



INFLATION REPORT

March 2009



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* Submitted by the Technical Team for a meeting of the Board of Directors on April 29, 2009.

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

THE INFLATION TARGETING STRATEGY IN COLOMBIA

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is intended primarily 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 forecast for inflation 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 the deviation would not be due to temporary shocks, the BDBR modifies its policy stance. For the most part, this is accomplished 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 recent and anticipated changes in inflation and its short and mid-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.

CONTENTS

Assessment of Inflation and Policy decisions	9
I. Inflation and Its Determining Factors	17
A. Recent Developments in Inflation	17
B. Inflation Determinants	21
Box 1: The Decent Change in the Market Basket Measure	36
II. Financial Markets	38
A. External Markets	38
B. Domestic Financial Markets	42
III. Macroeconomic Prospects	53
A. The International Situation	53
B. Balance of Payments	59
C. Internal Growth	60
D. The outlook for Inflation	62
Box 2: Protectionism: Old and New Responses to the World Crisis	66
Attachment: Macroeconomic Forecasts by Local and Foreign Analysts	69

INDEX OF GRAPHS

Graph 1	Annual consumer inflation and targets	18
Graph 2	Annual core inflation indicators	19
Graph 3	Weighted inflation diffusion index	19
Graph 4	Annual inflation in regulated prices and their components	19
Graph 5	Annual inflation in tradables and non-tradables excluding food and regulated prices	20
Graph 6	Annual inflation in non-tradables excluding food and regulated prices	20
Graph 7	Annual food inflation	21
Graph 8	Food inflation per cause	21
Graph 9	Real annual GDP growth	21
Graph 10	Annual GDP growth in tradables and non-tradables	23
Graph 11	Monthly IPI. excluding coffee processing	24
Graph 12	Building permits	25
Graph 13	Fedesarrollo monthly consumption indicator	25
Graph 14	Growth in household consumption and retail sales	25
Graph 15	Capital goods imports and gross fixed capital formation in machinery and equipment (constant pesos)	25
Graph 16	Job creation	27
Graph 17	Employment in industry and commerce	31
Graph 18	Nominal sector wage indexes	32
Graph 19	Total PPI and by origin	33
Graph 20	PPI by branches	33
Graph 21	Cost index based on SAM	33
Graph 22	Installed capacity utilization	34
Graph 23	Observed and potential GDP growth	34
Graph 24	Output gap	34
Graph 25	Observed inflation and inflation expectations	35
Graph 26	Percentage of inflation target credibility for 2002 to 2009	35
Graph 27	Inflation forecast by banks and stock brokers	35
Graph 28	Total central bank assets in developed economies	39
Graph 29	Liquidity conditions on U.S. market for commercial paper	40
Graph 30	Mortgage interest rates in the United States	40
Graph 31	Stock market indexes in the developed economies	40
Graph 32	Commercial paper outstanding in the United States. by type of issuer	41
Graph 33	Credit default swaps at five years	42
Graph 34	A. Emerging market stock index in domestic currency B. Emerging Currency Index against the Dollar	42
Graph 35	Latin American exchange rate index	43
Graph 36	Base money, by use	45
Graph 37	Monetary aggregates and deposits	45
Graph 38	Deposits	46

Graph 39	Reserve and non-reserve CDTs and bonds (share)	46
Graph 40	Gross portfolio in domestic currency with leasing	46
Graph 41	Change in consumer loan portfolio provisioning	47
Graph 42	Loan portfolio and investments as a share of total assets	48
Graph 43	Policy. IBR and TIB interest rate	49
Graph 44	Nominal interest rates on deposits	49
Graph 45	Nominal interest rates on commercial loans	50
Graph 46	Nominal interest rates on household lending	50
Graph 47	Real DTF	50
Graph 48	Real interest rate on lending	50
Graph 49	Real interest rate on ordinary lending	51
Graph 50	Real interest rate on preferential loans	51
Graph 51	Real interest rate on treasury loans	51
Graph 52	Real interest rate on consumer loans	51
Graph 53	Nominal interest rates: TES	52
Graph 54	IGBC (Colombian Stock Exchange Index)	52
Graph 55	Industrial production in the developed economies	54
Graph 56	Exports of the developed economies	55
Graph 57	U.S. Retail Sales	55
Graph 58	U.S. Consumer confidence index	55
Graph 59	European consumer confidence index	56
Graph 60	Exports in dollars from several asian economies	56
Graph 61	GDP of several Latin American countries	56
Graph 62	Chinese Exports	57
Graph 63	Forecasts for GDP growth in 2009	61
Graph 64	Fan chart for total inflation	64
Graph 65	Fan chart for non-food inflation	64

INDEX OF TABLES

Table 1	Annual inflation broken down by upward pressure at September 2008	18
Table 2	Real annual GDP growth by demand	22
Table 3	Real annual GDP growth by sector	24
Table 4	Job market indicators	28
Table 5	Job market indicators for household heads	30
Table 6	Indicators of social security in the national total	31
Table 7	Percentage of beneficiaries by agreed wage increase level for this and next year	32
Table 8	Central bank benchmark rates	39
Table 9	External borrowing	48
Table 10	Changes in real growth forecasts for Colombia's trading partners	58
Table 11	International prices	58

ASSESSMENT OF INFLATION AND POLICY DECISIONS

The annual variation in consumer prices (CPI) was 6.14% in March, which is 1.53 percentage points (pp) less than the increase reported at the end of 2008 (7.67%). This confirms the downward trend in inflation that began five months ago. The pattern of inflation during the quarter is explained by less of an adjustment in food prices, with fruits and vegetables being the only exception.

The non-food CPI also saw less of an annual increase during the same period, due to the slowdown in regulated prices. The other core inflation indicators declined, with the exception of the CPI excluding food and regulated prices, which has remained at around 4%. Consequently, the averages for the three core inflation indicators normally calculated by the Central Bank of Colombia declined. These measures do not include prices for goods and services that can be affected by temporary supply shocks; they include only those that can be affected by monetary-policy measures.

The annual variation in tradable prices, excluding food and regulated prices, rose slightly throughout the first quarter of this year. Factors such as devaluation in the price of the peso at the start of 2009 prevented the reduction in international prices for raw materials and other industrial goods from being fully passed through to local prices. However, the tendency in the exchange rate reversed during the past month.

In February and March 2009, the annual increase in prices for non-tradable goods and services, excluding food and regulated prices, stabilized at rates near 5.5%, which is the upper limit of the target range for inflation this year. These prices are closely related to the trend in local demand. The inflation inertia observed in this basket of goods and services is explained largely by the way highly indexed prices performed, such as those for education, health care and, to a lesser extent, rentals.

The reduction in inflation during the quarter was accompanied by external and internal factors that have helped to relieve inflationary pressure. The following are the details with respect to those factors:

- On the external front, the new figures for the financial system in the United States bolstered confidence on the securities market, raising

the stock market indexes. However, the forecasts for 2009 announced by leading international organizations such as the International Monetary Fund (IMF) indicate that economic growth in the United States will be negative (-2.6%) and job creation will be extremely weak. The outlook for the European economies is no better and the expectation is for a slow recovery that would begin to take shape in the final quarter of this year. In Latin America, the generalized contraction in industrial production and the drop in inflation are a reality.

- The world economy and world trade suffered a dramatic setback during the first quarter of 2009, in addition to the drop experienced during the fourth quarter of last year. These results largely confirm the fears of a sharp recession in the global economy. The range of real external indicators points to more of a decline than was envisioned in the last edition of this report. The external market for Colombian products continues to weaken and remittances from Colombian migrants keep losing momentum.
- On the internal front, after the peak in 2007, the increase in internal demand and economic growth declined during the first three quarters of 2008 to respective average annual rates of 4.4% and 3.6%. During the final quarter of 2008, these same variables slowed dramatically to 1% and -0.7%, which is less than the Central Bank and the market expected. Accordingly, GDP growth was 2.5% in 2008, which is a third of the rate observed in 2007.
- The available indicators on supply and demand show the first quarter of 2009 may have seen negative economic growth similar to what was observed at the end of 2008. They also confirm the output gap is in negative terrain and no demand-pulled pressures are anticipated for this year.
- According to the monthly and quarterly surveys conducted by the Central Bank of Colombia, inflation expectations continue to fall. Analysts' one-year ahead forecast for CPI growth, coupled with the longer term expectations for inflation implicit in the government's debt, show rates below the midpoint of the 2009 target range.
- Non-labor costs continued to decline during the first quarter of 2009, as suggested by the pattern in the producer price index (PPI). According to that indicator, annual producer inflation was 6.8%, which is 2.2 pp less than in December. The decline in international oil prices and the government's decision to lower gasoline and diesel prices as of May will permit lower costs for transport and other items that affect the CPI.
- The wage hikes reflected by the sector indicators available in February show declining increases. In the case of employees covered by collective bargaining agreements, their wage adjustments remain pegged to the annual variation in the CPI. The result was higher increases for this group of employees compared to the adjustments registered in 2008. The rise in the minimum wage led to a similar situation.

- Labor supply measured by the global participation rate (GPR) increased between December 2008 and February of this year. Because the rate of growth in that variable exceeded the increase in employment, the net result has been a higher unemployment compared to the same period last year.
- The broad monetary aggregate (M3) has lost momentum, after reflecting an upward tendency in its annual variation between November 2008 and February of this year. Even so, the annual growth rate for this aggregate is still well above the nominal increase in GDP estimated for 2009.
- So far this year, the balance of funding use and sources for institutions in the banking system shows the priority is on investments and, to a lesser degree, on credit. The slowdown in growth in the portfolio denominated in domestic currency continued until mid-February, but was less pronounced in March and early April. In real terms, the increase in the portfolio exceeds the historic average calculated since 1971, primarily because of the way the commercial loan portfolio performed. On the other hand, consumer lending continued to lose momentum.
- Unlike the situation in the developed countries, lending institutions in Colombia are solid. This is crucial if the credit channel is to operate as it should. In fact, the sector has capital adequacy indicators above the regulatory levels and continues to register important profits.
- The drop in interest rates on savings and lending shows the cut in the Central Bank's benchmark rate was passed through quickly to the market. The pattern in the non-food CPI also helped to lower those rates, in real terms, to levels near the average calculated since 2001.

In view of the foregoing, the interest rate reduction policy initiated by the Board of Directors of the Central Bank of Colombia in December 2008 was maintained between February and April 2009. During that three-month period, the reduction amounted to 100 basis points (bp) per month, inasmuch as inflation expectations were declining and within the target range, accompanied by less-than-potential economic growth. Given this scenario, demand and future economic growth can be supported without compromising the inflation target. Accordingly, in April 2009, the benchmark rate was set at 6%, which is 300 bp less than in January 2009.

The Board will continue to monitor the international situation carefully, along with the forecasts for inflation and growth. It reiterated that monetary policy in the future will depend on the new figures that become available.

Board of Directors, Banco de la República (Central Bank of Colombia)

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The technical team of the Economic Studies Division dedicates this report to the memory of JORGE E. MARTÍNEZ T., a teacher and a fine gentleman with a good heart who radiated joy and tranquility. He was a brave contender and an excellent economist, invariably willing to lend a hand and to provide support and advice, as well as compassion and understanding. He will be remembered always as a friend we could turn to and trust for solutions, intelligent advice and a kind word in difficult times. May he rest in peace.

I. INFLATION AND ITS DETERMINING FACTORS

Annual consumer inflation in Colombia fell sharply during the first quarter of the year. Core inflation was down as well, but less so.

GDP weakened more than expected in 2008. The fourth quarter witnessed a drop in production, the first since 1999.

The first quarter of 2009 is expected to see another decline in GDP.

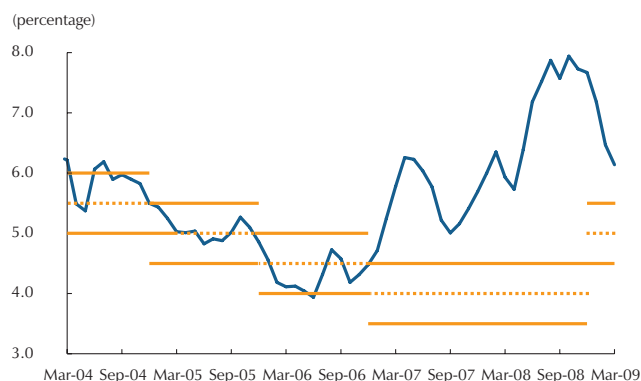
Idle productive capacity rose significantly during the last two months.

A. RECENT DEVELOPMENTS IN INFLATION

Annual consumer inflation in Colombia fell sharply during the first quarter of the year, pulled down by lower increases and declines, primarily in food and fuel prices. The forecasts outlined in earlier editions of this report signaled a major reduction in consumer inflation during the first three months of the year. However, the actual decline was more than the Central Bank's technical team and most analysts expected. Nowadays, the tendency in inflation in Colombia is similar to what it is in most developed and emerging economies, where weak demand associated with the international financial crisis has neutralized the pressures that were brought to bear on prices throughout most of 2008.

In Colombia, total annual inflation at March was 6.1%, compared to 7.7% in December 2008. With respect to the cumulative figure for the quarter, the increase in the consumer price index (CPI) was 1.9% (as opposed to 3.4% in 2008). It is important to point out that inflation reached a high of 7.9% in October of last year, following several quarters of almost continuous growth. However, it began to decline in November and December (Graph 1). Yet, despite the rapid slowdown, the outcome in March was still above the target range set for this year by the Board of Directors of the Central Bank of Colombia (BDCB) (between 4.5% and 5.5%).

Graph 1
Annual consumer inflation and targets



Source: DANE; calculation by Banco de la República (Central Bank of Colombia)

The contribution of each of the major CPI sub-baskets to the reduction in inflation so far this year is shown in Table 1. Nearly 90% of the decline is attributed to the food CPI. The remaining 10% pertains to the CPI for regulated goods and services, which includes fuel prices. In contrast, tradables and non-tradables, excluding food and regulated prices, exerted some upward pressure, but it was not substantial.

As planned, the National Bureau of Statistics (DANE) introduced a new basket for measuring the CPI, effective as of January, and made several methodological changes in the estimate. In general, the new basket does not appear to significantly have changed the calculation of inflation in Colombia.

In accordance with theory and empirical evidence, updates in the structure of the basket of family goods and services, such as the one this year, make it possible to minimize the overestimates of inflation that are due to the presence of various biases in the CPI calculation. (Box 1).

Table 1
Annual inflation broken down by upward pressure at September 2008

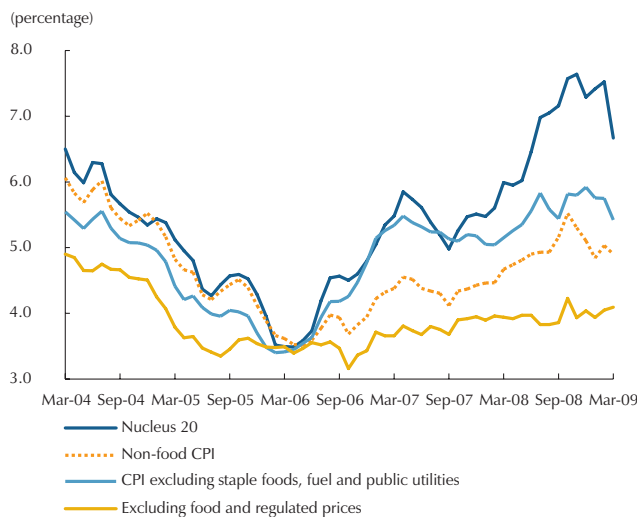
Description	Weight	Annual growth				Share (%) of build-up between Dec-08 and Mar-09
		Dec-08	Jan-09	Feb-09	Mar-09	
Inflation						
Total	100.00	7.67	7.18	6.47	6.14	100.00
Non-food	71.79	5.11	4.84	5.03	4.90	10.38
Tradables	26.00	2.37	2.38	2.33	2.45	(1.55)
Non-tradables	30.52	5.24	5.08	5.39	5.36	(2.53)
Regulated	15.26	9.45	8.49	9.01	8.11	14.46
Food	28.21	13.17	12.24	9.50	8.67	89.62
Vegetables, fruits, tubers and milk	5.12	21.94	18.94	11.89	12.28	39.23
Cereals, oils and others	8.03	19.02	18.63	16.11	12.89	38.97
Food outside the home and others	11.59	7.27	7.08	7.17	6.71	5.15
Beef and substitutes	3.47	6.45	6.42	4.64	4.17	6.26

Source: DANE; Calculations by Banco de la República (Central Bank of Colombia).

1. Core Inflation

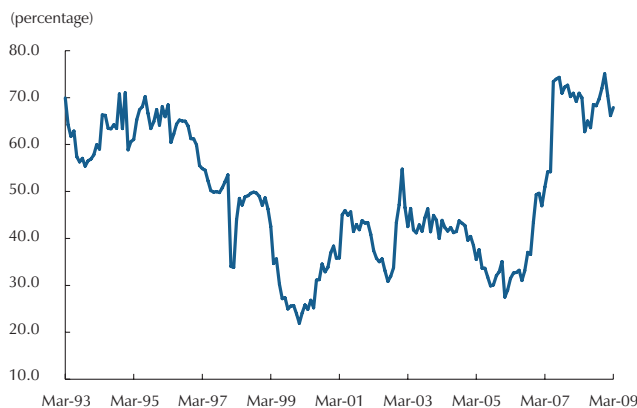
Core inflation declined during the first quarter of the year, although less so than total inflation. By the end of the first quarter of 2009, the average of the three indicators published regularly by the Central Bank of Colombia (nucleus 20, non-food CPI and CPI excluding perishable foods, public utilities and fuel) was 5.7%, which is slightly above the inflation target. In December, the average was 6.1%.

