombian economy. The central scenario outlined in this report does not contemplate a sharp decline in terms of trade, despite the slowdown in the US economy. If emerging economies such as China and India continue to exhibit stable growth, despite a moderate recession in the United States, the demand for raw materials is not expected to decline abruptly. On the contrary, what we saw during the first months of the year was an upsurge in prices, which the International Monetary Fund (IMF, 2008a) says was due to a variety of factors. The first is devaluation of the dollar, which makes it much less expensive to consume raw materials. The second is the store of value guaranteed by some of these raw materials, oil and gold being two examples. Accordingly, higher inflation raises the demand for these products. The third factor is the added profitability these assets may offer, given the drop in the Fed's interest rates and devaluation of the dollar. Finally, there is the increase in liquidity worldwide, which also would fuel the demand for raw materials (Frankel, 2006). This last factor would be a more long-term structural explanation than a short-term, cyclical one.[3]

3 Arango, Arias and Flórez (2008) proved this hypothesis in a paper due to be published shortly by the Central Bank of Colombia in *Borradores de Economía* (Working Papers).

3. The Financial System

More of a decline in world liquidity or a situation characterized by excessive stress in capital markets could imply negative consequences for credit institutions in the developing countries, which would affect their economies. These effects could be passed on through financial system liabilities and assets.

a. *Consequences for Liabilities*

Fewer international borrowing facilities for local banks or mass withdrawals of deposits by foreigners in search of better yields (or havens) in other countries would create illiquidity problems for a country's credit institutions. On this point, an IFM study (2008b) for Latin America shows that most of the increase in credit within the region has been funded with local deposits and sovereign debt. The participation of non-residents in that funding has been very limited. Moreover, countries such as Colombia, Chile, Brazil and Peru, where the interest rate is the main monetary-policy instrument, have yet to be affected by the liquidity crisis in the US market, since the overnight rate on the inter-bank market has moved at same pace as the benchmark rate set by each central bank.

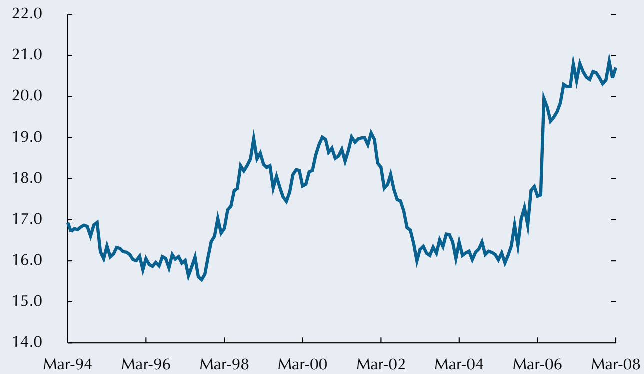
In addition, there may be restrictions on credit and liquidity, or the headquarters of large banks may decided to decapitalize branches and subsidiaries in the developing countries; however, there has yet to be any evidence of this happening in Latin America. To begin with, in the case of Colombia, the share of international bank assets as a percentage of total bank assets (Graph B1) is low compared to the other countries in the region. Secondly, the existence of these international institutions, such as branches, subject to the same regulations that apply to national banks, is an additional advantage in terms of having locally construed capital. This lessens the risk of that capital being reduced through remittances to the institution's headquarters.

b. *Consequences for Assets*

An adverse external scenario would create problems for export companies to the point where some might default on their loans from the financial system. Although studies to assess this risk are still underway for the Colombian case, the results of Zamudio's study (2008) for the sector that exports to Venezuela show that potential default on the obligations of those exporters would have a very limited impact on the financial system. Moreover, in the last few years, the risky commercial loan portfolio has remained low and coverage rates have increased of late, now that the credit-risk management system (SARC) is in effect for loans of that type.

Contrary to the situation in the banking markets of the developed economies, the Latin American countries have a very small percentage of structured or securitized products originating in the United States that affect the value of their assets.

Graph B1
Assets of Foreign Banks
(As a percentage of total assets)



Source: The Central Bank of Colombia

Investments as a share of the total assets of banks established in Colombia have declined considerably in the last few years (from 33% in 2005 to 19% in 2007). This means the negative impact of an investment devaluation generated by an adverse external scenario is now less than in it was before. In addition, the drop in the price of Colombian government bonds (TES) during the last six-month period was more the result of local factors than the external situation.[4] With respect to the stock market, the elasticity of the Colombian Stock Market Index (IGBC) to movement in the S&P 500 in the United States has been less than in countries such as Brazil, Mexico, Chile, Peru and Argentina.

Finally, unlike most developed countries, a number of indicators show there have been no credit restrictions motivated by the situation in the United States. In fact, the total gross loan portfolio is growing at nearly twice the nominal GDP estimated for 2008, and the Central Bank's quarterly survey of expectations shows that credit availability is at historically high levels.

4. Remittances

Remittances are another channel that has become more important in recent years, not only for the Colombian economy, but also for a number of economies in the region. During the last five years, this item has accounted for more than 10% of GDP in countries such as El Salvador, Honduras and Nicaragua. In Mexico and Colombia, it represents approximately 3%.

Although remittances in Colombia, in terms of GDP, have demonstrated a certain stability in dollars, the levels reported in 2007 show an increase of nearly 36% compared to the remittances registered in 2005 (Table B3). Furthermore, as a

4 Such as the increase in inflation or the monetary policy on lending

Table B3
Balance of Payments: Foreign Income in Colombia from Workers' Remittances

	2005 (pr)	2006 (pr)	2007 (pr)
Remittances from workers: income (millions of dollars)	**3,314**	**3,890**	**4,493**
As a percentage of GDP	2.7	2.9	2.6
As a percentage of current income-balance of payments	11.1	11.1	10.8
CAs a percentage of merchandise exports	15.2	15.4	14.7
Number of Times Exports of:			
Coffee	2.3	2.7	2.6
Petroleum and petroleum by-products	0.6	0.6	0.6
Coal	1.3	1.3	1.3
Non-traditional exports	0.3	0.3	0.3
As a percentage of:			
Income from foreign direct investment (percentage)	32.3	60.2	49.8

(pr) preliminary.
Source: The Central Bank of Colombia.

percentage of current exports, this item accounts for almost 15% of merchandise exports and 50% of income from foreign direct investments.