Graph 2
Annual core inflation indicators



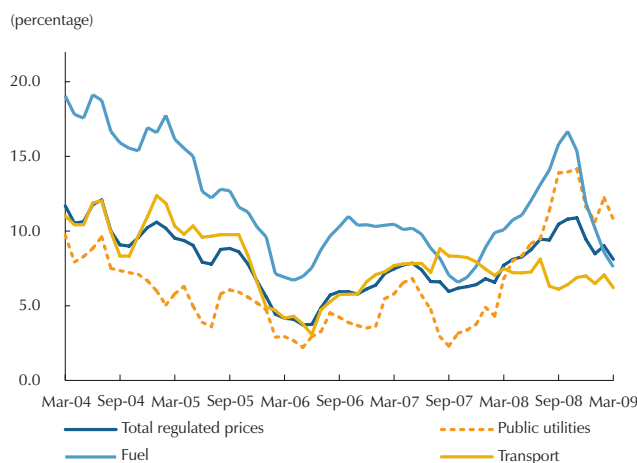
Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph 3
Weighted inflation diffusion index



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph 4
Annual inflation in regulated prices and their components



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

All three indicators showed a downward tendency during the quarter. However, in March, nucleus 20 remained high (6.7%), continuing to exceed the target range set by the BDCB. The performance of non-food CPI was particularly significant; its annual variation was 4.9% at March, which is less than the figure registered in December (5.1%) and the highest witnessed in recent years during October (5.5%) (Graph 2).

Although the decline in core inflation indicators may be a sign that demand is exerting less pressure on prices and inflation expectations are falling, much of their reduction during the first quarter was possible thanks to lower raw material costs, including moderation in fuel and other regulated price adjustments. The role of regulated prices can be observed with the CPI indicator that excludes food and regulated prices, which has exhibited less variation in recent months and is around 4% (Graph 2).

On the other hand, by March, most of the prices in the consumer basket continued to post relatively high annual increases. The inflation diffusion indicator, which measures the weighted percentage of annual price increases above the midpoint of the 2009 target for inflation (5%), remained at historically high levels, although it has exhibited some decline so far during the first quarter (Graph 3).

The highlight for the non-food CPI components was the quick and largely anticipated decline in the annual variation in the regulated CPI, which was 8.1% in March as opposed to 9.5% in December and 10.9% in November (the highest in several years) (Graph 4). The reduction was possible largely because of the stability in consumer fuel prices. Although there was no decline in this item between December and March, it did remain stable compared to the sharp increases witnessed during the same period the year before. This meant a downward tendency in its annual variation and in other prices, such as those for public transportation (which use fuel as input), and in the annual variation in regulated CPI as a whole.

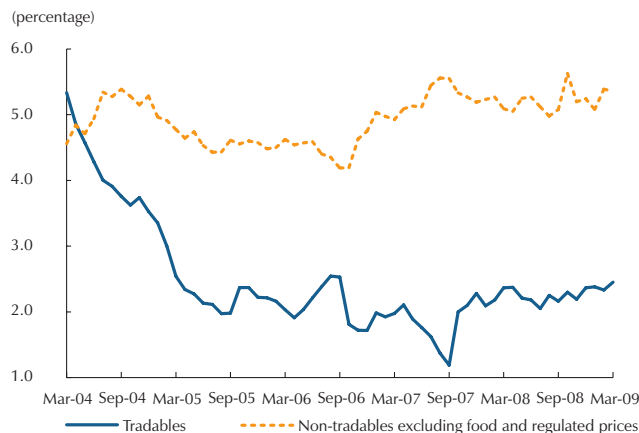
Added upward pressure within the group during the remainder of 2009 may come from energy rate hikes. The annual variation in this item by March

was still above 17%, partly because a number of the supply contracts for 2009 between electrical generating companies and distributors were signed last year, coinciding with the peak in international fuel prices. Also, generating capacity would be surpassed by demand and companies are producing more thermal energy to satisfy local demand, which raises their operating costs.

In the case of fuel, the government's recent decision to lower the price of regular gasoline by about 5% (COP\$400), effective as of May 2009, may represent a nearly 30 bp decline in inflation, according to estimates by the Central Bank. This smaller impact on annual inflation includes the direct effect of the gasoline price cut and the indirect effect of the lower production costs associated with the reduction in transportation costs.

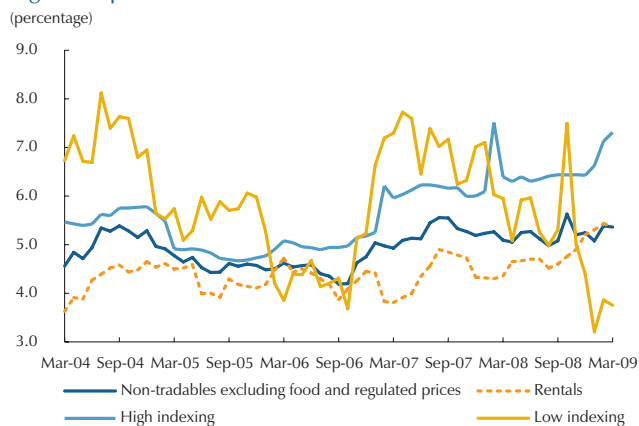
Contrary to the pattern in regulated prices, both the non-tradable and tradable CPI without food exerted upward pressure during the first quarter of 2009. In particular, the annual increase in the non-tradable CPI has been slightly above 5.0% as of mid-2007, having gone from 5.3% to 5.4% between December 2008 and March of this year, which is slightly more than was forecast by the Central Bank (Graph 5).

Graph 5
Annual inflation in tradables and non-tradables excluding food and regulated prices



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph 6
Annual inflation in non-tradables excluding food and regulated prices



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

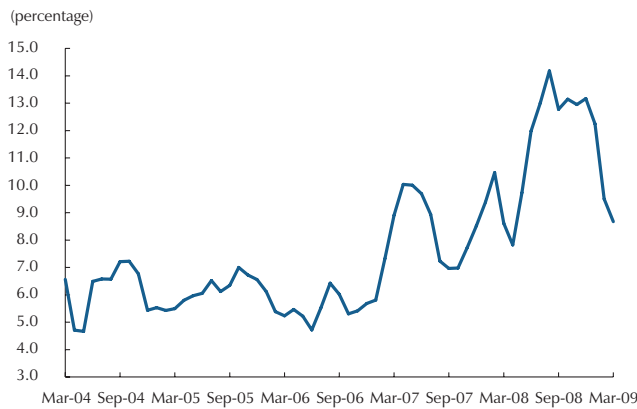
This upsurge, which is surprising given sluggish demand, may be related to the high indexing that is characteristic of a number of non-tradable items and to the role the minimum wage hike could play in labor-intensive services. An example of this situation is rentals (5.4% in March), having exhibited a clear upward tendency since September of last year, as have other items such as education, health care and financial services. In all, the annual variation in the CPI for those items was 6.4% in December 2008 and 7.3% in March. In contrast, the items with little indexing in their price formation have shown a downward tendency since the final quarter of 2008, which is consistent with weak local demand (Graph 6).

Although the annual variation in the tradable CPI, excluding food and regulated prices, remains well below the inflation target range, it began to increase gradually as of the fourth quarter of last year, from the 2.2% level, closing out the first quarter of 2009 at 2.5% (Graph 5). This build-up would be related to peso depreciation with respect to the dollar since the second half of 2008 and the start of 2009.

2. Food Inflation

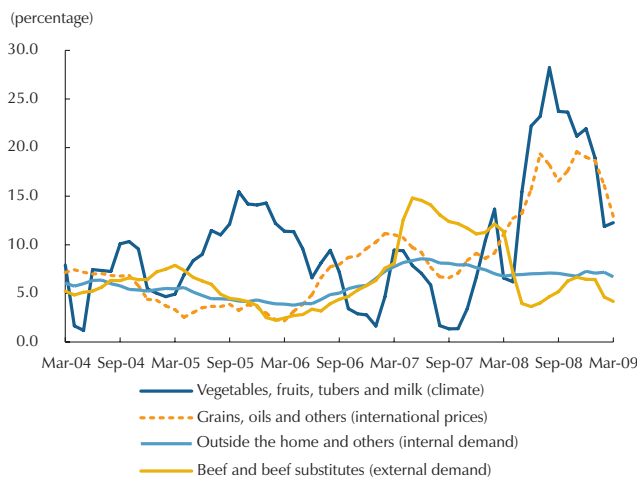
As in many countries, a number of food prices in Colombia have declined or increased far less than last year. This is consistent with the pattern

Graph 7
Annual food inflation



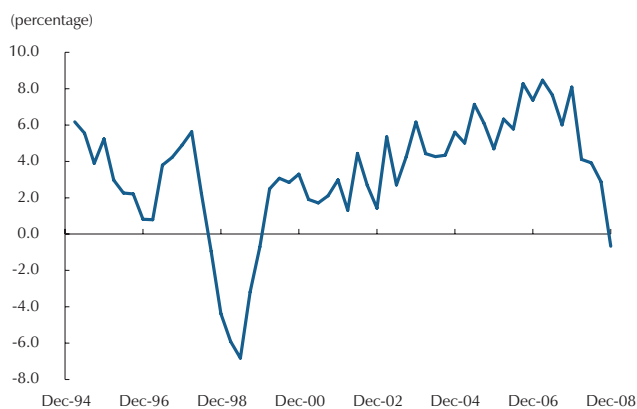
Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph 8
Food inflation per cause



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph 9
Real annual GDP growth



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

in international prices and the reduction in input and transport costs. Factors favorable to supply in Colombia also helped to curb price increases. Within the country, peso depreciation did not prevent the reduction in external prices and costs from being passed on to local prices. Consequently, the annual variation in the food CPI declined sharply during the first quarter, more so than was forecast in earlier editions of this report, having gone to 8.7% in March compared to 13.3% in December (Graph 7).

Perishable foods contributed the most to the slowdown in annual food CPI inflation, particularly the prices of vegetables, fruits, tubers and milk (Graph 8). Something similar happened to the prices for imported food such as oils and grains. Together, these two sub-groups account for nearly 80% of the slowdown in annual consumer inflation witnessed during the first three months of the year.

On the other hand and considering the reduction in food price hikes, annual inflation in the CPI for food outside the home showed an important downward tendency for the first time in two years, having gone from nearly 8.0% in December to 6.7% in March. Moreover, the annual increase in the price of meat and near-meat substitutes dropped from 6.5% in December to 4.2% in March. Weak local demand may explain this performance in both cases.

B. INFLATION DETERMINANTS

1. Aggregate Demand in 2008 and the First Quarter of 2009

a. Aggregate Demand in 2008

According to DANE, the annual increase in GDP during the fourth quarter of 2008 was -0.7%, which is below the forecast presented in earlier editions of this report and less than what market analysts expected. There has not been a drop in quarterly GDP, in annual terms, since 1999. This is indicative of more pronounced economic weakening than was observed at the start of 2008 (Graph 9).

There was no decline in internal demand during the fourth quarter (1.0% growth). However, net external demand (exports minus imports) did fall by 13.7%. The result was a broader trade deficit as a percentage

of GDP measured in constant pesos. The annual increase in exports in constant pesos was above 6% and was offset by more growth in real imports (10.3%).

Consequently, the increase in GDP was 2.5% for 2008 as a whole, which is five percentage points (pp) less than in 2007. Internal demand also experienced a sharp slowdown (by 4.9 pp), but continued to grow more than total GDP.

Broadly speaking, weaker output growth during 2008 can be attributed to several factors: a) higher inflation, principally in food prices, which meant less real available income for families; b) less investment and public spending, mainly at the local government level; c) the interest rate hikes implemented since April 2006 as a monetary policy measure; d) several negative supply shocks, particularly a number of strikes (transport, sugarcane cutters, ferronickel, the judicial sector); and e) the worsening the international crisis, which undermined consumer and investor confidence and reduced the external demand for Colombian products. All of this was particularly evident during the second half of the year.

As for demand, household consumption contributed the most to the slowdown last year, especially non durable goods consumption (Table 2). To some extent,

Table 2
Real annual GDP growth by demand

	2007 (a)	Annual percentage variation					Yearly total (b)	(b) - (a)	Contribution to the slowdown in 2009
		I Qtr.	II Qtr.	III Qtr.	IV Qtr.	2008			
Household consumption	7.6	4.2	2.8	1.5	1.7	2.5	(5.1)	(3.3)	
Non-durables	6.7	2.8	2.6	(0.1)	0.6	1.5	(5.2)	(1.2)	
Semi-durables	8.9	3.1	2.5	1.4	1.2	2.1	(6.8)	(0.4)	
Services	7.0	6.2	4.0	3.3	2.9	4.1	(2.9)	(0.9)	
Durables	12.9	(4.3)	(5.3)	(4.6)	(1.2)	(3.9)	(16.8)	(0.9)	
Government consumption	4.5	1.4	2.9	1.2	(0.1)	1.3	(3.2)	(0.6)	
Gross capital formation	13.7	8.1	9.9	13.1	(0.0)	7.7	(6.0)	(1.6)	
Civil works	21.5	(14.8)	(8.4)	9.3	(12.7)	(7.1)	(28.6)	(1.9)	
Construction and buildings	3.7	25.0	26.8	26.9	(1.0)	18.8	15.1	0.7	
Others	14.0	12.6	13.3	10.5	6.3	10.6	(3.3)	(0.5)	
End internal demand	8.5	4.7	4.5	4.1	1.0	3.5	(4.9)	(5.4)	
Total exports	11.4	14.5	9.0	3.4	6.3	8.1	(3.3)	(0.6)	
Total imports ^{b/}	13.9	12.9	9.4	8.1	10.3	10.1	(3.7)	(1.0)	
GDP	7.5	4.1	3.9	2.9	(0.7)	2.5	(5.0)	(5.0)	
Government: consumption + investment ^{a/}	8.5	(2.8)	(0.2)	3.1	(3.5)	(0.9)	(9.4)	(2.3)	

a/ Considers civil works as private investments.

b/ This item reduces GDP.

Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

the latter could be related to the increase in food prices (as mentioned earlier). Consumption of services and durable goods also declined, partly due to the monetary-policy stance adopted as of April 2006.

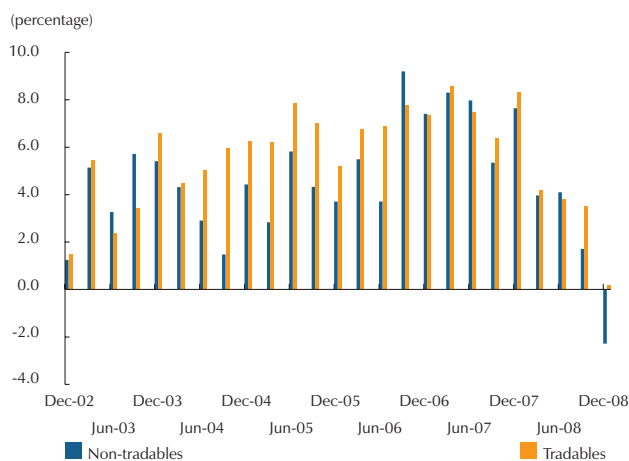
Another important contribution to the slowdown came from public spending, which is understood as the sum of public consumption and investment in civil works (the latter being an estimate of public investment). This particular aggregate accounted for 2.3 pp of the reduction in growth for the entire year (Table 2). As mentioned in earlier editions of this report, the poor pattern of investment in civil works was related, above all, to low spending on civil works at the local government level, due to the change in municipal and departmental administrations. Usually, the incoming administration spends the first year deciding on its development plan. However, the slowdown in public consumption also was due to an important effect created by the statistical basis, which was raised 8.5% in 2007.

Contrary to the situation with total consumption and public investment, the strong momentum in private investment continued throughout the year, making a positive contribution (0.2%) to growth. However, unlike past years, private investment in 2008 was concentrated more on petroleum and coal (Table 2).

Exports continued to develop at a good pace during 2008, although less so than in 2007 (Table 2). The loss of momentum was felt mainly during the second half of the year, largely as a result of two factors: 1) aggravation of the external crisis, which meant less demand for Colombian products at most export destinations and 2) fewer non-traditional exports to Venezuela and Ecuador, due to the trade restrictions those countries imposed last year.

Imports slowed as well, but continued to grow by more than 10%. The decline in momentum was mostly in consumer purchases. This is in keeping with sluggish consumption overall. The strong increase in imports of capital goods continued.

Graph 10
Annual GDP growth in tradables and non-tradables



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

On the supply side, economic growth declined in both the tradable and non-tradable sectors (Graph 10). The slowdown in the tradable sector was concentrated primarily in industrial manufacturing, which was off by 2%, for the first time since 1999 (Table 3). The drop in industry was due primarily to several subsectors; namely, vehicles, oil refining and clothing. Mining and quarries constituted the high point in the tradable sector, having increased sharply in 2008 (from 2.9% in 2007 to 7.3% in 2008), partly offsetting the decline in manufacturing production.

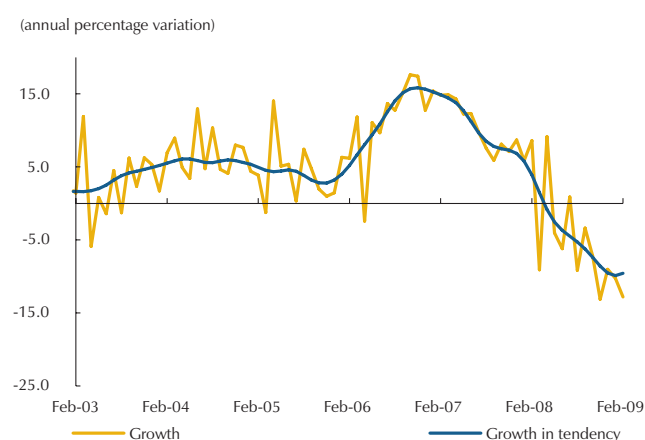
The slowdown in the non-tradable sectors was concentrated mostly in commerce and construction. Civil works explain the negative momentum in the construction sector. In contrast, building construction, including housing, accelerated during the first three quarters, growing by nearly 19% for the entire year (Table 3).

Table 3
Real annual GDP growth by sector
(percentage)

	2007	I Qtr. 08	II Qtr. 08	III Qtr. 08	IV Qtr. 08	2008
Agriculture, forestry, hunting and fishing	3.9	3.8	5.6	2.1	(0.6)	2.7
Mining and quarries	2.9	4.5	8.1	10.0	6.6	7.3
Manufacturing industry	9.5	1.8	1.2	(2.6)	(8.0)	(2.0)
Electricity, gas and water	3.7	0.7	1.7	1.2	1.0	1.2
Construction		0.6	4.4	16.1	(8.0)	2.8
Buildings	1.1	24.8	26.5	25.8	(0.6)	18.7
Civil works	19.1	(15.0)	(8.3)	9.5	(12.6)	(7.1)
Commerce, repairs, restaurants & hotels	8.7	2.1	2.9	0.2	(0.1)	1.3
Transport, storage & communication		8.8	4.5	2.3	0.8	4.0
Financial, insurance, real estate and business service companies	7.3	7.0	5.0	6.4	4.0	5.6
Social, community and personal services		3.2	3.2	1.6	0.5	2.1
Sub-total: Aggregate value	7.2	3.8	3.8	2.9	(0.6)	2.5
Taxes minus subsidies	11.5	6.9	5.6	2.8	(1.7)	3.3
Gross domestic product	7.5	4.1	3.9	2.9	(0.7)	2.5

Source: DANE; calculations by Banco de la República (Central Bank of Colombia)

Graph 11
Monthly IPI, excluding coffee processing



Source: DANE (MMM); calculation by Banco de la República (Central Bank of Colombia).

b. Outlook for the First Quarter of 2009

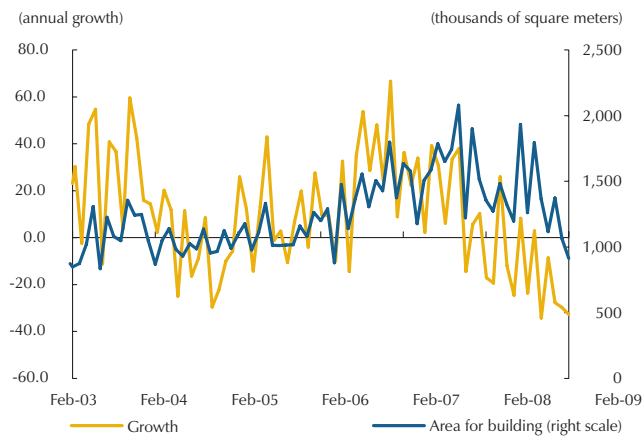
Indicators for the first quarter of this year show the Colombian economy continues to weaken. The figure announced by DANE for industrial production shows further decline. In February, the annual growth rate was -12.8%, which is less than the figure registered the month before, when industrial production was down by 10.3% (Graph 11).

Other supply-side indicators are equally troubling. For example, the demand for energy registered a 5.1% decline when adjusted by the number of working days, despite a recovery in March, when it was up by 5.0% (compared to -3.2% the month before). Likewise, the February indicator for industrial orders, compiled by Fedesarrollo, was still low, while inventories remained high. The correlation

between this last measurement and production is negative. In the case of building construction, the reduction in permits (32.7% in February) (Graph 12) and in cement production (21% in February) offer no reason for optimism.

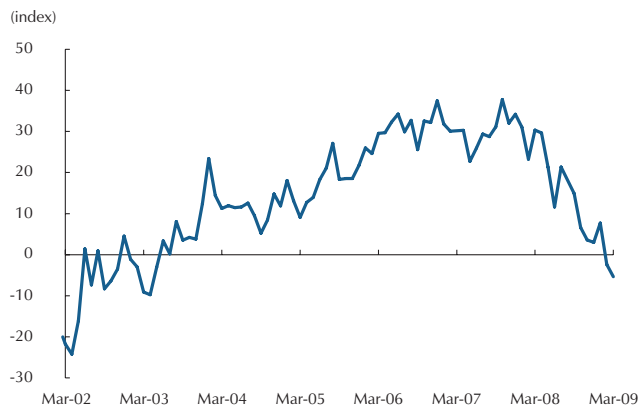
As for demand, the Fedesarrollo consumer confidence indicator in March was down again, suggesting weak household consumption during the first quarter of the year (Graph 13). The retail sales index, according to DANE, exhibited a

Graph 12
Building permits



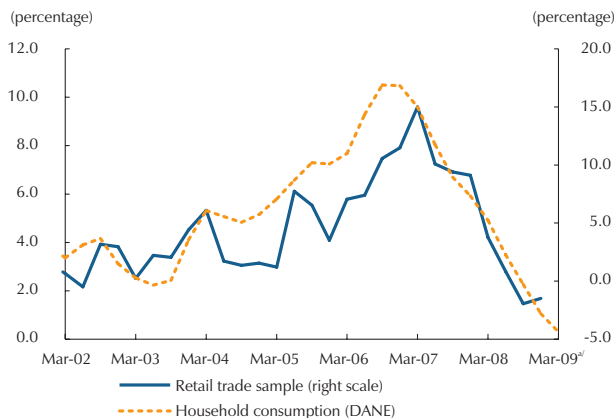
Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph 13
Fedesarrollo monthly consumption indicator



Source: Fedesarrollo.

Graph 14
Growth in household consumption and retail sales



a/ January-February average.
Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

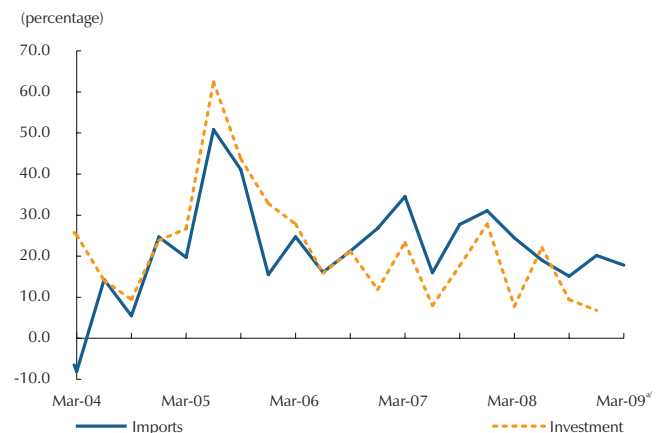
similar pattern, registering an annual decline of 4.1% in February. In the past, there has been an important correlation between retail sales and household consumption (Graph 14).

Finally, with respect to investments other than those related to home building, the signs are more favorable. By February, imports of capital goods, measured in constant pesos, had sustained a positive annual growth rate of 17.8% (Graph 15).

All these indicators suggest the Colombian economy continued to weaken during the first quarter of 2009. Judging by the poor performance of traditional and non-traditional exports during January, which were down respectively by 13.6% and 14.8%, in dollars, the external crisis continues to have an important impact within the country (See the highlighted section on the next page).

In addition to less external demand, consumer confidence is another channel through which the crisis is being passed on (Graph 13). This situation may have been aggravated by household borrowing,¹ which is now relatively high, and by the limited rise in employment and the growth in unemployment (see the following section).

Graph 15
Capital goods imports and gross fixed capital formation in machinery and equipment (constant pesos)



a/ January-February average.
Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

1 See the March 2008 edition of The Financial Stability Report, Chapter III, Section B, Central Bank of Colombia.

EXPORTS BY JANUARY 2009 AND IMPORTS BY FEBRUARY 2009

By January 2009, the annual decline in total exports in dollars was 13.2%, owing to a 14.8% drop in non-traditional exports (excluding gold) and a 13.6% reduction in traditional exports. Coal was the only traditional export product to experience positive annual growth (88%), while ferronickel, petroleum and petroleum derivatives, and coffee posted respectively annual reductions of 61%, 42% and 15%. This was due to lower implicit prices, not to export volume (with the exception of coffee).

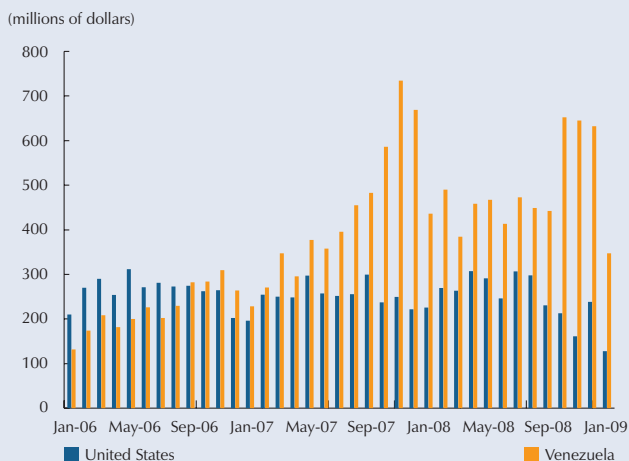
In terms of their destination, non-traditional exports performed poorly compared to the same period in 2008 (Graph A). Annual sales to Venezuela were down 20% by January 2009. This is in sharp contrast to the pattern observed in 2008, when the average increase in sales to that country was 23.4%. Sizeable reductions were reported by every sector exporting to Venezuela, with the exception of agriculture. Sales to the United States (excluding gold) were down as well, registering 43.4% negative annual growth compared to a positive annual increase of 1.8% in 2008. The value of the products exported to the United States (excluding bananas) also registered important reductions in January.

On the other hand, the decline in non-traditional exports was offset slightly by sales to Ecuador and to the rest of the world.

In fact, the annual increase in exports to Ecuador was 1.7% in January 2009 and 0.4% for the rest of the world during the same period. In the case of Ecuador, sales of non-traditional products were bolstered by the industrial sector, particularly food and beverages, transport material, and graphic arts. As for the rest of the world, the only sectors reporting increases compared to January 2008 were clothing, food and beverages, and machinery and equipment.

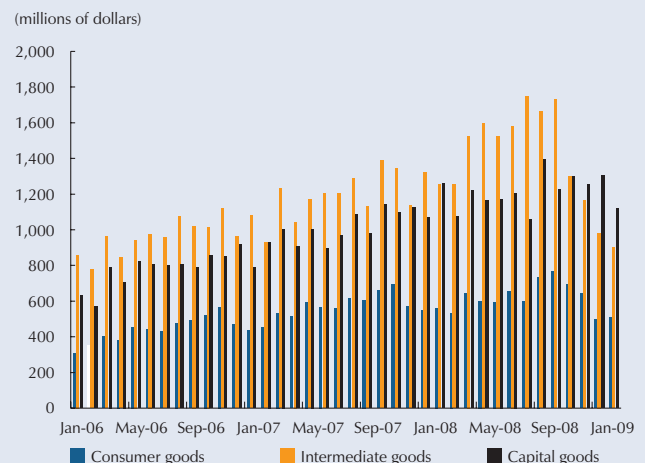
During the year to February 2009, total imports fell by 11.7% with respect to the same period in 2008. An analysis based on the type of goods (pursuant to the Cuode classification by economic use and destination) shows the decline was spearheaded, in part, by intermediate goods. The average increase in the purchase of intermediate goods slowed from approximately 25.6% in 2008 to an annual rate of -26.9% for the first two months of this year. At the same time, consumer goods registered an annual rate of -9.5% at February 2009 compared to 12.2% growth in 2008. Capital goods were the only imports to see positive growth during the first two months of the year, although they did not perform as well as in 2008, having increased 4.0% in the first two months of 2009 compared to 21.7% average annual growth the year before. This may indicate that investment, apart from investment in building construction, has continued to expand (Graph B).

Graph A
Non-traditional exports to the United States and Venezuela



Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

Graph B
Merchandise imports



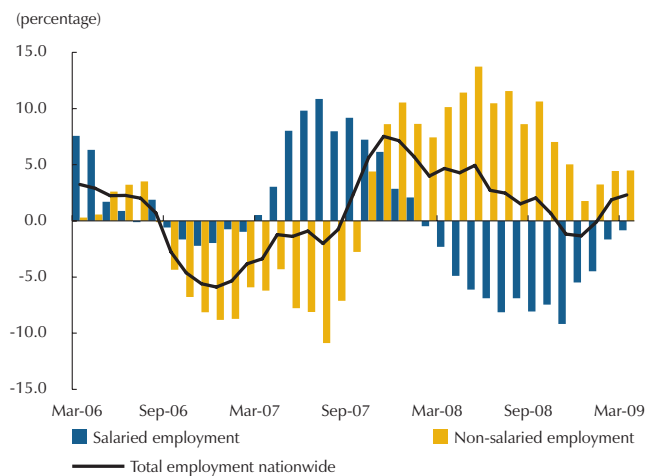
Source: DANE; calculation by Banco de la República (Central Bank of Colombia).

This being the case, annual GDP growth during the first quarter probably will remain negative. However, the contraction may be similar to what it was in the fourth quarter of 2008, provided public consumption and investment in civil works recover compared to the levels observed at the end of last year.

2. The Job Market and Wage Costs

The first quarter of 2009 saw higher unemployment rates, coinciding with a weaker economy. However, the Comprehensive Household Survey (GEIH: Spanish acronym) conducted by DANE shows this was more the result of growth in labor supply or participation than job elimination. In fact, job elimination continued to increase during the early months of the year, but not as quickly, and probably with some deterioration in job quality and stability, as suggested by the results of sector surveys. On the other hand, a looser labor market relieved pressure on wage increases in a number of sectors, allowing for wage hikes at rates below the increase in the minimum wage and in inflation.

Graph 16
Job creation
(national total – order 3 moving average)



According to the GEIH, the increase in the total number of occupied or employed workers during the first quarter of the year was 2.3% nationwide and 1.3% in the thirteen major cities. As was the case throughout 2008, salaried employment continued to decline, although less than in 2008 (Graph 16). As for the national total, the drop in salaried employment is related solely to the reduction in public-sector workers and employees, since employees who reported having been hired by the private sectors would have increased slightly. However, the latter declined in the thirteen major cities (see the results on the following page). This being the case, total job creation remained concentrated in non-salaried workers, particularly the self-employed; in annual terms, their number rose by approximately 7.5% with respect to both the national total and the thirteen major cities (Graph 16).

The slow pace of new job creation occasioned slight annual increases in the different employment rates² considered in the survey, with the exception of the thirteen major cities, where growth in employment was extremely low and did not manage to compensate for the increase in the working age population (1.9% annual) (Table 4).

On the supply side, the first quarter witnessed annual growth in labor participation in every segment of the survey (measured by the global participation rate [GPR]³) (Table 4). The surge in GPR was particularly strong in the urban areas. During the early stages of a downward phase in the economic cycle, GPR tends to

² The employment rate (ER) is defined as the ratio of employed to the working-age population.

³ The GPR is defined as the ratio of the economically active population (EAP) to the working age population (WAP).

Table 4
Job market indicators

	2005	2006	2007	2008	2009	Diff. Between 2007 and 2008	Previous Quarter ^{a/} diff. Between 2007 and 2008
National global participation rate	60.2	60.5	57.6	58.8	59.7	0.9	(1.3)
Rural area	56.9	56.1	51.2	52.9	53.5	0.5	(2.0)
Municipal areas	61.3	61.9	59.7	60.6	61.6	1.0	(1.1)
Thirteen Cities	63.0	63.2	61.3	62.6	63.5	0.9	(0.2)
National employment rate	52.1	52.9	50.2	51.7	52.0	0.3	(1.6)
Rural area	52.1	51.5	47.0	48.5	49.1	0.6	(2.1)
Municipal areas	52.1	53.3	51.2	52.7	52.9	0.2	(1.4)
Thirteen cities	53.1	54.3	53.2	54.9	54.6	(0.3)	(0.8)
National Unemployment Rate	13.5	12.6	12.9	12.1	12.9	0.8	0.7
Rural area	8.4	8.2	8.3	8.4	8.2	(0.2)	0.5
Municipal areas	15.0	13.9	14.2	13.1	14.2	1.0	0.7
Thirteen cities	15.8	14.0	13.3	12.3	14.0	1.7	1.0

a/ Pertains to absolute annual variations for the fourth quarter (October-November-December)
Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

THE MOMENTUM IN EMPLOYMENT AND UNEMPLOYMENT IN THE THIRTEEN MAJOR CITIES DURING THE FIRST QUARTER OF 2009

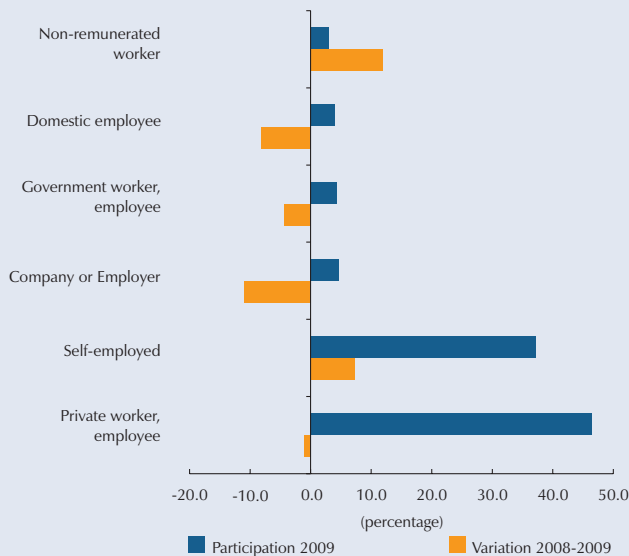
An analysis based on occupational position shows the weak pattern in the thirteen major cities during the first quarter was due to the sharp annual reductions registered by companies and employers, internal employment and government employees. These segments, as a whole, account for 13% of the employed population. Private employment, which is the main component of salaried employment and a significant portion of the total, was down slightly as well. The increase in employment is fueled solely by the non-salaried nucleus; in other words, by self employment and non-remunerated workers (40% of the total employed) (Graph A).

A breakdown of the increase in employment by economic sectors (Graph B) shows the manufacturing industry,

transport, storage and communications, and other branches with less weight¹ experienced annual declines in the demand for work. Because it carries more weight in the total (18%), the manufacturing industry was the sector with the most pronounced negative contribution. Commerce, restaurants and hotels, real estate activities, and construction were the sectors that contributed to the rise in employment.