Although there are no recent estimates of the impact a slowdown in the United States economy would have on remittances, it might not be insignificant. However, it is important to point out that countries such as Spain and Venezuela, among others, have been increasing their share as a source of remittances. In this sense, if the slowdown in the United States does not imply a recession worldwide, it would have less of an effect on remittances (Table B4).

Table B4
Remittances by Country of Origin

	Percentage Distribution by Amount		
	2005	2006	2007
United States	45.3	41.3	39.4
Spain	38.8	39.0	39.1
Venezuela	0.5	3.0	6.9
Other	15.5	16.6	14.5
Total	**100.0**	**100.0**	**100.0**

Fuente: Encuesta Trimestral de Remesas- Banco de la República.

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III. Macroeconomic Perspective

A moderate recession in the United States, such as the one contemplated in this report, would not have serious implications for terms of trade or foreign direct investment.

However, the main risk confronting the external scenario is a more pronounced and lasting recession in the United States and its negative effects on world demand.

Economic growth in Colombia is expected to slow during 2008; how much will depend largely on the external situation.

The uncertainty surrounding the inflation forecasts has increased. The primary risks to inflation come from the possible persistence of food and fuel price hikes associated with international prices.

There are risks of inflationary pressures originating with wage hikes and increased expectations of inflation.

A. THE INTERNATIONAL CONTEXT

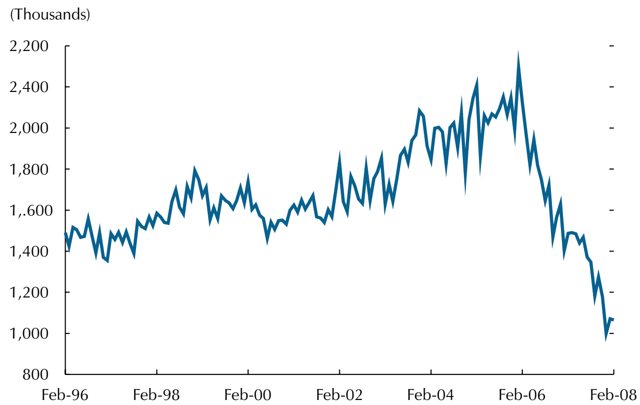
Considering what happened last quarter, our central scenario for the external context continues to contemplate a moderate recession in the US economy, accompanied by less growth in the other developed economies. However, growth in the emerging market economies, lead by China and India, will keep world economic growth relative high.

Our central scenario for the external context continues to contemplate a moderate recession in the U.S. economy.

By the first quarter of the year, the US economy would be performing very much as forecast in the last report. The latest available indicators suggest that GDP will continue to weaken.[12]

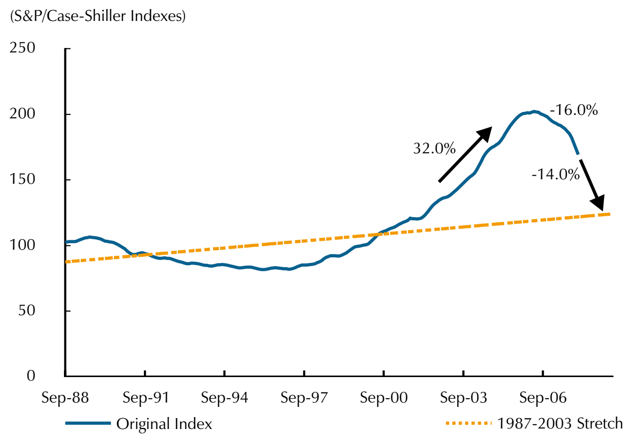
12 A preliminary figure on growth during the fourth quarter of 2007 (0.6% annualized quarterly) was released while this report was being written.

Graph 41
Home Building Permits
in the United States



Source: Datastream.

Graph 42
Real Housing Price Index



Source: Datastream, Calculations by the Central Bank of Colombia

Figures on services and industry in the United State reflect poor performance, with a high likelihood of decline. Consumer perception on the economy, both current and expected, has suffered, and real retail sales at March showed no growth. Moreover, job creation was negative for the third month in a row, with significant increases in the unemployment rate, which went from 4.5% in April 2007 to 5.1% in March 2008.

The housing market shows no signs of stabilizing. Home building permits were down and housing inventories have increased, prolonging the downward pressure on home prices (Graphs 41 and 42). This situation has affected the mortgage loan market, where default is more pronounced among loans granted recently and is not confined to the subprime portfolio. The result is an increase in bank foreclosures.

Because of problems in the mortgage loan market, risk perception remains high and is affecting the liquidity and capital adequacy of financial markets in the developed economies. The loan supply has declined as a result. The latest surveys show considerably more constraints on lending, not only for mortgages but for retail and commercial loans as well.

In this context, the US economy is likely to face a period of low growth, with slow recovery towards 2009. There are several reasons for this forecast. The first concerns the high levels of household borrowing, which are matched by high and chronic external and fiscal imbalances. The second is the crisis in confidence derived from the sharp reduction in financing available to households and families. The third reason is the high price of raw materials. It they remain high, the effect would be equivalent to a negative shock to productivity, which could curb economic growth.

In view of the above, the forecast in this report for US economic growth during 2008 is still at 0.8%. However, the forecast for growth in 2009 was reduced to 1.2%.

The mid-term outlook for the other developed economies is also less favorable than it was three months ago. Although the euro zone and the Japanese economy continue to register positive growth rates, there already are signs of a slowdown, *The forecast for US economic growth in 2008 is still at 0.8%. However, the forecast for growth in 2009 was reduced to 1.2%.*

possibly due to fewer available loans for households and companies. Added to this is the negative effect appreciation of the yen and the euro against the dollar is having on their exports. This being the case, the forecast for growth in the euro zone and Japan is slightly lower in this report, consistent with what analysts expect (Table 9).

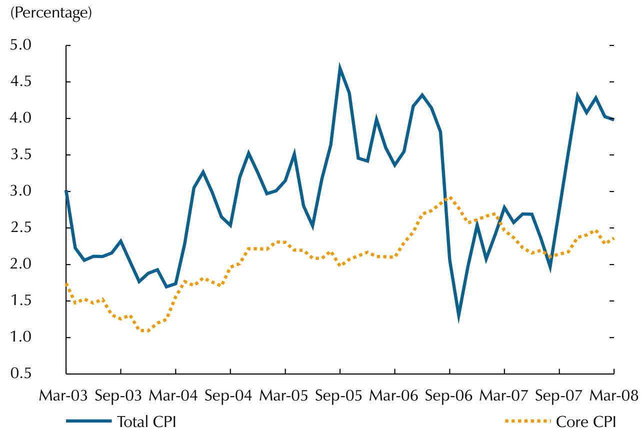
Table 9
Growth Forecasts for Colombia's Major Trading Partners
(Percentage)

	Observed 2007	Pronósticos para Forecasts for 2008 to: Apr-08	Pronósticos para Forecasts for 2008 to: Jan-08	Pronósticos para 2009, to: Apr-08
Main Partners				
United States	2.2	0.8	0.8-1.5	1.2
Euro Zone	2.6	1.5	1.9	1.8
Ecuador	1.9	2.7	2.2	3.5
Venezuela	8.4	5.8	6.0	4.0
Other Partners				
Japan	1.8	1.3	1.5	1.8
China	11.4	10.2	10.5	9.6
Peru	8.1	7.0	6.8	6.4
Mexico	3.1	2.6	3.2	3.3
Chile	5.3	4.2	4.9	4.7
Argentina	8.3	6.9	6.2	5.0
Brazil	5.2	4.6	4.7	4.4
Bolivia	4.0	4.1	4.5	4.1
Developed Countries	2.2	1.4	2.0	1.4
Developing Countries	5.9	4.6	5.0	4.3
Total Trading Partners	**3.6**	**2.6**	**2.6-2.9**	**2.5**

Source: Datastream, Consensus, IMF and the Central Bank of Colombia

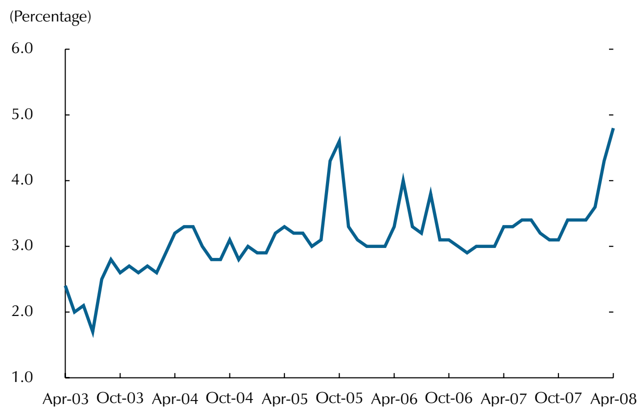
The first-quarter reductions in the benchmark interest rates for US monetary policy were larger and faster than anticipated in the previous edition of this report. Therefore, any reductions that might be in store for the near future will probably be few. The expectation in this report is that the Fed will lower its policy rate to 1.75% in the coming months, from 2.25% at the end of March. However, given the inflation situation and expectations of inflation for the short-term (Graphs 43 and 44), the Fed does not have much room to maneuver. The central banks in the euro zone and Japan are less likely to reduce their benchmark rates, due to the increased pressure being brought to bear on inflation.

Graph 43
Annual Consumer Inflation in the United States



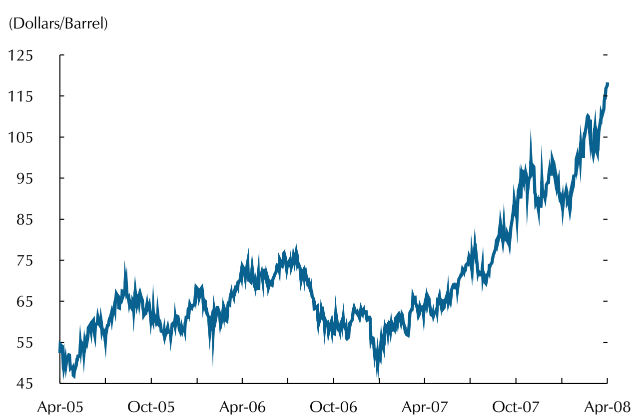
Source: Datastream

Graph 44
Survey of Inflation Expectations in the United States for a One-Year Horizon



Source: Datastream, Michigan.

Graph 45
Price of Oil (WTI),
New York Stock Exchange



Source: Datastream

At this point, there are no major changes in the forecasts for the emerging economies. Their performance so far this year has yet to be affected by the problems in the developed economies. In fact, by March, the Chinese economy had grown by 10.6% and, although Chinese exports have suffered, internal investment and consumption have offset much of the decline in momentum.