¹ Agriculture, livestock, hunting, forestry and fishing; mining and quarries; supply of electricity, gas and water, and financial brokerage activities.

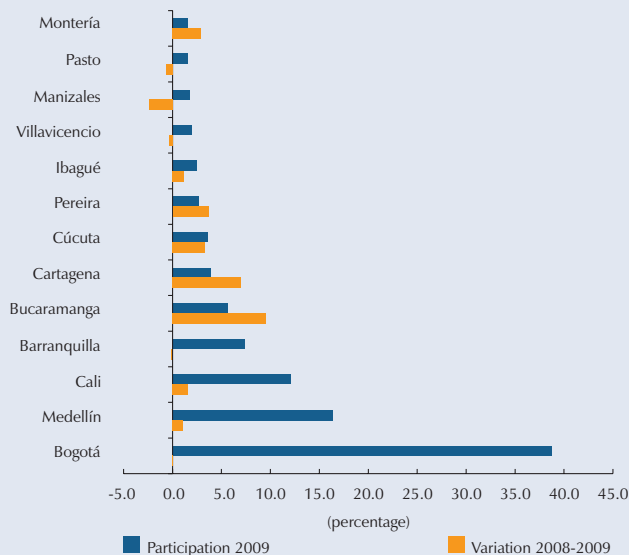
Graph A
Participation and growth in employment in the 13 major cities by occupational position



Source: DANE.

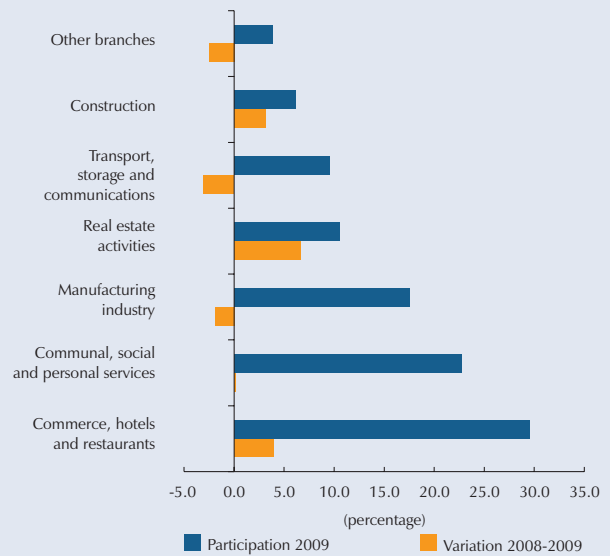
An analysis of employment by city is shown in Graph C. Manizales, Pasto, Villavicencio and Barranquilla, which account for 13% of total employment, experienced a decline in annual employment during the first quarter. The most growth in employment occurred in Bucaramanga and Cartagena, in that order. The three major metropolitan areas (Bogotá, Medellín and Cali), which account for 67% of the employed, exhibited growth rates that did not exceed 2%.

Graph C
Participation and growth in employment by city



Source: DANE.

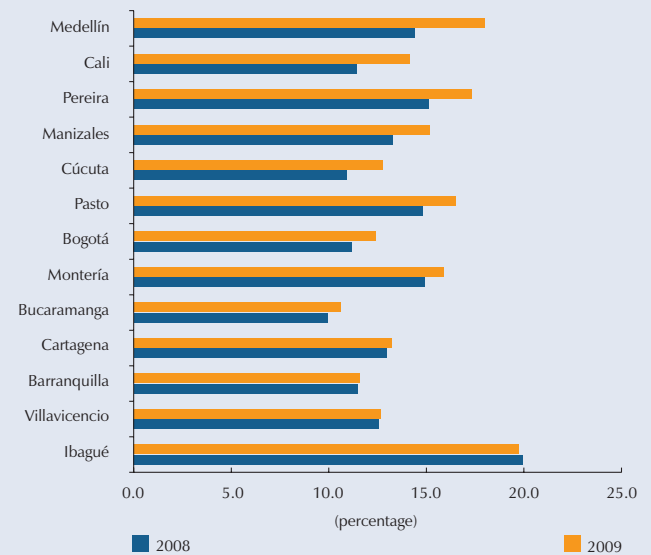
Graph B
Participation and growth in employment in the 13 major cities by economic branch



Source: DANE.

Finally, when calculating the unemployment rate compared to the same quarter the year before, we find that the cities with the largest increases are not necessarily those that reported a drop in employment (Graph D). In fact, Medellín, Cali and Pereira showed the highest jump in the unemployment rate, despite growth in the number of employed. This would signal an expansion in the labor supply that exceeds the demand for labor in those cities.

Graph D
Unemployment rate in the thirteen major cities: 2008-2009^{a/}



a/ The cities are listed in descending order according to the annual variation in the unemployment rate.
Source: DANE.

increase owing to the departure of secondary workers from the job market. Less income for household heads and the decline in the quality of work would explain this phenomenon.

The unemployment rate increased because growth in the labor supply during the first quarter outpaced growth in the demand for labor (employed). This was particularly evident in the urban areas and in the national total, but did not occur in the rural areas. Accordingly, quarterly unemployment in the major metropolitan areas was 14.0%, which is 1.7 pp more than during the same period in 2008. As to the national total, unemployment during the quarter was 12.9%, having risen 0.8 pp (Table 4).

The most stable employment throughout the economic cycle is that of household heads. Therefore, a drop in employment in this group may be indicative of a serious economic downturn. This did not appear to be the case in Colombia up until the first quarter of 2009, since employment among household heads had not fallen in any of the survey domains. In fact, the early months of this year saw an annual increase of 3.2% in the national total and 1.0% in the thirteen major cities.

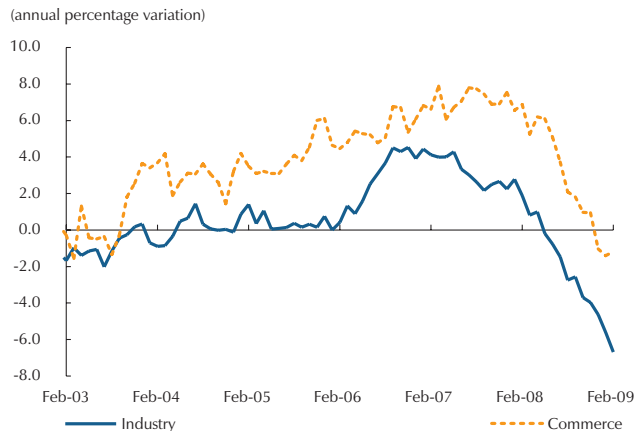
However, the pace of job creation has not stayed abreast of the increase in labor supply within this segment of the population. As a result, their unemployment rates are up. As is the case with the total population, the annual increase in the unemployment rate is more pronounced in the thirteen major cities (1.0 pp from 6.6% in 2008 to 7.6% in 2009) (Table 5).

Table 5
Job market indicators for household heads

	(January-February-March Average)					Diff. between 2008 and 2009	Previous quarter ^{a/} diff. between 2007 and 2008
	2005	2006	2007	2008	2009		
National global participation rate	80.4	80.4	79.2	79.6	80.2	0.5	(1.3)
Rural area	85.0	85.4	83.6	83.4	84.7	1.3	(0.3)
Municipal areas	79.0	78.9	77.9	78.5	78.9	0.3	(1.6)
Thirteen cities	78.3	79.0	77.8	79.1	78.9	(0.2)	(1.2)
National employment rate	75.7	75.5	74.7	74.9	74.9	(0.0)	(1.7)
Rural area	82.4	82.7	81.5	81.1	82.1	1.0	(0.7)
Municipal areas	73.7	73.4	72.7	73.1	72.8	(0.3)	(2.0)
Thirteen cities	72.3	73.1	72.6	73.9	72.8	(1.0)	(1.9)
National unemployment rate	5.8	6.0	5.7	5.9	6.6	0.7	0.6
Rural area	3.0	3.2	2.5	2.8	3.1	0.3	0.5
Municipal areas	6.7	7.0	6.7	6.9	7.7	0.8	0.6
Thirteen cities	7.6	7.4	6.6	6.6	7.6	1.0	1.0

a/ Pertains to absolute annual variations for the fourth quarter (October-November-December).
Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

Graph 17
Employment in industry and commerce



Source: DANE (MMM); calculations by Banco de la República (Central Bank of Colombia).

In contrast, the figures from the industry and commerce surveys show lower annual employment rates, particularly during the first quarter of the year. By February, the annual decline in industrial employment was 6.7%. This is more than in earlier months and completes ten straight months of annual declines. Total employment in commerce contracted as well, but not as much as industrial employment (-1.2% by February) (Graph 17). When analyzed according to the type of work contract, the decline in employment largely involves temporary employment in industry and permanent employment in commerce.

Although the social security indicators continue to report positive annual growth in the number of people who contribute to social security, the annual variations are less than those reported in the previous

quarter, with the exception of ARP affiliates, which increased at a slightly higher rate. As cautioned in previous editions of this report, these recent figures can be somewhat distorted given the new mechanisms being used to gather information (e.g. the Comprehensive Contribution Payment Statement or PILA), as well as the added incentives to join the social security system (Table 6).

Table 6
Indicators of social security in the national total

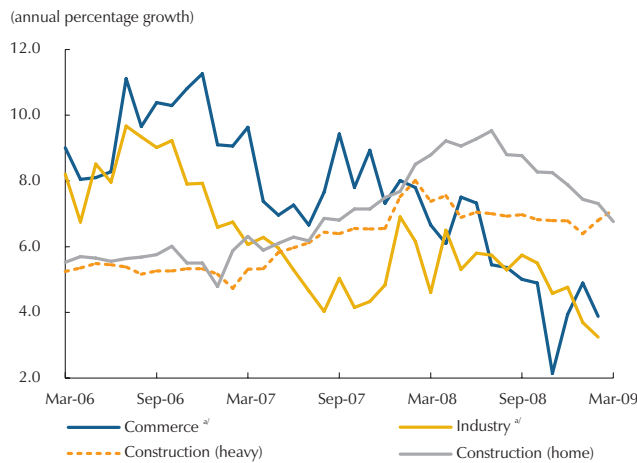
Subsystems	2008	2009	Cutoff dates	Variation 2008-2009		Percentage variation three months ago
				Absolute	Percentage	
Workers affiliated with family subsidy funds	5,380,697	5,688,445	March	307,748	5.7	6.4
Professional risk management (ARP) affiliates	5,983,066	6,269,036	January	285,970	4.8	3.7
Active Pension Fund Contributors (ISS + AFP)		5,549,906	February	472,243	9.3	10.0
ISS Pension contributors	1,705,712	1,789,733	February	84,021	4.9	3.5
Mandatory pension fund contributors	3,371,951	3,760,173	February	388,222	11.5	13.3
Voluntary pension fund contributors		522,923	February	10,330	2.0	6.0

Source: Ministry of Social Protection, with data from the Social Security Institute (ISS), Office of the Financial Superintendent, and the Family Subsidy Superintendent

Broadly speaking, the employment figures show the job market is not as tight. Coupled with an environment where inflation expectations are declining, this has reduced some of the upward pressure on wage hikes so far this year. Although the increase in the legal minimum wage for 2009 was 7.7%, in keeping with inflation in 2008 (which was relatively high), that increase does not seem to have influenced an important percentage of the wage agreements reached in Colombia.

Available sector wage indicators for the first quarter appear to corroborate that notion; they show annual rates of increase that are declining and less than the rise in the minimum wage. In the case of industry and commerce, the wage increases during the first two months of the year were even less than the actual rate of inflation.

Graph 18
Nominal sector wage indexes
(annual percentage growth)



a/ Data at February.
Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

In February, the annual growth in nominal industrial wages was the lowest on record (3.2%). During that month, the annual increase in wages in commerce was 3.9%, which also was lower than in past months. By March, nominal wages in home construction had risen 6.8% in annual terms, which also is less than at the end of 2008. However, those in the heavy construction sector accelerated slightly, posting an annual increase of 7.1% by March, which is higher than in past months (Graph 18). So far this year, all the average wage hikes in these sectors were below the increase in the minimum wage (7.7%).

The majority of the wage increases decided agreed on between January and March through collective bargaining agreements for the current year (50%) were consistent with the increase in the minimum wage, and tended to be at a higher rate than those agreed on in 2008 for the same year (Table 7, Panel

A). Out of all the agreements reached by March, 38% call for wage increases in 2010 equal to inflation in 2009, and 53% were from one to two percentage points higher, which indicates the degree of wage indexing in the CPI is the same as last year (Table 4, Panel B). It is important to point out that only a small portion of all workers in Colombia (around 2%) benefit from collective bargaining agreements.

Table 7

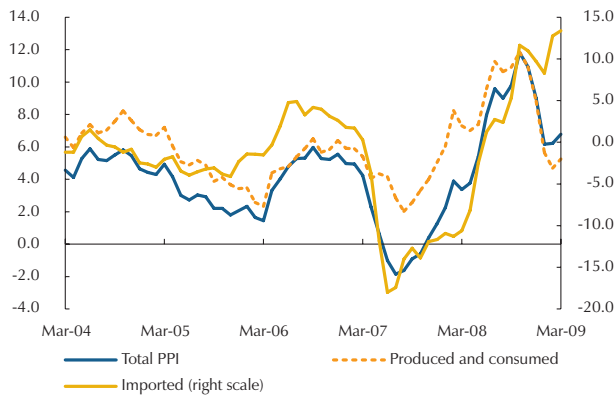
A. Percentage of beneficiaries by agreed wage increase level for current year						
	<5	[5.6]	[6.7]	[7.8]	[8.9]	>9
Agreed in 2008 (figures at December) ^{a/}	2.18	25.09	38.91	22.18	7.64	4.00
Agreed in 2009 (figures at March) ^{b/}	1.79	1.79	5.36	50.00	25.89	15.18
B. Percentage of beneficiaries by agreed wage increase level for next year						
	<7	>= 7	CPI	CPI + (0.1]	CPI + (1.2]	CPI + >2
Agreed in 2008 (figures at December) ^{c/}	9.28	8.44	26.58	31.65	20.25	3.80
Agreed in 2009 (figures at March) ^{d/}	3.16	4.21	37.89	32.63	20.00	2.11

a/ 275 collective bargaining agreements nationwide.
b/ 114 collective bargaining agreements nationwide.
c/ 237 collective agreements nationwide.
d/ 95 collective agreements nationwide.
Source: Ministry for Social Protection; calculations by Banco de la República (Central Bank of Colombia).

3. Other Costs

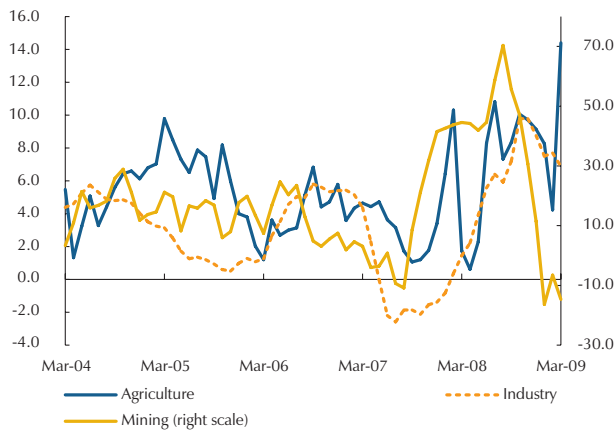
Inflationary pressures derived from non-labor costs declined during the first quarter of the year, as suggested by developments in the producer price index (PPI) and other sector cost measurements. Much of this tendency was due to prices for domestic products, since the price of imported goods remained high because of further depreciation in the Colombian peso.

Graph 19
Total PPI and by origin
(annual variation)



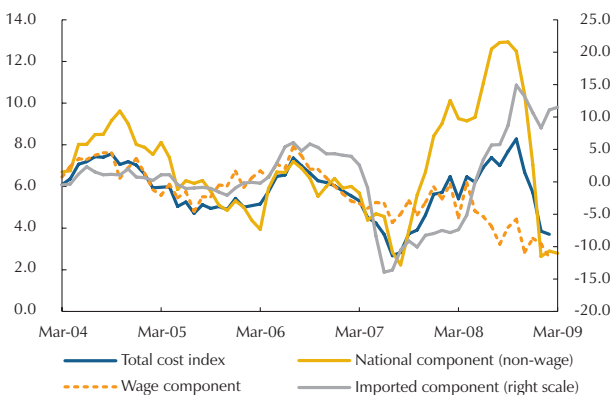
a/ Data at February
Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

Graph 20
PPI by branches
(annual variation)



Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

Graph 21
Cost index based on SAM
(annual variation)



Source: DANE; calculations by Banco de la República (Central Bank of Colombia).

In March, annual producer inflation measured by total PPI was 6.8%, having fallen sharply compared to the rate posted in December (9.0%). According to the origin of goods, the quarterly slowdown in the produced and consumed component explains most of the drop in producer inflation during the first quarter. In contrast, annual increase in the imported PPI rose during that period (Graph 19). Most of the build-up in the imported PPI was the result of depreciation, since PPI inflation calculated in dollars is declining.

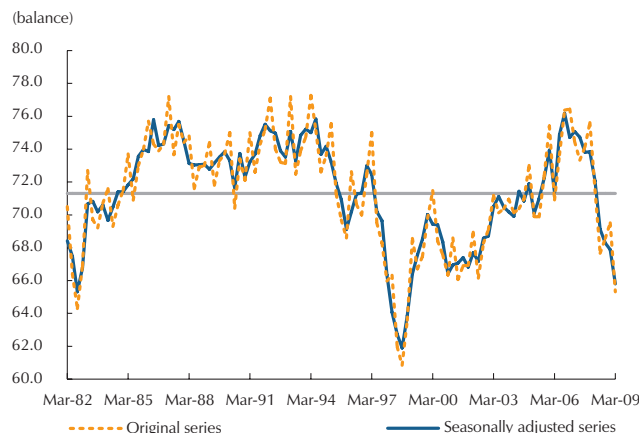
Although the slowdown in total PPI growth is evident in quarterly terms, annual PPI inflation in March grew was higher compared to the rate posted in February. Most of the surge during March was concentrated in the agricultural PPI (Graph 20). A breakdown of this sub-basket shows the rise in prices during March was concentrated in produced and consumed products, specifically in a number of agricultural products such as potatoes, beef, eggs, vegetables and fruits. The annual increases in the industrial and mining PPI during March continued to decline. In fact, the mining PPI is still in negative terrain. The downward trend in the industrial PPI was concentrated in the produced and consumed component, which may indicate a weak demand.