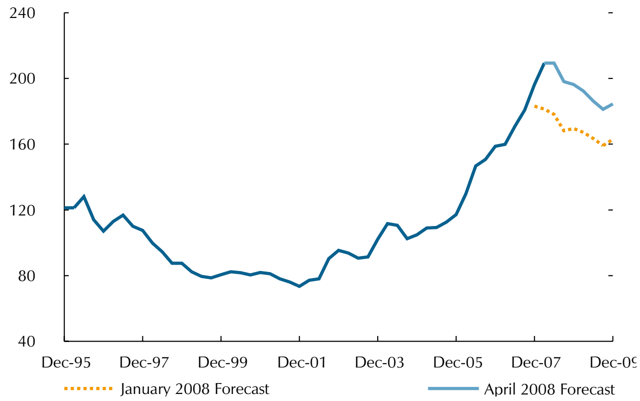
The growth anticipated for our trading partners is similar to the forecast three months ago. The forecast for Venezuela is 5.8% growth in 2008 and 4.0% in 2009, with local demand at levels similar to those observed in 2007 (19%). The forecasts for Ecuador improved slightly compared to the last report and are now 2.7% for this year and 3.5% for the next. Our exports to both these countries will continue to depend more on the behavior of local demand than on GDP.

In the foregoing context, terms of trade for Colombia and for most economies in the region are expected to remain high or to increase. This forecast is based on the upward trend in prices for most raw materials during the first quarter, which tended to exceed the forecasts published in the previous edition of the *Inflation Report.*

Oil is the prime example. The price of a barrel of oil was nearly US$120 in the weeks before this report was released (Graph 45). That being the case, we now expected the price to average US$95 per barrel in 2008 (compared to US$87 forecast in the December report).

The third quarter of last year witnessed unexpected increases in all other commodity prices. As with oil, the driving force behind these hikes is world demand, which remains strong, coupled with the emergence of different supply shocks and increased speculation due to a weaker dollar worldwide. Although some decline in prices is expected, particularly for next year, they would still be quite high. According to The Economist Intelligence Unit, commodity prices, excluding energy, would increase by 10.6% in 2008, compared to 0.4% forecast three months ago (Graph 46). The projection

Graph 46
Full Commodity Price Index,
Excluding Oil (WCF)



Source: The Economist Intelligence Unit.

for next year is a reduction of 7.4%, on average, provided there is some restraint in world demand.

The forecasts for Colombia's main exports also were revised upward, especially in the case of oil, coal and gold (Table 10). However, as mentioned before, there is a great deal of uncertainty about the future of these prices.

Broadly speaking, most of momentum in the Latin American economies, including the Colombian economy, will be supported by high terms of trade. Accordingly, one would expect capital to continue to flow towards the region's emerging economies. Foreign direct investment, in particular, is expected to remain at levels similar to those observed during the past two years (see the Box).

Table 10
International Prices

	2005	2006	2007	Forecast for 2008	
				Current [a/]	Previous [b/]
Coffee (*ex dock*) (dollars/pound)	1.2	1.2	1.3	1.4	1.2
Oil (dollars/barrel) [c/]	49.8	58.3	66.2	90.2	67.1
Coal (dollars/ton)	47.8	48.0	50.8	69.6	55.7
Ferronickel (dollars/pound)	2.4	3.6	5.5	4.2	3.8
Gold (dollars/troy ounce)	445.0	604.6	696.9	960.4	865.4

a/ Balance of payments estimated in April 2008
b/ Balance of payments estimated in January 2008.
c/ Average price of crude exported by Colombia, based on an assumed WTI price of US$95 in 2008.
Source: The Central Bank of Colombia

The major risk to the international scenario described above is a more pronounced and longer economic recession in the United States, and the adverse effect it would have on global demand. The problems in the US economy are structural; they will take time to resolve and will require more than monetary and tax-policy adjustments. This would be particularly true if the U.S. financial sector moves towards a credit crunch, in which case it would take the country longer to emerge from the downward cycle and growth in 2009 would be affected. If that were to happen, one would expect to see a sharp drop in terms of trade and capital flows to the emerging economies.

Moreover, the steady increase in prices for oil and other raw materials in recent weeks adds to the possibility that levels for all of 2008, and even 2009, will exceed those contemplated in the central scenario described above. This would suggest a more profound uncoupling of the region's emerging economies from U.S. growth than the one considered in this report.

B. BALANCE OF PAYMENTS

A comparison between the forecasts published in the December 2007 edition of the *Inflation Report* and the current ones shows better prospects for Colombia in the external context. In particular, the improvement in international commodities prices associated with our exports could make up for less external demand as a result of less growth on the part of our trading partners, primarily the United States. Both factors influence projections on income and other items in the balance of payments.

With respect to imports, the forecast for 2008 is growth at a pace similar to the one observed during 2007. The increase in foreign purchases would be associated with investment projects and the purchase of military equipment (the value of which would equal 0.6% of GDP). In this event and considering the uncertainty surrounding the extent of the slowdown in the US economy and how it might affect world growth and international commodity prices, Colombia's current account deficit is expected to be about 3.6% of GDP.

As to the flow of capital into Colombia, the Bank's central scenario assumes the decisions made by foreign investors concerning the investment projects that have been announced already will not be affected by the uncertainty surrounding the recession in the United States. Accordingly, FDI flows are expected to be high and similar to what they were in 2007.

C. INTERNAL GROWTH

1. GDP Forecast for 2008

Economic growth is expected to be more moderate in 2008, following the build-up observed at the end of 2007. However, the current forecast for 2008 is higher than the one in the December report, since the pace of growth at the end of last year was more than what the Central Bank anticipated.

As in December, the expectation in this report is that a number of factors will allow the economy to slow gradually towards rates that are compatible with the Central Bank's long-term target for inflation. The following are the main ones:

- The policies adopted by the Central Bank since 2006, which have begun to be reflected primarily in a reduced supply of retail loans

- The estimated slackening in world growth, especially growth of the developed economies

- Less momentum in exports to Venezuela

The country's current account deficit in 2008 is expected to be about 3.6% of GDP.

Colombia's economic performance will be determined largely by how the external context and particularly by less growth in the U.S. economy.

The performance of the Colombian economy will be determined largely by the external context, particularly by less growth in the US economy and how it influences the other developed economies and emerging countries such as China and India.