Non-wage cost indexes weighted according to the social accountability matrix (SAM) were estimated using the PPI as the primary input. These measurements indicate inflationary pressures rooted in non-wage costs, particularly those of the national component, have fallen off sharply. The total non-wage index was up by an annual rate of 4.7% in March, as opposed to 7.9% in December. When the decline in the rate of sector wage adjustment is included as well to calculate the total cost index, we also see less of a slowdown in total costs to companies with respect to the quarter before. By February, the last month for which information is available, the global indicator showed an annual variation of 3.7%, compared to 6.7% three months earlier (Graph 21).

4. Surplus Production Capacity and Demand-pulled Pressure

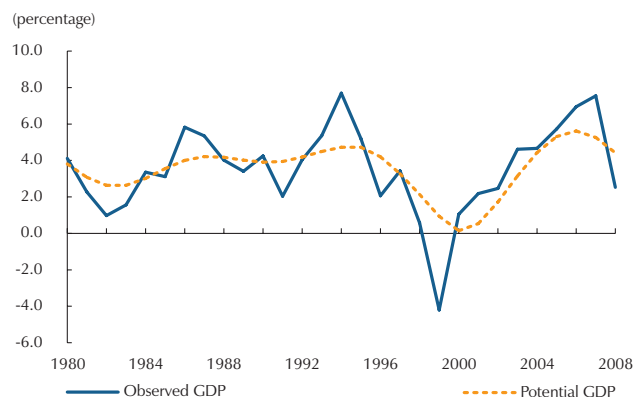
The pace of economic growth declined during 2008 and the early months of 2009, significantly reducing demand-pulled pressures. The drop in installed capacity utilization (ICU) confirms this situation.

Graph 22
Installed capacity utilization



Source: Fedesarrollo.

Graph 23
Observed and potential GDP growth



Source: Banco de la República (Central Bank of Colombia).

In fact, the ICU industrial indicators calculated by the National Association of Industrialists (ANDI) and by Fedesarrollo continued to exhibit a sharp downward tendency. The UCI indicator measured by Fedesarrollo for the first quarter of 2009 was 65.3%, which is six pp less than in March 2008 and well below its historic average (71.3%) (Graph 22).

Other indicators, such as demand as the main obstacles to industrial expansion (ANDI) and expected demand in relation to productive capacity (Fedesarrollo), also suggest demand-pulled pressures have fallen off considerably due to the slowdown in the economy. Moreover, as indicated in the preceding section, the increase in the labor supply at a time when employment growth is extremely slow also points to a looser labor market, which can be taken as an increase in surplus productive capacity in the economy. All of this forecasts less demand-pulled pressure on prices in 2009 and 2010 compared to the situation in past years.

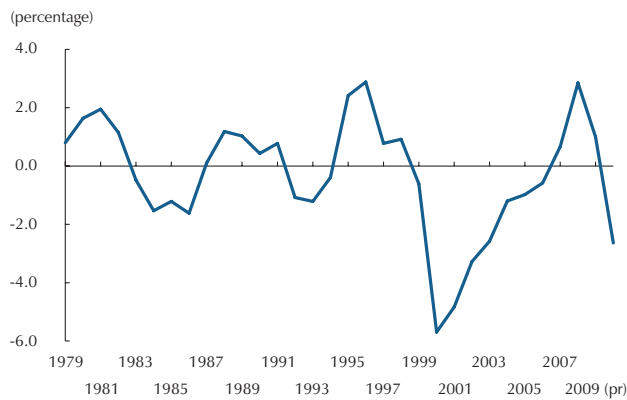
The rise in surplus productive capacity also appears to be accompanied by less potential for long-term economic growth. This perception would be valid not only for the Colombian economy but for most of the emerging and developed countries as well. During 2009, both the world economy and the Colombian economy suffered a variety of shocks that reduced productive performance and, in turn, generated a higher level of uncertainty about the development of global economic activity in the short and medium-term. As mentioned in past editions of this report, emerging market economies are experiencing higher financial costs in the current situation, accompanied by a reduction in investment flows and restrictions on international trade (see Box 2,

page 65). This situation tends to lower potential growth. Moreover, if not resolved quickly, the problems in the international financial system can be equivalent to a supply shock that would reduce potential growth worldwide, including the emerging market economies and Colombia in particular.

According to preliminary econometric estimates, average potential output growth for 2008 would be around 4.5%. In 2009, it is likely to be less. Both figures represent a decline with respect to the estimates of potential growth published in earlier editions of this report for past years (around 5.5 %) (Graph 23).

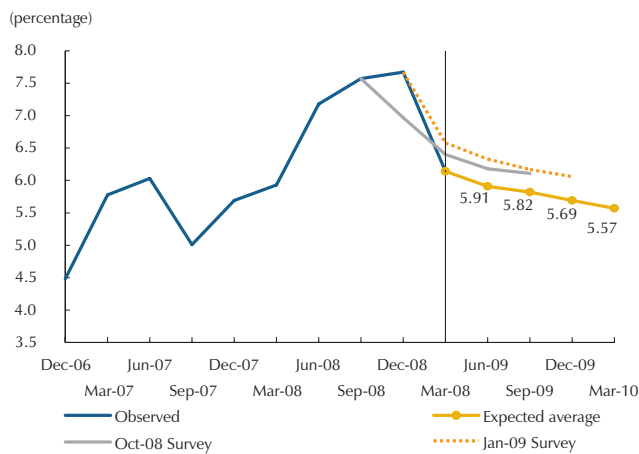
The foregoing implies the output gap would have been 1%, on average, during 2008 and surely will be in negative terrain right through 2009 (-2.6% on average, given the outlook for growth discussed in Chapter III) (Graph 24). It is important to remember that developments in the output gap will depend largely on the intensity with which the crisis evolves in the industrialized economy and the extent to which it is passed on to the emerging market economies.

Graph 24
Output gap



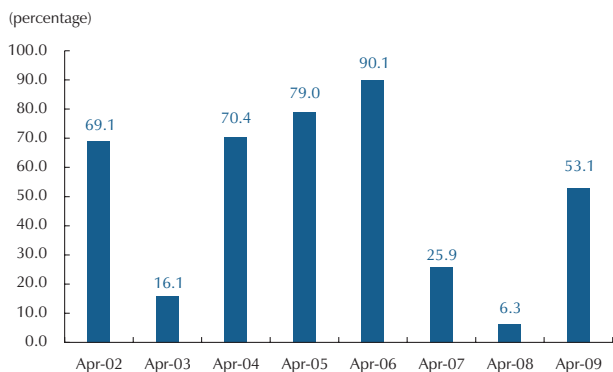
(pr) preliminary.
Source: Banco de la República (Central Bank of Colombia).

Graph 25
Observed inflation and inflation expectations
(at three, six, nine and twelve months)
(annual inflation)



Source: Banco de la República (Central Bank of Colombia).

Graph 26
Percentage of inflation target credibility for 2002 to 2009
(survey done each year in April)



Source: Banco de la República (Central Bank of Colombia).

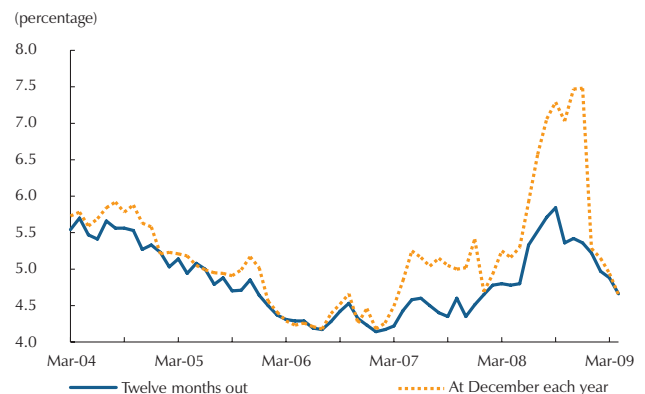
5. Inflation Expectations

So far this year, there has been a downward trend in inflation expectations. This is consistent with less demand-pulled pressure anticipated by agents in the Colombian economy and with lower prices for raw materials and fuel, as well as the decline in observed inflation.

According to the Central Bank's quarterly survey applied to different sectors at the start of April, expectations at different horizons show a substantial drop in this variable compared to the results three months before. Specifically, inflation is expected to be 5.7% by the end of 2009, which is still above the upper limit of the target range (5.5%). Even so, the survey shows an important decline in inflation expectations compared to what was reported in the last edition of this report (the expectation in the January survey was 6.1% inflation by December 2009). In the same survey, 53.1% of those interviewed expect inflation by the end of 2009 will be within the target range set by the BDCB, which is more than the proportion reported on the same date last year (Graphs 25 and 26).

Other indicators show an even sharper drop in expectations. For example, the monthly survey of financial market operators in April 2009 shows inflation is expected to be 4.7% by December 2009. This figure is near the bottom of the target range and far less than the prediction in the December report (5.3%) (Graph 27). Expectations derived from fixed-rate TES versus TES-UVR suggest inflation expectations at horizons of one to ten years are around 5%, which is less than the levels forecast in the last edition of this report (5.5%).

Graph 27
Inflation forecast by banks and stock brokers



Source: Banco de la República (Central Bank of Colombia).

Box 1 THE RECENT CHANGE IN THE MARKET BASKET MEASURE

Edgar Caicedo García*

The consumer price index (CPI) is one of the most analyzed and widely used indicators in the world. Besides providing information on changes over time in the buying power of economic agents and serving as a monetary policy goal, it is used in Colombia and in other countries in a variety of ways, one being to index the price of numerous goods and services, leasing agreements, public utilities and health care, pensions, and certain stock market and financial values. Precision and reliability are of the most importance in a statistical calculation that is monitored as closely as the CPI. Accordingly, bureaus of statistics the world over regularly make methodological changes in the market basket measure.

The CPI was first produced officially by DANE in 1954. Prior to that year, several calculations of the index were done by the Central Bank of Colombia and the General Accounting Office. The way DANE produces the market basket measure has been revised five times since the 1950s.

The first DANE market basket measure was known as CPI-20. It began to be produced in July 1954. The reference base for its calculation was not defined until a year later, being the month of June 1955 = 100. This index lasted for more than 20 years. The pattern of household consumption used to determine the weights of the different items was obtained from the Income and Spending Survey (EIG in Spanish) applied in 1953, which included the cities of Bogotá, Medellín, Cali, Barranquilla, Bucaramanga, Manizales and Pasto. A second basket was introduced in 1978. DANE used the 1970 EIG for CPI -40 (reference base December 1978 = 100) and continued with the same seven cities used in the previous CPI. CPI-60 began to be used in 1988 (base December 1988 = 100) and its coverage was expanded to include thirteen cities, with Pereira, Cartagena, Montería, Villavicencio, Cúcuta and Neiva added to the initial seven. The EIG conducted between March 1984 and February 1985 was used to update the structure of the weights assigned to each item. CPI-98 was introduced in the nineties (reference base December 1998 = 100). It used the weights obtained with the EIG in 1994 and 1995.

CPI-08 (reference base December 2008 = 100) is the consumer basket effective since January of this year. The methodological changes involved broadening the geographic coverage to include 24 cities, the new ones being Riohacha, San Andrés, Valledupar, Santa Marta, Quibdó, Popayán, Armenia, Tunja, Ibagué, Sincelejo and Florencia. The number of basic expenses¹ was increased from 176 to 181. Most notable among the new ones are social security services, complementary payments for health care, automobile insurance, purchase of mobile phones and accessories, and, sweets, candies and gelatin. The basic expenses include items such as coupons for prepaid medical care, payments to geriatric care facilities and daycare centers for children, user fees for EPS and EPS-S (health care institutions), co-payments for hospitalization, postgraduate enrollment fees, gym fees, housing complex administration fees and digital reproduction equipment, among other items.

The changes in the structure of weights and groups introduced with the new basket are shown in Table B1.1. The groups were increased from eight to nine because transportation was divided into two groups: transportation and communications. In addition, the weight afforded to housing, transportation and education as part of the basket increased, while the weight assigned to the other groups declined.

In keeping with international recommendations, DANE introduced methodological improvements with each revision of the CPI. However, updating the market basket is intended not only to improve the quality of the index, but also to eliminate certain biases that emerge over time in the way the CPI is calculated.² These biases tend to overstate inflation, since an outdated CPI fails to take into account new items that are less costly, new points of sale with more competitive prices, and better quality products. Moreover, it does not permit households to change their consumption patterns in the direction of less expensive products (substitution bias). According to studies done for Colombia by Caicedo (2002)³

* This section is an extension and, in some parts, a summary of Box 1: “The New DANE Market Basket Measure and Its Implications,” published in Report by the Board of Directors to the Congress of the Republic of Colombia, Central Bank of Colombia, March 2008. The author is an inflation expert who works with the Macroeconomic Programming Department of the Economic Studies Division. The opinions expressed in this article are his own.

1 The price indexes for basic expenses offer more of a breakdown than any of the other price indexes published by DANE. Information on the articles that constitute basic expenses is not public.

2 See J. Hausman (2003). “Sources of Bias and Solutions to Bias in the Consumer Prices Index”, *Journal of Economics Perspectives*, vol. 17, no. 1.

3 Edgar Caicedo (2000). “Sesgos en la medición del IPC, el caso colombiano”, *Ensayos sobre Política Económica*, no. 38, Central Bank of Colombia.

Table B1.1
Comparison Groups and Weights

CPI-60		CPI-98		CPI-08	
Food	34.84	Food	29.5	Food	28.2
Housing	31.84	Housing	29.4	Housing	30.1
Clothing	9.23	Clothing	7.3	Clothing	5.2
Health	3.83	Health	4.0	Health	2.4
Education, culture & recreation	6.69	Education	4.8	Education	5.7
		Entertainment	3.6	Entertainment	3.1
Transportation & communications	7.53	Transportation & communications	13.5	Transportation	15.2
				Communications	3.7
Other expenses	6.04	Other expenses	7.9	Other expenses	6.4

Source: DANE.

and Langebaek and Caicedo (2007),⁴ a CPI that is in effect for ten years accumulates these biases to the point of overstating annual inflation by 6%. For example, if inflation in Colombia was 7.67% in 2008, it would have been 6% less without any bias whatsoever; that is, 7.21%.

Given the problems with bias, it would be interesting to ask what annual inflation would have been by March 2009 had there been no change in the consumer basket. For an answer, one must continue to calculate the previous CPI

(CPI-98), with the same items and weights that were used while that CPI was in effect and using the same reference base; that is, December 1998 = 100. According to the results of that exercise, annual consumer inflation at March 2009 would have been 6.59% rather than 6.14%, had the consumer basket not been updated. These biases and the other reasons outlined herein justify DANE's regular updates in the CPI basket, partly in response to international recommendations.⁵

4 Andrés Langebaek and Edgar Caicedo (2007), "Sesgo de medición del IPC, nueva evidencia para Colombia," Borradores de Economía, no. 435, Central Bank of Colombia.

5 See ILO, IMF and others (2006), Manual del índice de precios al consumidor: teoría y práctica, Washington.

II. FINANCIAL MARKETS

The central banks of most developed economies have lowered their interest rates to almost 0%.

The developed countries have issued a considerable amount of public debt.

In the emerging countries, the sovereign debt premium has declined recently.

In Colombia, the increase in lending continues to surpass the increase in nominal GDP, despite the drop in consumer lending.

Since 19 December 2008, the intervention rate has been reduced by 400 bp to 6%. The pass-through to market rates has been quick, especially for commercial rates.

A. EXTERNAL MARKETS

So far this year, the international financial markets have shown signs of recovery and greater stability, following a phase of extreme volatility and lack of confidence in the final quarter of 2008. As noted in the last edition of this report, the actions taken by economic authorities allowed for an improvement in liquidity by the end of the year, and that situation has continued up until April. However, the credit channel has yet to be re-established and there is uncertainty about the capital adequacy of banks and financial institutions in the developed countries.

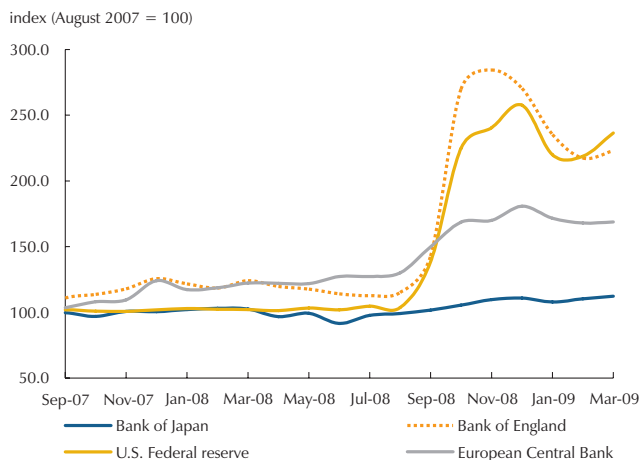
The central banks of the developed economies drastically cut their benchmark rates after the second half of 2008. Many of those rates were lowered to almost zero and remain at that level (Table 8). By April 2009, the U.S. Federal Reserve Bank (the Fed) had reduced its rate at an interval between 0 and 0.25%, the European Central Bank (ECB) had cut its rate to 1.25%, the Bank of England (BI) to 0.5% and the Bank of Japan (BJ) to 0.1%.