There is currently a great deal of uncertainty about the extent of coordination between the U.S. economic cycle and those of the emerging economies. In this report, that coordination is assumed to be partial, above all in the case of emerging economies that are exporters of raw materials, such as Colombia. The upward trend in China, India and other large emerging economies is expected to continue, despite the slowdown in the United States and in some of the other developed economies. As a result, terms of trade for Colombia and much of Latin America will remain at historically high levels.

In view of the foregoing, two scenarios were taken into account to determine the forecast for economic growth in Colombia during 2008. Both depend on how the U.S. economy performs. The first scenario contemplates a reduction in GDP in the United States during 2008, with a positive growth figure for the entire year at around 0.8%, as well as raw material prices that are higher and exceed those observed in 2007, on average. In the case of oil, West Texas Intermediate (WTI) is expected to average US$95 a barrel. Venezuela is expected to see a relatively high degree of economic growth, but less than in past years. However, this does not imply a slowdown in local demand in Venezuela.

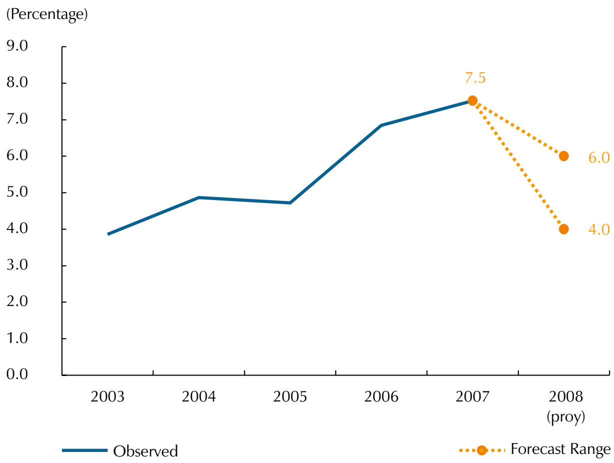
From the standpoint of this scenario, confidence in Colombia would remain high, allowing for the significant influx of foreign exchange for DFI to continue. In fact, it is expected to be similar to what it was in 2007. The supply of foreign exchange would be reinforced by the flow of remittances, which are not expected to be seriously jeopardized by less economic growth in the United States and Europe.

The second external scenario assumes a sharper recession in the United States, with 0% growth for the year as a whole. In that case, the impact on the world economy would be greater. Prices for raw materials would suffer a setback compared to their current levels and would be similar to those observed last year. The price of oil would be expected to average US$70 per barrel. This would mean less economic growth in Venezuela, including less of an increase in local demand. The influx of foreign exchange in the form of remittances and FDI would be affected as well.

In this report, coordination between the economic cycles in the United States and Colombia is assumed to be partial

In addition to both these scenarios, the GDP forecast for 2008 took into account the uncertainty that surrounds government spending, particularly on investment. This is due, among other reasons, to numerous plans for road and transport expansion, and the increase in military spending announced by

Graph 47
GDP Growth Forecast for 2008



(proj.) projected
Source: DANE, Calculations by the Central Bank of Colombia

the government. Consequently, the estimates were developed with the idea of more investment in civil works (associated with government investment), somewhere between 6% and 9%. However, these rates are still below those reported in the last four years and, for that reason, they might underestimate the performance of this item in 2008.

The two external scenarios also consider different degrees of FDI, consistent with different levels of deficit in the current account.

A moderate slowdown in economic growth in Colombia is expected for 2008.

Accordingly, the Bank's models indicate the Colombian economy could grow by 4% to 6% during 2008 (Graph 47). This is broader than the range published in the December report (3.7% to 5.7%), but assumes more moderate expansion than in past years. The most pronounced tendency would be concentrated in the upper part of the range. The indication in this report is that growth will likely be near 5.2%, which is more than the forecast in December (5.0%). The following are the reasons for the increase:

- Less economic growth in the United States had no impact on exports in dollars during the first quarter of the year. On the contrary, they tended to accelerate, largely because of high oil prices, but also because there has been no slowdown in non-traditional exports to countries such as Venezuela.

- A number of indicators in the United States suggest better-than-expected performance for that country's economy in the first quarter of the year.

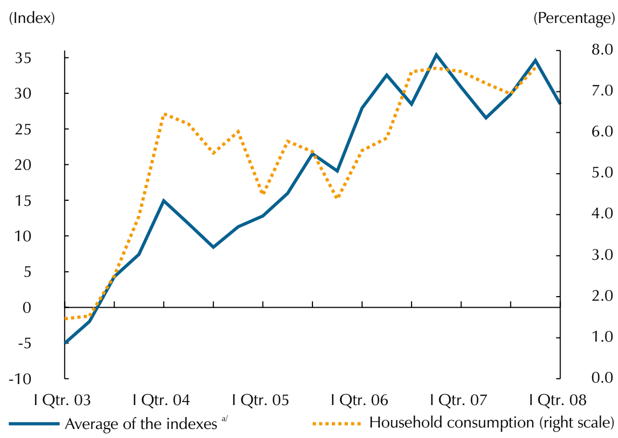
- Although several indicators for Colombia's productive sector in the first quarter suggested less of an increase compared to 2007, they still denote solid economic growth. The Fedesarrollo consumer confidence indicator for March suggests that private consumption (61% of GDP) continued to perform at historically high rates (Graph 48).

- In recent weeks, the prices of raw materials exported by Colombia surpassed the levels anticipated in this report for the year as a whole. This could have a positive impact on the amount of income available within the country and, ultimately, on spending.

The forecast for growth in 2008 is between 4.0% and 6.0%, with 5.2% being the most likely figure.