Table 8
Central bank benchmark rates

	Current level	Last change	Next meeting
United States	(0 - 0.25)	16 Dec 08 (-87.5 bp)	24-Jun-09
Euro Zone	1.25	2 Apr 09 (-25 bp)	7-May-09
United Kingdom	0.50	5 Mar 09 (-50 bp)	7-May-09
Czech Republic	1.75	5 Feb 09 (-50 bp)	7-May-09
Japan	0.10	19 Dec 08 (-20 bp)	22-May-09
Brazil	10.25	29 Apr 09 (-100 bp)	10-Jun-09
Mexico	6.00	17 Apr 09 (-75 bp)	15-May-09
Chile	1.75	9 Apr 09 (-50 bp)	7-May-09
Colombia	6.00	30 Apr 09 (-100 bp)	29-May-09
Peru	5.00	8 Apr 09 (-100 bp)	7-May-09
Turkey	9.75	16 Apr 09 (-75 bp)	14-May-09
China	5.31	22 Dec 08 (-27 bp)	2 Qtr-09
New Zealand	2.50	30 Apr 09 (-50 bp)	11-Jun-09
Australia	3.00	7 Apr 09 (-25 bp)	5-May-09
India	4.75	21 Apr 09 (-25 bp)	2 Qtr-09
South Africa	8.50	30 Apr 09 (-100 bp)	28-May-09

Source: Central banks, Bloomberg and JP Morgan

Graph 28
Total central bank assets in developed economies



Source: Central Banks.

Having exhausted this instrument, several central banks decided to expand their balance sheets and have increased their assets since September 2008, particularly the central banks in the United States and Great Britain (Graph 28)⁴.

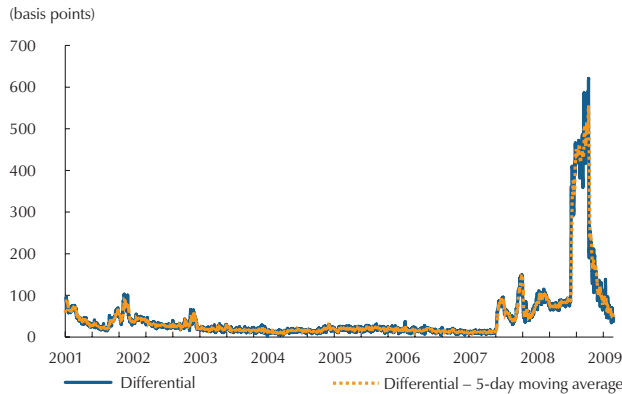
The Fed, in particular, has expanded its balance sheet, with an emphasis on the asset side. This strategy, known as credit easing, is intended to reduce interest rate differentials and to improve the functioning of private credit markets. In addition to the programs instituted last year,⁵ the Fed introduced the Term Asset-backed Securities Loan Facility (TALF) in March to re-establish the securitization process for consumer, automobile, student and business loans.

During that month, the Fed also announced the purchase of up to an additional US\$750 billion (b) in mortgage backed securities, bringing the total to

4 A balance-sheet increase similar to the one observed in the developed economies is not risk free. A portion of that expansion can lead to the creation of money, which could mean inflationary pressure in those economies in the future. Moreover, excessive central bank intervention in the financial market, particularly in the inter-bank market, could create incentive for private banks not to be quick about renewing their intermediation activities.

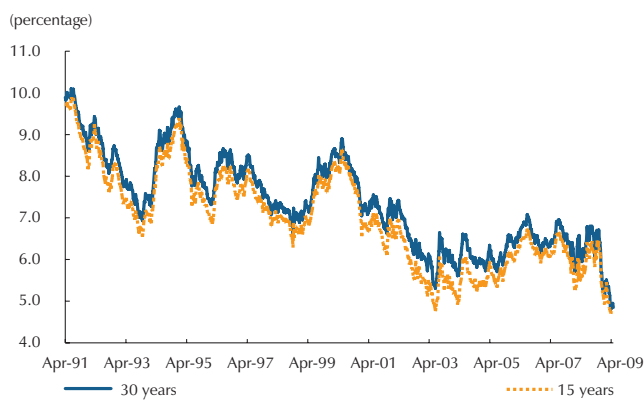
5 Most of the Fed's programs and those of the U.S. Treasury Department were explained in the last edition of this report.

Graph 29
Liquidity conditions on U.S. market for commercial paper^{a/}



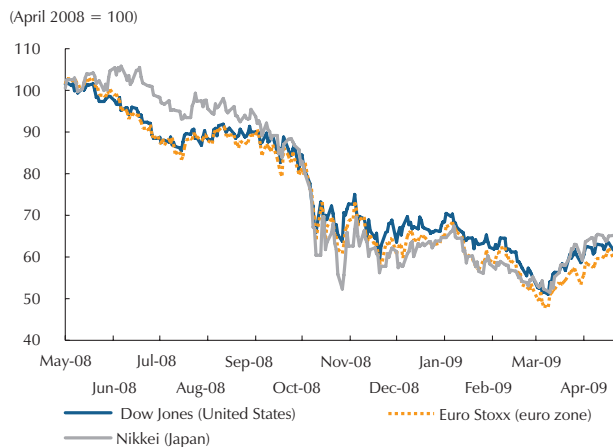
a/ Difference between interest rates on A2/P2 and AA rated non-financed commercial paper.
Source: U.S. Federal Reserve Bank

Graph 30
Mortgage interest rates in the United States



Source: Datastream.

Graph 31
Stock market indexes in the developed economies



Source: Bloomberg.

US\$1.25 trillion (t). It also will purchase US\$100 b in mortgage debt issued by government sponsored enterprises (GSE) and US\$300 b in long-term U.S. Treasury bonds.

Consequently, the efforts to re-establish the credit channel have reduced not only the differentials between rates on the interbank market,⁶ as noted in the last edition of this report, but also in the market for commercial paper (Graph 29). At the same time, these policies have allowed long-term mortgage rates to decline, which could encourage households to purchase new homes and begin to halt the deflationary spiral and the poor condition of the real estate market⁷ (Graph 30).

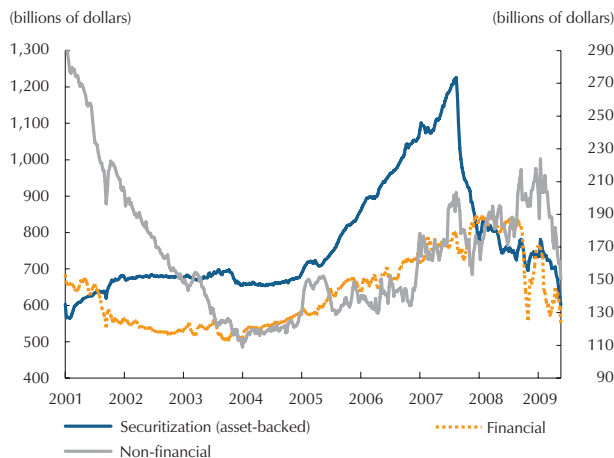
The effort and commitment authorities have demonstrated to stabilize the financial markets produced a positive response from the stock market at the beginning of March (Graph 31). In addition to the confidence generated among investors, there were two events that contributed to stock performance: 1) several banks showed better than expected results on their balance sheets; and 2) some economic figures were no so negative, pointing to a slowdown in the economic decline and a perception of smaller losses in the future. However, part of these events could be over magnified due to excessive investor optimism over a quick economic recovery.

Despite stabilization of the interbank market and the market for asset-backed instruments, the financial markets have yet to normalize entirely and the uncertainty about them persists. Many toxic assets continue to deteriorate bank balance sheets, creating capital adequacy problems for financial institutions. We will have to wait for the results of the financial stress test and the validity of its assumptions to know the condition in which many institutions find themselves from the standpoint of solvency and to identify their capital needs.

6 The differential between the Libor and T bills at three months (TED spread) is a case in point, having declined to pre-crisis levels since January 2009. Some analysts also use the differential between the Libor and the overnight swap index (OSI) to gauge liquidity conditions on the interbank market.

7 In February, President Obama announced a government program that earmarks nearly US\$75 b to help home owners reschedule or refinance their mortgages.

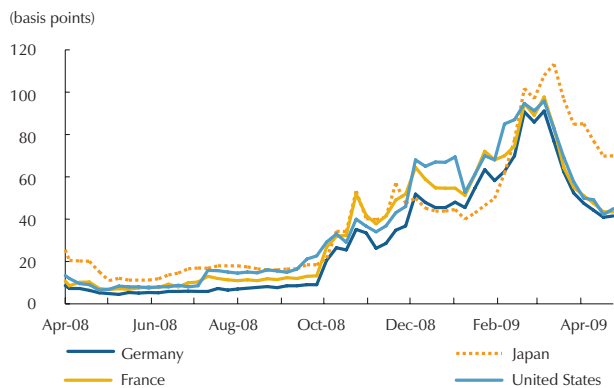
Graph 32
Commercial paper outstanding in the United States, by type of issuer^{a/}



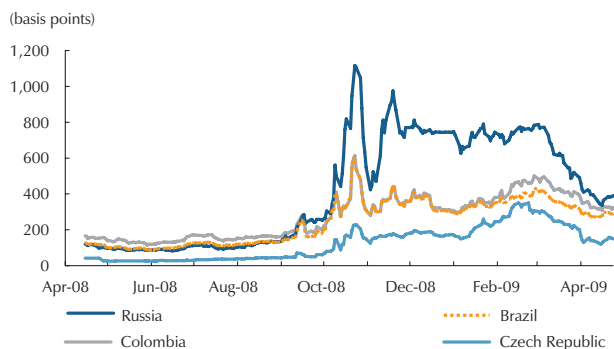
a/ (commercial paper outstanding), seasonally adjusted series
Source: Bloomberg

Graph 33
Credit default swaps at five years

A. CDS of the developed economies^{a/}



B. CDS of the emerging market economies



a/ The CDS of Germany, Japan and France are associated with the dollar, while those of United States are associated with the euro.
Source: Bloomberg

The latest Fed survey shows lending standards remain high, despite some moderation. On the demand side, the slowdown in the productive sector and the labor market has made agents less willing to borrow. The result has been a sharp deceleration in commercial and consumer lending.

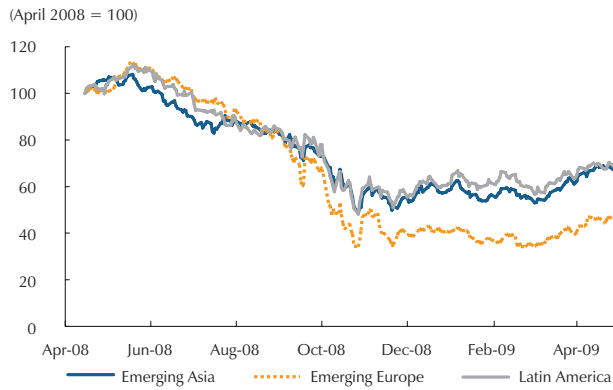
Credit in the form of commercial paper has fallen off sharply as well (Graph 32), despite the improvement in liquidity. This instrument is vital to financial and non-financial entities alike from the standpoint of short-term funding. Companies rely on commercial paper for resources to finance working capital with a number of administrative and tax exemptions. The size of the market for commercial paper can amount to as much as 50% of bank lending in the United States. The sharp contraction in the outstanding debt of this type issued by financial and non-financial sectors is shown in Graph 32, although the most pronounced decline has been in the securitization market. The companies in that niche are dedicated exclusively to obtaining highly liquid resources in the commercial paper market to fund the purchase of mortgage, consumer and even commercial loan packages. The absence of new issues since mid-2008 has reduced the amount of outstanding commercial paper by 50%, making it a prime example of the credit crunch in the United States.

The fiscal situation of many developed economies is another area of major concern. Their risk premiums rose at the beginning of the year, due to the pressure being exerted on the budgets of those countries, the uncertainty over how the financial recovery plans will be financed, and doubts about the need for more resources in the future. However, during the past month and a half, renewed optimism about the economic outlook allowed these premiums to decline (Graph 33, Panel A).

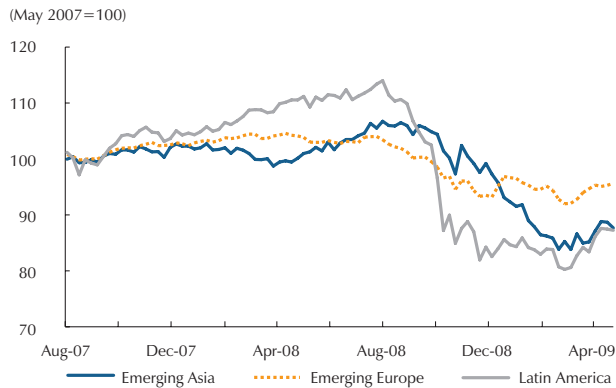
With respect to the emerging market economies, risk perception has decreased, as illustrated by the Emerging Markets Bond Index (EMBI+) and credit default swaps (CDS) (Graph 33, Panel B). This is due largely to increased confidence worldwide and to good news about the implementation of fiscal packages and economic recovery in countries such as China and India. As evidence of the latter, there has been some recovery in commodity prices on international markets. However, risk perception

Graph 34

A. Emerging market stock index in domestic currency



B. Emerging Currency Index against the Dollar



Source: Bloomberg.

remains high for certain Eastern European countries, since they continue to need a great deal of external financing and their financial systems are frail.

The emerging stock market suffered sharp devaluations up until late February, which were particularly intense in the Eastern European countries. On average, the markets in that region fell 70% between June 2008 and February 2009; in Latin America, they were down by 55%, as in emerging Asia (Graph 34 Panel A). However, given the increased appetite for equity instruments, the stock market indexes recovered during March and April, but are still below the levels registered in mid-2008.

As to the exchange market, the momentum has been similar to that of the variable-income market, with sharp depreciation in emerging currencies against the dollar during the second half of 2008 and up until late February 2009 (Graph 33, Panel B). As of March, there has been a strong and generalized recovery in exchange rates within the developing markets.

The exchange rate in Colombia depreciated 18.8% during the period from January to early March. As of that date and until the end of April, it appreciated by nearly 11%, as did the region's other currencies.

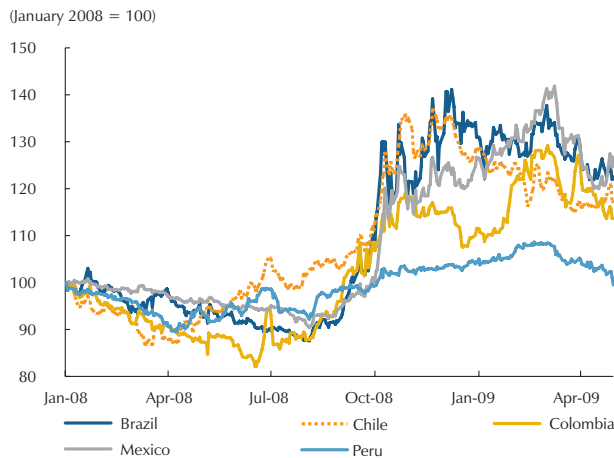
The Latin American currencies that appreciated the most during April were those of Colombia, Brazil and Peru (Graph 35).

B. DOMESTIC FINANCIAL MARKETS

The interest rate cuts initiated by the Central Bank of Colombia in December 2008, which totaled 300 bp by March, were passed through to average deposit and lending rates in the market. The interest rates on different types of lending have declined by almost as much or more than the accumulated cut. Therefore, the pass-through feasibly could continue and the new 100 bp cut in policy rates during April could pass through to market interest rates. This latest measure placed the Central Bank's benchmark rate at 6%.

Monetary aggregates and lending in domestic currency continue to increase at real annual rates that surpass estimated GDP growth for this year. The portfolio denominated in domestic currency, which had slowed since the start of 2007, registered a pause in that tendency, with increases near 15.4%. This performance is explained by the improved momentum in the commercial loan portfolio (18.4%), compensated by the reduced speed of consumer lending

Graph 35
Latin American exchange rate index



Source: Datastream; calculations by Banco de la República (Central Bank of Colombia).

(6.5%). The annual increase in the mortgage loan portfolio has been relatively stable throughout the year (near 14%).

There has been a blatant slowdown in consumer lending. The outstanding consumer loan portfolio declined during the final weeks of April, after having been stable since November 2008. Likewise, the reductions in interest rates on new consumer loans are less than the policy rate cut.

The national banks reported a significant decline in their outstanding portfolio in foreign currency as of the last quarter of 2008. Factors such the drop in foreign trade and the demand for higher standards on external lending contributed to that tendency. In addition, the reduction in interest rates on commercial lending in Colombia has given

companies an incentive to replace external borrowing with internal credit, which was one of the reasons for the build-up in the commercial loan portfolio. Companies also have used the placement of bonds in domestic currency and direct external borrowing by the private sector⁸ as financing mechanisms.

There has been a considerable increase in investments in securities by credit institutions. Between 15 November 2008 and 10 April 2009, the nominal value of TES held by the financial system grew at twice the rate of the increase in the portfolio. Even so, the value of bank investments as a share of total bank assets remains at what can be considered historically low levels.

As illustrated by a number of indicators and different surveys, a portion of the growth in bank investments in securities⁹ can be explained by the increase in risk perception, stiffer standards for extending credit (especially consumer loans), and less demand for new loans.

The policy rate should continue to pass through to the market during the second quarter of 2009. Moreover, the TES due to mature in May (approximately COP\$4 trillion) will mean a fair amount of resources available to the banking system for its operations.

1. Monetary Aggregates

As usually happens after the end of the year, the balance of base money was down by March 2009. In fact, according to the sources of growth in this aggregate, the COP\$4.1 t reduction is explained by the increase in National Treasury deposits with the Central Bank (COP\$3.9 t), net sales of foreign exchange and

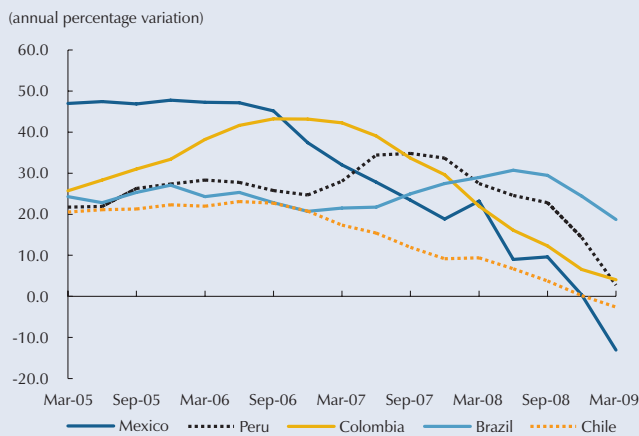
8 For example, loans from parent companies, with suppliers or with other foreign banks.

9 Another explanation is the expectation of TES valuation due to the Central Bank rate cuts.

THE DYNAMICS OF CREDIT IN LATIN AMERICA

Real consumer lending in Latin America has been slowing since last year, possibly for reasons that deal with both supply and demand. During the early months of 2009, that tendency became more pronounced, as illustrated in Graph A. The consumer loan portfolio in Chile and México declined during the first quarter of this year; in Colombia and Peru, it decelerated as well, but still is in positive terrain (registering real increases of nearly 5%). Brazil is the less extreme case, with real growth above 15%.

Graph A
Real consumer loan portfolio

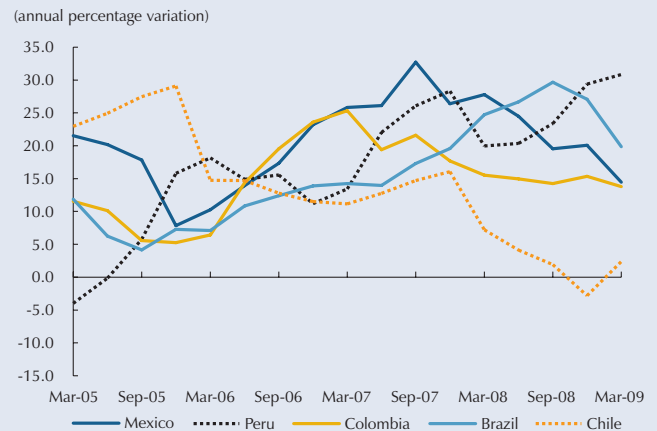


Note: The figures for Peru, Chile and Colombia are for February 2009.
Source: The central banks of each country.

The situation with respect to the commercial loan portfolio is more mixed. In México, Chile and Colombia, a slowdown has been observed since 2007, although to different degrees, with Chile being the country reporting the least growth. In Brazil, the slowdown is much more recent and began in September of last year. Peru is the exception. Its commercial loan portfolio has been on the rise since last year and is growing at a rate of 30%¹ (Graph B).

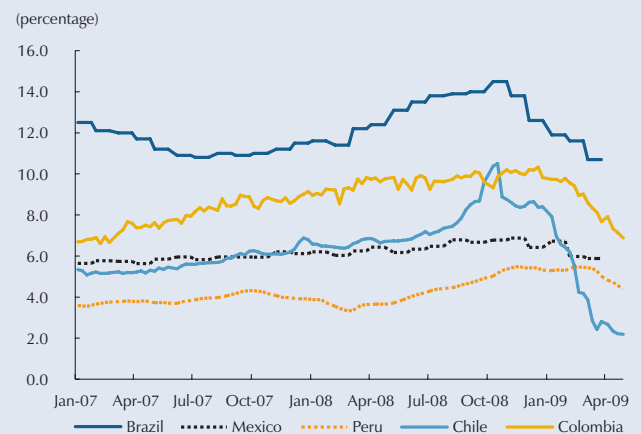
As to the pattern in interest rates throughout the region, those on deposits have reacted to the monetary stimulus of most central banks and recently posted major reductions (Graph C). Lending rates have not been as quick to react to monetary policy, although the latest figures show reductions in Colombia, Chile and Peru.

Graph B
Real consumer loan portfolio



Note: The figures on Peru, Chile and Colombia are for February 2009.
Source: The central banks of each country.

Graph C
Deposit rates in Latin America (e.a.)



e.a.: effective annually.
Source: The central banks of each country.

Finally, despite the sluggishness in lending, the liquidity and capital adequacy ratios of banks and financial institutions remain stable. They do not register the problems that confront financial institutions in the developed countries.

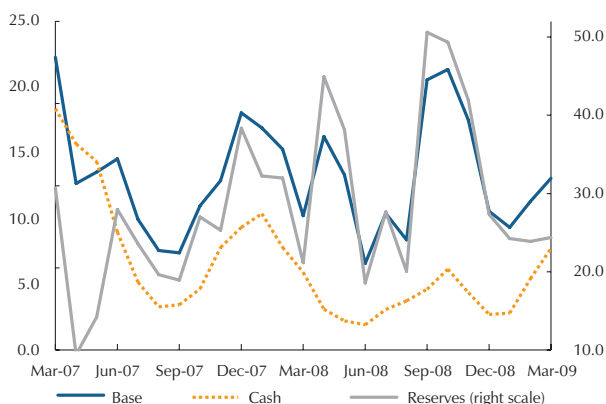
¹ Commercial lending in dollars in the Peruvian economy has slowed recently, as has lending to micro-businesses.

TES (COP\$1 t), and the decline in interest-bearing non-reserve deposits in the financial system (IBNRD, COP\$500 b). The main expansionary factor was the increase in financial sector repos with the Central Bank (COP\$1.7 t).

Even so, the annual expansion in base money during the first quarter of the year accelerated as a result of more demand for cash. The monthly averages for the weekly balances between December 2008 to March 2009 show the annual growth in base money went from 13.5% to 15.5% (Graph 36).

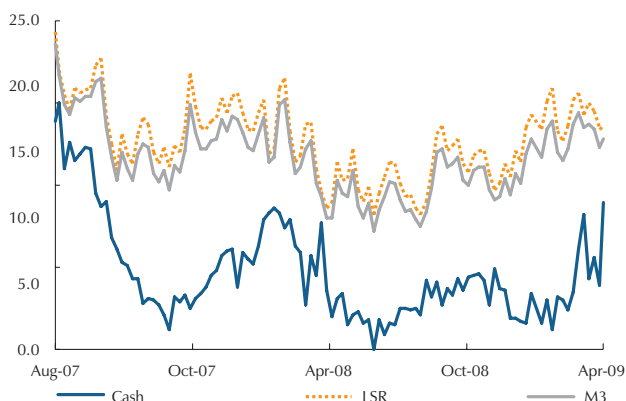
Lower interest rates on savings and declining inflation contributed to the rise in demand for cash. The increase in this variable rose by 4 pp during the first quarter of 2009 (from 7.2% to 11.2%), breaking the downward tendency observed during the fourth quarter of 2008 (Graph 36). In contrast, the same period saw a continued deceleration in the annual increase in demand for bank reserve (from 27.3% to 24.4%). This is explained by the reduction in reserve requirements ruled by the BDBC as of December 2008 and the shift in bank liabilities towards those with fewer reserve requirements (Graph 37).

Graph 36
Base money by use
(annual percentage variation in average monthly data)



Source: Banco de la República (Central Bank of Colombia).

Graph 37
Monetary aggregates and deposits
(annual percentage variation in weekly data)



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

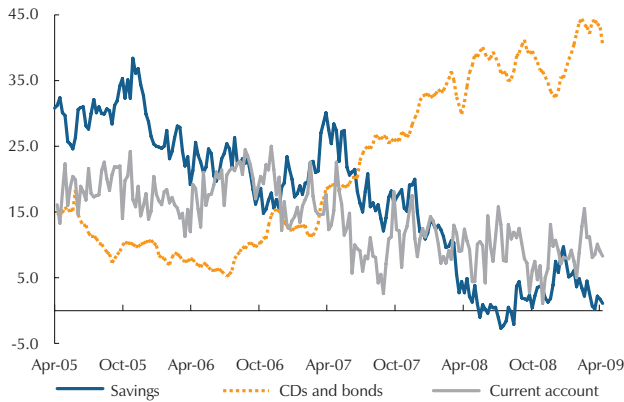
The annual increase in deposits or liabilities subject to reserve requirements (LSR), which account for approximately 90% of M3, accelerated up until February 2009 and slowed in March, but continued to post rates well above the nominal increase in GDP. The annual growth rate between the end of December and February 27 went from 19.3% to 20.6%, then declined to 17.1% on April 10 (Graph 37).

Although the monetary multiplier was reinforced by the reduction in reserve requirements, the temporary decline in money supply generated by the transfer of deposits from the National Treasury to the Central Bank continued during the final weeks of March and in early April. In effect, during the slowdown in LSR, the National Treasury deposited an additional COP\$3.4 t with the Central Bank, which is equivalent to 2% of the liabilities subject to reserve requirements. However, this has not been an obstacle to granting credit, since the rate of growth in deposits has outpaced the increase in lending.

From the standpoint of funding instruments, financial intermediaries remained focused on term deposits, preferably non-reserve deposits or those for more than 180 days (Graph 38).

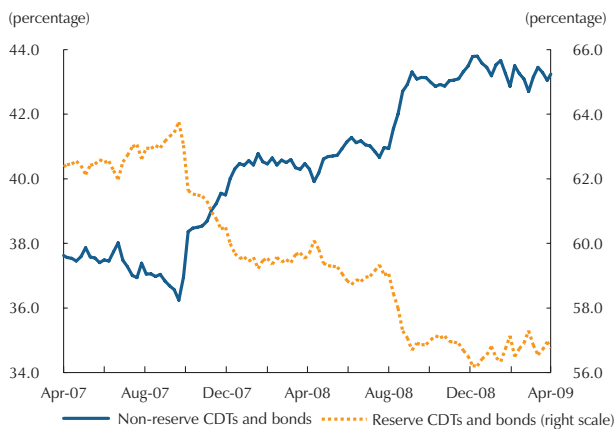
The annual increase in time certificates of deposit (CDT: Spanish acronym) and bonds has been above 35% during the last nine months and 40% since mid-January, with more than 43% represented by long-term instruments (Graph 38). Accordingly, during the last two years, CDs and bonds have come to

Graph 38
Deposits
(annual percentage variation in weekly data)



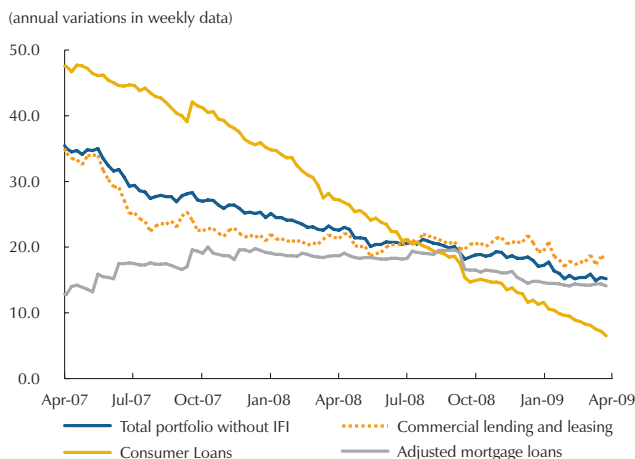
Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 39
Reserve and non-reserve CDTs and bonds (share)



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 40
Gross portfolio in domestic currency with leasing
(annual variations in weekly data)



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

account for a strong share (13 pp) of LSR. In fact, it increased from 34% to 47% between June 15, 2007 and April 10, 2009. This was in detriment to savings deposits, which lost 11 pp during the same period (Graph 39).

2. The Loan Portfolio

The slowdown in the loan portfolio in domestic currency, which began in March 2007, has come to a halt. During the nine weeks between February 12 and April 10, the increase fluctuated around 15.4%. This momentum is the result of a build-up in the commercial loan portfolio, which went from an annual rate of 17.0% to 18.4% between those dates, and less of an increase in the consumer loan portfolio, which declined from 9.7% to 6.5%. The growth rate in the mortgage loan portfolio during that same period was relatively stable (14.3%) (Graph 40).

New commercial loans have been extended in the preferential and ordinary lines, which are up by 36% as a whole compared to the same period in 2008. At the same time, disbursements on treasury loans (for less than one month) have declined. So far this year, their annual growth rate is down by 42%. This pattern, begun last quarter, is consistent with the preference among companies to guarantee their financing needs by expanding the term and, more recently, by replacing external borrowing with internal loans.

Consumer lending is showing signs of contraction. The outstanding balance, which had been relatively stable at COP \$40 t since the end of October, is down by COP\$500 b since March of this year. The disbursements are led by credit card lending, which have increased 8.1% so far this year, while other types of disbursements declined 6.6%.

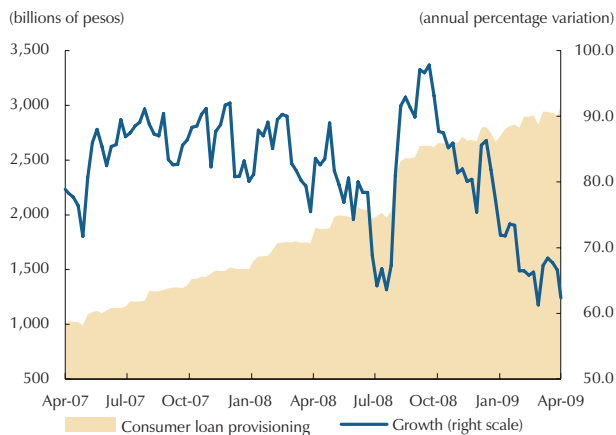
The pattern in the consumer loan portfolio is explained by supply and demand factors. The supply factors include, among others, sluggish demand due to less economic activity, a larger unemployment rate, a historically high household consumer debt,¹⁰

10 Financial Stability Report, Central Bank of Colombia, March 2009, p. 64.

and a cyclical contraction in the demand for durable goods, following the upturn between 2005 and 2007.

On the supply side, credit institutions have added to their criteria for consumer lending, given the increase in delinquency and the risk posed by consumer lending. By the same token, the return for banks on loans of this type has declined due to the increase in provisions, which rose 62% in the last twelve months. This is equivalent to an increase of COP\$1.2 t¹¹ (Graph 41).

Graph 41
Change in consumer loan portfolio provisioning



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

So far this year, foreign currency loans extended by local banks have declined by US\$791 m. This is equivalent to a negative annual variation of 21.6%. Only a fraction of that amount has been substituted with direct foreign borrowing by the private sector. With the February data, direct financing increased by US\$63 m during the year, while the decline in local financing in foreign currency during the same period came to US\$322 m. This tendency is the opposite of what occurred during the fourth quarter of 2008, when the increase in direct borrowing (US\$413 m) nearly doubled the decline in foreign currency lending (US\$211 m) (Table 9).

The slump in the loan portfolio denominated in foreign currency, which includes short-term resources used mainly to finance foreign trade operations, may suggest the drop in foreign trade is becoming more pronounced. Resources from direct suppliers continue to decline as well. Accordingly, some of the need for corporate financing is being met by national banks in domestic currency.

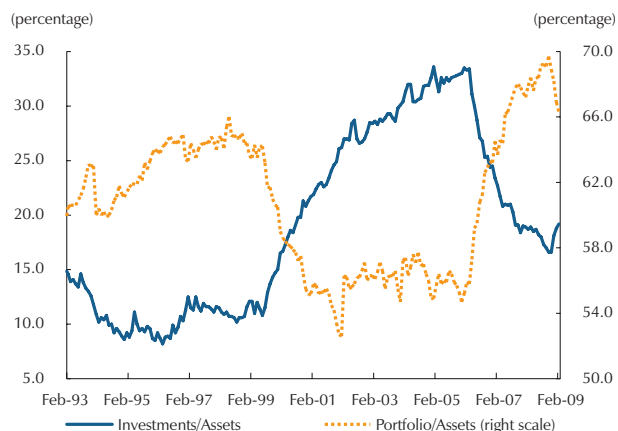
Table 9
External borrowing
(U.S. millions)

	Portfolio in foreign currency	Direct private sector borrowing	Total	Annual percentage growth
Jun-08	3,781	13,157	16,938	13.17
Sep-08	3,708	13,487	17,196	10.31
Dec-08	3,498	13,900	17,397	7.45
Feb-09	3,175	13,963	17,138	5.87
Mar-09	2,916			
Var Jun-Sep	(72)	330	258	
Var Sep-Dec	(211)	413	202	
Var Dec-Feb	(322)	63	(259)	
Var Feb-Mar	(260)			

Source: Banco de la República (Central Bank of Colombia).

11 Equal to 25% of the profits reported by credit institutions as a whole in 2008.

Graph 42
Loan portfolio and investments as a share of total assets



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Intermediaries also opted to increase their investment portfolios, particularly with internal public debt securities. Part of this tendency is explained by factors such as expectations of TES valuation, given the Central Bank's interest rate cuts, and the increase in portfolio risk, especially for consumer lending. Balance sheet information shows an increase of COP\$6.1 t between November 15, 2008 and April 10, 2009 in the nominal value of TES held by credit institutions, while the increase in the portfolio (d/c) that includes leasing came to COP\$3.2 t. Although the build-up in investment acquisition is important, its value with respect to total assets still is historically low (Graph 42).

In short, so far this year, credit institutions have had enough resources, as indicated by the change in liabilities subject to reserve requirements, which satisfied the demand for commercial and mortgage

lending, while the consumer loan portfolio continued to slow. The assets in the financial system also reflect a substitution of the commercial loan portfolio in foreign currency for local currency, and sizeable increase in financial investments.

During the second quarter of the year, particularly as of the third week of May, the deposit market will be bolstered by the increased availability of resources from the National Treasury, since approximately COP\$4 t in TES are due to mature.