The forecasts, by type of spending, for the most likely projection are shown in Table 11. Despite the upward bias, all the aggregates are expected to be less than those registered in 2007. The slowdown in household consumption would be due, in part, to the country's monetary policy, but also to the effect high

Graph 48
Household Consumption
and the Fedesarrollo Consumer Survey



a/ Average of the Fedesarrollo Consumer Indexes, including the Consumer Confidence Index (CCI), the Consumption Expectation Index (CEI) and Index of Economic Conditions (IEC).
Source: Fedesarrollo, calculations by the Central Bank of Colombia

Table 11
Central Scenario by Type of Expenditure
(Percentage)

	2007	2008 (proj.)
End consumption	**6.3**	**5.5**
Households	7.3	5.9
Government	2.9	4.0
Gross capital formation	**21.2**	**13.5**
FGross fixed capital formation (GFCF)	18.2	14.1
GFCF without civil works	15.8	16.3
Civil works	28.2	6.0
Variation in inventories (VI)	44.4	10.0
Total exports	**7.5**	**5.5**
Total imports	**16.4**	**14.0**
GDP	**7.5**	**5.2**
Final Domestic Demand	9.7	7.5
Final Domestic Demand without Inventory Change	8.8	7.4

(proj) Projected
Source: DANE, calculations by the Central Bank of Colombia

food prices have on the buying power of available income. A shift in private consumption towards services and away from durable goods is expected as well, largely due to the behavior of interest rates. Investment should continue to grow at a significant rate, particularly to expand production capacity in tradable sectors, primarily mining.

The most uncertain forecasts are for the external sector, where a slowdown in exports is anticipated as a result of worsening external conditions. Considerable growth in imports is expected, fundamentally due to the acquisition of military equipment, imports associated with foreign investment and those that would be required for civil engineering works (Table 11).

This report does not rule out the possibility of rather weak growth during the first quarter of the year compared to the forecast for 2008 as a whole. This would be due, among other factors, to Easter Week in March, which implies fewer working days during the first quarter of the year with respect to the same period in 2007. Another factor is the new method being used by DANE to calculate GDP for 2008, which adds a great deal of uncertainty to the forecasts.

D. INFLATION FORECASTS

1. Forecasts

Growth during the first quarter will be affected by the presence of more holidays compared to the same period in 2007.

As explained in earlier sections of this report, inflation during the first quarter of the year was subject to a variety of pressures that were not fully anticipated in the December report. Accordingly, the results tended to be well over the projections outlined in that edition. The forecasts developed by the Central Bank's technical team increased, particularly for 2008, after these pressures were included and the forecast errors of the last quarter were taken into account.

The higher forecasts were mostly for food and regulated price inflation, although the forecast for inflation without food and regulated prices also was raised slightly. There were no relevant changes in the non-tradable inflation forecast.

The central forecasts point to a decline in total inflation during the second quarter of the year.

According to the Bank's model, total consumer inflation would be 4.9% by the end of 2008, which is above the forecast in December (4.7%) and outside the target range set by the BDBR (between 3.5% and 4.5%). For 2009, the same model points to a reduction in inflation towards the 4.0% level, ending the year very close to what was forecast in the last report (Table 12). In November 2007, the BDBR stated the mid-point for target inflation in 2008 would be between 3.0% and 3.5%.

The central forecast suggests that total consumer inflation would peak in March of this year and decline during the second quarter, following a path similar to the forecast for food inflation. Non-food inflation would fluctuate around 4.7% throughout 2008, being slightly higher than the forecast in the December report.

Since last year, inflation in Colombia has been subjected to a range of pressures that explain why prices have increased above and beyond the Bank's targets. For the forecasts in the last report, it was assumed the price hikes would subside slowly, as of early 2008, allowing for a gradual reduction in inflation. However, the beginning of the year saw a continuation of inflation pressures and some even increased, especially outside pressures.

The reasons that explain the higher forecasts for the remainder of 2008 are linked essentially to the recent rise in fuel and food prices. The assumption behind the central forecast is that most of the price hikes in recent months are temporary. Nevertheless, the higher levels at the start of the year would be conducive to annual inflation in fuel, transport and food throughout 2008 that is above the forecast in the December report.

The central forecast for food contemplates a gradual reduction in international prices and in prices for other farm products imported by Colombia (grains, oils and oil seeds). In 2009, they should return to the average levels reported in 2007. This would allow for a reduction in internal inflation in processed foods to the 4% level, provided the peso does not depreciate sharply.

High oil prices have had an impact on the forecast for fuel and public transportation, particularly in 2008. Both these items are included in the regulated CPI. As of 2009, inflation in fuel and public transportation is expected to converge toward the long-term targets.

The higher forecasts for the rest of 2008 are associated primarily with the recent rise in fuel and food prices.

The forecast for regulated prices also was affected by price increases above and beyond those anticipated for public utilities. This was due to application of the price indexing mechanisms contemplated in the rules on regulated prices. However, these increases are expected to be concentrated in 2008. In 2009, the readjustment in rates should be more consistent with the Central Bank's targets, following the course projected for consumer inflation.

The central forecasts in this report with respect to tradable and non-tradable inflation, without food and regulated prices, have not changed significantly compared to the estimates in the last quarterly report.

In the case of non-tradables, this occurred despite the fact that growth during 2007 surpassed earlier forecasts and has raised the estimates for 2008. The explanation lies with the fact that estimates of the output gap were not changed substantially in this report, since most of the momentum observed in 2007 was accompanied by an equivalent increase in the productive capacity of the economy. In other words, the outlook in this report is for more potential or non-inflationary growth in the economy than what was forecast in earlier reports. However, this does not mean the economy is free of demand-pulled inflation pressures in 2008, since the gap would remain positive throughout the year and non-tradable inflation would remain well above the BDBR targets until next year.

Tradable inflation would continue to be low in 2008 and in 2009, thanks to accumulated appreciation in the exchange rate. Moreover, in an external context marked by high prices for commodity exports and sizeable inflows of FDI, the exchange rate is not expected to weaken sharply.

2. Risks

As in the December 2007 edition of this report, the degree of uncertainty surrounding the inflation forecasts on this occasion is higher than ever, mainly due to external events related to the weakening economy in the United States and how it might affect variables such as world demand, terms of trade and

Table 12
Central Model Forecasts (TMM) [a/]
(Percentage)

	Total Inflation	Food Inflation	Non-food Inflation				Output Gap
			Total	Non-tradable	Tradable	Regulated	
Dec-07	**5,7**	**8,5**	**4,4**	**5,2**	**2,3**	**6,4**	**2,6**
Mar-08	5,9	8,5	4,7	5,1	2,4	7,7	2,2
Jun-08	5,4	6,8	4,8	5,1	2,5	8,5	1,8
Sep-08	5,5	7,3	4,7	5,0	2,6	7,4	1,4
Dec-08	**4,9**	**6,0**	**4,5**	**5,0**	**2,2**	**7,1**	**0,7**
Mar-09	4,0	3,8	4,2	5,2	2,2	5,4	0,2
Jun-09	4,1	4,3	4,0	5,0	2,4	4,5	(0,2)
Sep-09	4,1	4,1	4,1	4,8	2,8	4,8	(0,6)
Dec-09	**4,0**	**3,9**	**4,0**	**4,4**	**3,2**	**4,2**	**(0,8)**
Mar-10	**3,8**	**3,8**	**3,9**	**4,1**	**3,5**	**3,9**	**(1,0)**

a/ These forecasts are based on a monetary policy that is intended to ensure compliance with the long-term targets for inflation.
Source: The Central Bank of Colombia

Tradable inflation would remain below target.

capital flows, among others. For this reason, the extent of the risk balance (*Fan Chart*) is still considerable.

The main risks are linked to the following circumstances.

- As mentioned, the United States might face a more pronounced and prolonged downward cycle than is anticipated in the central scenario. This would do more damage to the global economy. If that were the case, the Colombian economy would be expected to exhibit less momentum, which means that pressure on prices stemming from surplus demand would be less than estimated in this report.

- Investment in capital goods and in civil works has grown considerably in recent years and is expected to continue to do so throughout 2008. Since mid-2007, added investment has led to an increase in the productive capacity of the economy and less use of installed capacity in sectors such as industry, despite the strong momentum in demand. This being the case, the output gap may be closing faster than anticipated in the central scenario of this report. In fact, the stability of non-tradable inflation so far this year argues in favor of this conclusion.

- Accumulated peso appreciation against the dollar as of mid-2007 and particularly during the first quarter of 2008 (including the early weeks of April) has been considerable. However, it has yet to be mirrored in tradable inflation. Although the central forecast contemplates a slowdown in inflation towards the end of the year, the reduction could occur sooner and be more than expected.

The following are the risks of higher inflation:

- The increase in international food prices at the end of last year and during the early months of 2008 might not be temporary. If so, food inflation in Colombia would tend to remain high for longer than anticipated in the central forecast.

- If they remain in place, the recent hikes in international fuel prices would pose the risk of higher local rates for fuel, transportation and public utilities. The assumption in the central forecast is that average oil prices in 2008 will not exceed US$100 a barrel for WTI.

U.S. economic performance and its impact on world demand is a source of uncertainty for the inflation forecasts.

- The build-up in inflation at the start of the year and the increase in expectations may activate indexation mechanisms that had become less important in past years. This could generate higher and more persistent inflation than is contemplated in the central forecast, particularly through public utility rates.

Less inflation is a possibility, if use of installed capacity continues to decline, given the high rates at which investment is growing.

- At the beginning of the year, wages in various sectors of the job market increased at mounting rates that exceeded the targets for inflation, even after the productivity gains were taken into account. Rising expectations may be exerting second round effects on wage hikes. The central forecast in this report does not consider an increase in labor costs above and beyond the targets, but it could be a risk that would bring inflation pressure to bear this year and in 2009.

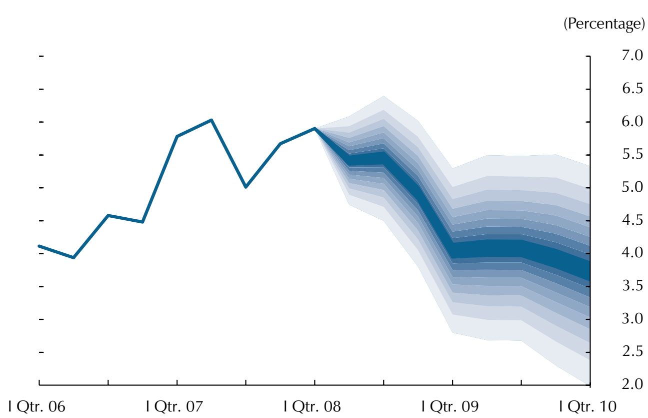
- If inflation ends the year above the target range, price and wage hikes in 2009 would have to be high. This would make it difficult to reduce inflation in the long run.

When measuring inflation for next year, it is important to remember that DANE plans to change the basic basket of goods and services it uses to calculate the CPI. Besides changes in methodology, this surely will imply the introduction of new goods and services, and a subsequent variation in the importance of different records within average household spending. In short, all of this will increase the margin of uncertainty surrounding the forecasts for 2009.

The upward risks originate with the persistence of food and fuel price hikes, wage pressures and the activation of indexation mechanisms.

Graph 49 shows the risk balance (fan chart) and includes a probability table. This report notes there is less chance of inflation below the top of the target range for 2008, compared to the results obtained earlier. As usual, an active monetary policy that is adjusted to ensure compliance with the long-term targets for inflation is implicit in the forecasts presented in this report.

Graph 49
Inflation Forecast Probability Distribution
(Fan Chart) a/



Accumulated Probability of Consumer Inflation for the Indicated Range

Inflation Ranges (%)	December 2008	December 2009
Above 5.5	19.3	5.0
Below 5.5	80.7	95.0
Below 5.0	54.7	86.8
Below 4.5	26.7	72.4
Below 4.0	8.8	53.0
Below 3.5	1.8	33.2
Below 3.0	0.2	17.4

a/ The forecasts are based on a monetary policy that is designed to ensure compliance with the long-term targets for inflation.
Source: Calculations by the Central Bank of Colombia

Attachment

Macroeconomic Forecasts by Local and Outside Analysts

The following is a summary of the latest forecasts by local and outside analysts with respect to Colombia's main economic variables for 2008 and 2009. When consulted, the analysts had access to data at March 2008.

1. FORECASTS FOR 2008

The forecasts for 2008 are shown in Table A1. Local and outside analysts expect the economy to grow by 5.3%, on average. This is three basis points above the forecast last quarter. With few exceptions, the forecasts continue to be revised upward, reflecting the favorable indicators of supply and demand in the economy. In effect, there has been a considerable increase in loans, import rates are substantial, and Fedesarrollo's consumer confidence index is still high. All of this suggests that private consumption will continue to grow at a good pace.

Although less than real GDP growth in 2006 and 2007, if this forecast materializes it would mark the fifth year in a row that growth has been equal to or above 5%. Figures like these were not considered likely at the start of the decade. According to current measurements of potential GDP, an increase between 5% and 6% appears to be more sustainable and would avoid the emergence of macro-economic imbalances that would destabilize this positive momentum in the mid-term.

The local analysts raised their inflation forecast by 63 bp (to 5.1%); the outside analysts expect an increase of 56 bp (to 5%). As in the last four reports, these rates exceed the target range set for this year (between 3.5% and 4.5%). This expectation is coherent with the outcome of the latest quarterly survey done by the Central Bank of Colombia, which indicates that only 6% of those interviewed believe the monetary authority will manage to keep inflation on target this year.

The forecasts for the exchange rate declined. The analysts expect it to end the year at Col$1,903; in other words, they anticipate 5.9% appreciation compared to the exchange rate at the end of 2007. The maximum forecast for depreciation is 3% (Col$2,078); the minimum is 15.3% (Col$1,750). This mirrors the high degree of uncertainty that exists in the market concerning the future of this variable.

Table A1
Forecasts for 2008

	Real GDP Growth (Percentage)	CPI Inflation (Percentage)	Nominal Exchange Rate (end of)	Nominal DTF (Percentage)	Fiscal Deficit (Percentage of GDP)	Unemployment Rate in Thirteen Cities (Percentage)
Local Analysts						
Alianza Valores	5.0	5.4	1,769	9.7	2.0	11.0
Anif	5.5	5.0	n.d.	n.d.	1.4	n.d.
Banco de Bogotá	5.5	5.1	1,850	9.5	1.5	10.0
Banco Santander	5.7	4.8	1,995	n.d.	(1.4)	10.1
Bancolombia-Suvalor	5.3	5.1	2,078	9.1	3.2	n.d.
BBVA Colombia	5.0	5.4	1,925	10.1	1.3	9.5
Corficolombiana-Corfivalle	6.0	5.0	1,852	10.0	n.d.	n.d.
Fedesarrollo	5.1	5.2	1,900	10.0	(1.4)	11.0
Average	5.4	5.1	1,910	9.7	0.9	10.3
Outside Analysts						
Bear Stearns	6.3	5.0	1,750	9.5	(0.5)	9.0
Citi Bank	4.9	5.1	1,850	10.0	(1.4)	10.4
CS First Boston	5.0	4.5	1,810	n.d.	1.4	n.d.
Deutsche Bank	5.4	5.1	2,055	n.d.	1.4	n.d.
Goldman Sachs	4.9	5.3	2,020	n.d.	1.4	n.d.
Average	5.3	5.0	1,897	9.8	0.5	9.7

n.d. Not available
Source: The Central Bank of Colombia, based on electronically supplied data.

With respect to the term deposit rate (DTF), the analysts raised their forecasts by 70 bp, which is very much in keeping with their new inflation forecasts. They expect the DTF to be 9.7% by the end of the year. This would suggest they anticipate no additional changes in the interbank rate (TIB) during the remainder of the year. The forecast for the consolidated fiscal deficit is around 0.7% of GDP, on average, which is quite similar to the latest projection by CONFIS for the consolidated public sector. The forecast for unemployment in thirteen cities was lowered by 70 bp to 10%, suggesting a slight improvement in the job market this year.

2. FORECASTS FOR 2009

On average, the forecast for economic growth in 2009 is 4.9% (Table A2) and 4.3% for inflation. As to the exchange rate, the analysts anticipate 5% average annual devaluation, compared to their forecasts for the end of 2008. The local analysts expect the representative market rate of exchange (TRM) to be near Col$1,982 by the end of 2008; the outside analysts expect it to be Col$2,026. This last forecast would imply 0.55% accumulated appreciation between 2008 and 2009, on average, compared to the levels registered at the end of 2007.

Table A2
Forecasts for 2009

	Real GDP Growth	CPI Inflation	Nominal Exchange Rate (end of)
	(Percentaje)		
Local Analysts			
Alianza Valores	n.d.	n.d.	n.d.
Anif	5.0	4.1	n.d.
Banco de Bogotá	4.5	4.5	1,900
Banco Santander	5.3	4.5	2,055
Bancolombia-Suvalor	5.0	4.3	2,036
BBVA Colombia	4.6	4.3	2,004
Corficolombiana-Corfivalle	5.5	4.5	1,950
Fedesarrollo	4.7	4.7	1,948
Average	4.9	4.4	1,982
Outside Analysts			
Bear Stearns	5.5	4.3	1,850
Citi Bank	4.5	4.2	2,000
CS First Boston	4.5	4.5	1,980
Deutsche Bank	5.5	4.4	2,199
Goldman Sachs	4.6	4.0	2,100
Average	4.9	4.3	2,026

n.d. Not Available.
Source: The Central Bank of Colombia , based on electronically supplied data.

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