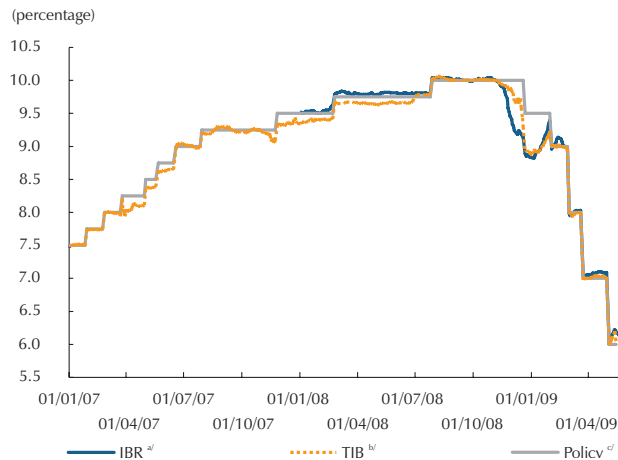
3. Interest Rates

Inflation, expectations of inflation and inflation forecasts have continued to decline so far this year. In addition, the impact of the international crisis on the Colombian economy became more evident, as reflected by the drop in foreign trade, less income from remittances and foreign direct investment (FDI), and the loss of confidence among economic agents. A number of economic indicators show that internal demand remains weak. In view of this situation, the BDBC agreed to continue the reduction in interest rates begun in December 2008.

Accordingly, the BDBC lowered the policy rate by 250 bp between January and March 2009 (-50 bp on January 30 and -100 bp at each of the meetings on February 27 and March 20). At its latest meeting, held on April 30, the BDBC agreed to another 100 bp cut. Consequently, since December 19, 2008, when the BDBC decided on a 50 bp reduction, the benchmark rate has been reduced by 400 bp from 10% to 6% (the current level).

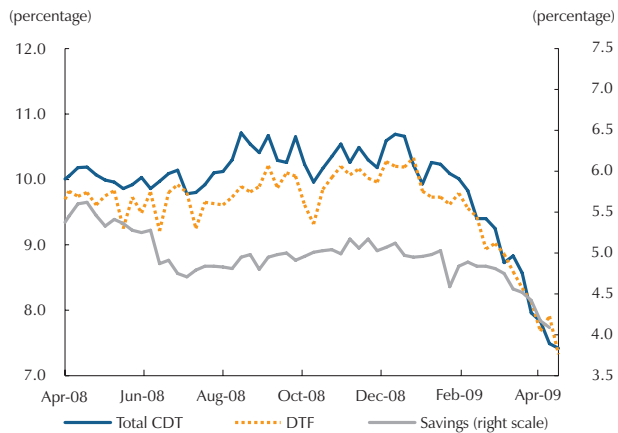
The interbank rate (TIB: Spanish acronym) and the bank reference indicator (IBR: Spanish acronym) have followed the same course as the policy rate (Graph 43). The weighted interest rate on deposits in the form of CDT and the DTF (CDs at 90 days) experienced a quick pass-through. Between December 19 and April 17, they declined by 324 bp and 283 bp, respectively. These are similar to the accumulated reduction in the policy rate during the same period. In fact,

Graph 43
Policy. IBR and TIB interest rate



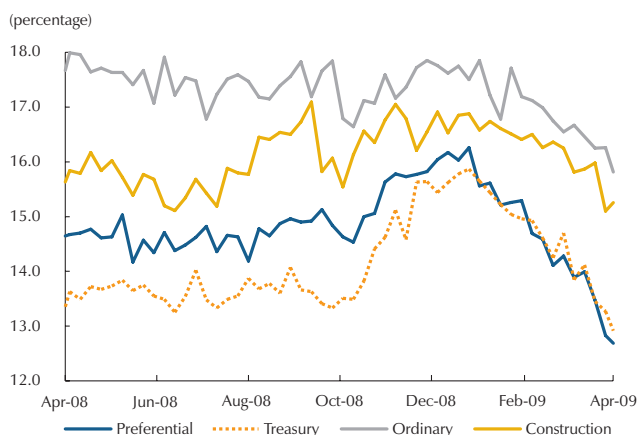
a/ Bank reference in Decator.
b/ Interbank interest rate.
c/ Repo auction rate.
Source: Banco de la República (Central Bank of Colombia).

Graph 44
Nominal interest rates on deposits



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 45
Nominal interest rates on commercial loans



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

even the interest rate on savings deposits responded by dropping 88 bp. (Graph 44).

The largest downward reaction to the policy rate cuts since December 19, 2008 has been in interest rates on commercial loans, particularly preferential lending (-342 bp), treasury loans (-298 bp), ordinary loans (-222 bp) and those to home builders (-150 bp) (Graph 45). The drop in interest rates on household lending during the same period has been less than the policy rate cut (Graph 46). The interest rate on consumer loans (other than credit card lending) declined by 65 bp in the presence of high volatility and an unclear tendency. As for interest on the purchase of a home, the rate is down by 85 bp.¹² The interest rate on credit card lending remains linked to the usury rate, but its response to the policy rate has been limited at best.

Real average interest rates on lending¹³ (Central Bank's methodology) and deposits (DTF), declined to 3.1% and 10.4%, respectively. These rates are 12 bp and 33 bp above the averages calculated since 2001, and 172 bp and 2007 bp below the historic averages calculated since 1986 (Graphs 47 and 48).

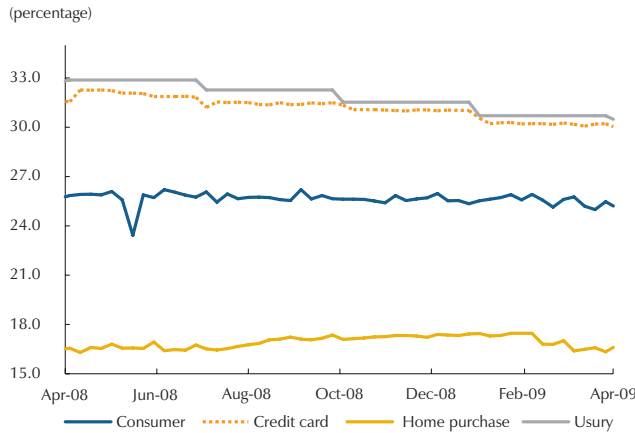
The various types of loans also have witnessed a reduction in real interest rates. For ordinary lending, the most important business credit facility, the rate declined to 10.1%. Respectively, this level is 168 bp and 65 bp below the historic averages calculated since 1998 and 2001. It also is less than the interest rate on ordinary lending in effect at April 2006 (11.4%), when the cycle of policy interest rate hikes began (Graph 49).

The most pronounced reductions have been in real rates for other lines of commercial lending (preferential and treasury), although their levels continue to exceed the averages calculated since the series originated (Graphs 50 and 51). The downward tendency in those rates is expected to continue, as they were the ones that increased the most when the policy rate was raised between 2006 and 2007. With respect to the real consumer lending rate, the current

12 In this case, the lower rate of inflation captured with the real value unit (UVR: Spanish acronym) also must have contributed to the decline.

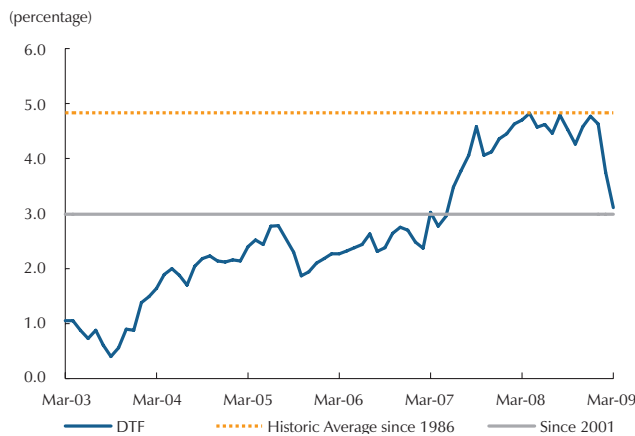
13 The lending rate indicator calculated by the Central Bank includes the interest rates for commercial and consumer lending.

Graph 46
Nominal interest rates on household lending



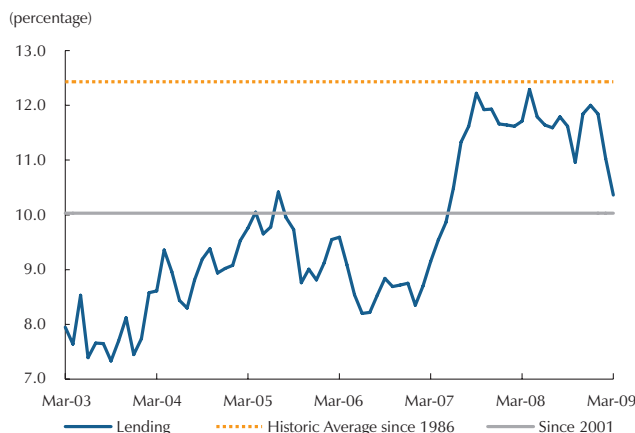
Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 47
Real DTF
(with non-food CPI)



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 48
Real interest rate on lending
(with non-food cpi)



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

level (19.5%), although less, is similar to what it has been since mid-2008. The fact that nominal and real consumer lending rates have not declined faster may be due to the increase in risk premiums associated with the deterioration in the consumer loan portfolio and the increased requirements placed on loans of this type by financial institutions, given the extent of household borrowing and added expectations of higher unemployment (Graph 52).

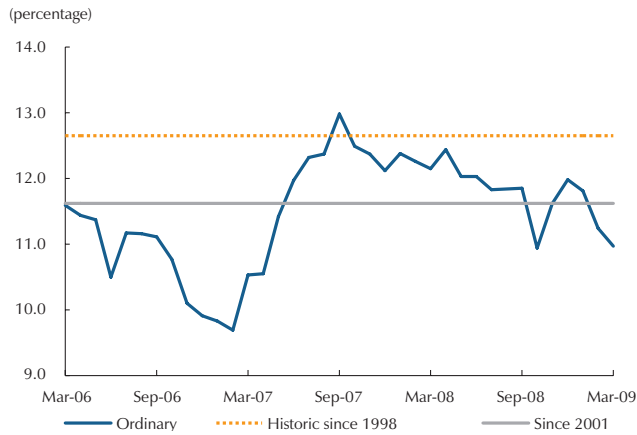
3. Other Financial Assets

Less pessimism on international financial markets, the decline in inflation and interest rates in Colombia, and the fact that agents have more confidence in local assets favored the valuation in TES (domestic government bonds) and a moderate stock market recovery.

TES valuation has been more pronounced in the short terms, and the yield curve has steepened as a result. On April 17, the spread between TES maturing in November 2010 and July 2020 was 242 bp (respective rates of 6.78% and 9.20%), which is more than the 123 bp difference registered by the same paper at the end of 2008 (respective rates of 9.46% and 10.69%) (Graph 53). The steeper yield curve is due to more of a preference for liquidity among investors than to fears of higher inflation. In fact, inflation expectations for the next twelve months, based on a comparison of TES denominated in pesos to TES-UVR, are below the mid-point of the target range for inflation this year.

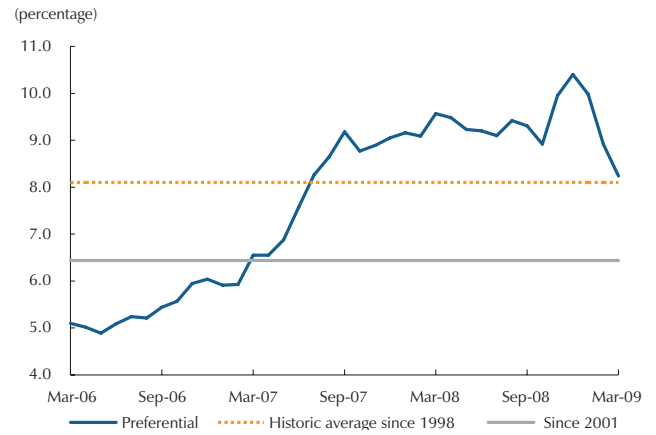
The Colombian Stock Market Index (IGBC: Spanish acronym) was at 8,045 pp on April 22, 2009. This is equivalent to an increase of 6.4% so far this year and an annual variation of -16.6% (Graph 54).

Graph 49
Real interest rate on ordinary lending
(with non-food cpi)



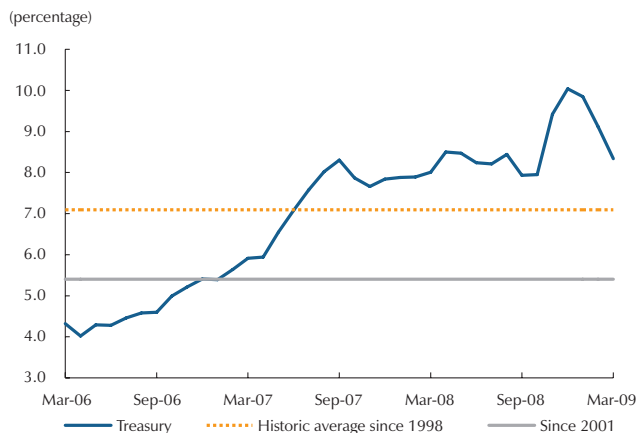
Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 50
Real interest rate on preferential loans
(with non-food cpi)



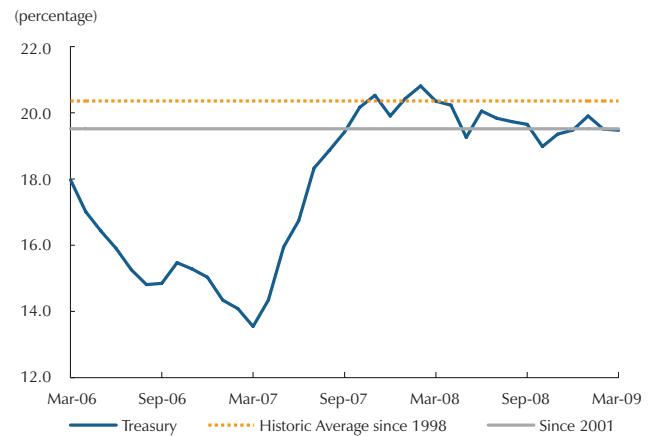
Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 51
Real interest rate on treasury loans
(with non-food CPI)



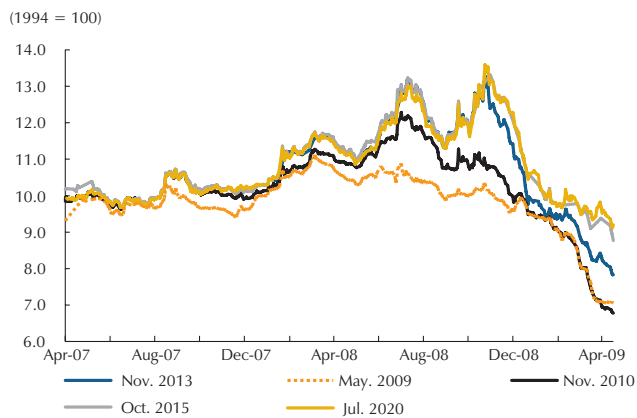
Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 52
Real interest rate on consumer loans
(with non-food CPI)



Source: Office of the Financial Superintendent; calculations by Banco de la República (Central Bank of Colombia).

Graph 53
Nominal interest rates: TES
(secondary market) (1994=100)



Source: Colombian Stock Exchange; calculations by Banco de la República (Central Bank of Colombia)

Graph 54
IGBC (Colombian Stock Exchange Index)



Source: Colombian Stock Exchange; calculations by Banco de la República (Central Bank of Colombia)

III. MACROECONOMIC PROSPECTS

The downturn in industry and commerce worldwide has been profound and more severe than expected.

The growth forecasts for Colombia's major trading partners were reduced.

The emerging market economies have a better chance of recovery because they have less debt and their financial systems are more solvent.

The growth forecasts for Colombia were revised downward. A recovery is expected as of the second half of the year.

Inflation in Colombia will continue to decline and is expected to be in the lower part of the target range by the end of 2009.

A. THE INTERNATIONAL SITUATION

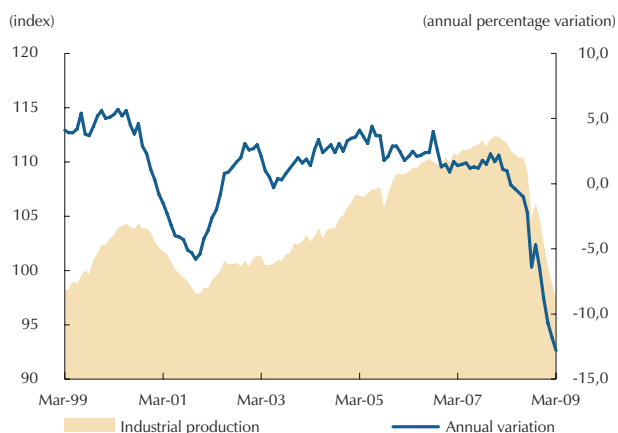
The world economy and commerce declined sharply during the first quarter of 2009, in addition to the dramatic drop witnessed during the fourth quarter of last year. This confirms many of the fears of a pronounced global economic recession. In fact, the various indicators of international productive activity point to a larger contraction than what was anticipated in the last edition of this report.

During the first quarter of 2009, the U.S. economy declined by 6.1% on an annualized quarterly basis (a/q).¹⁴ This is the third straight setback in GDP in the U.S., which registered a 6.3% decline in the fourth quarter of last year. In the United Kingdom, the drop during the first quarter was considerable as well (7.4%

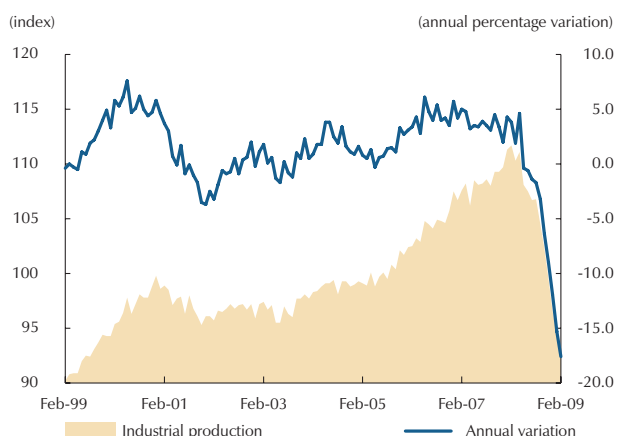
¹⁴ This figure pertains to the first revision by the Bureau of Economic Analysis (BEA). Total investment was the variable that contributed the most to the decline in GDP and, within it, the drop in inventories. Total investment experienced a contraction of 51.8% a/q; residential and non-residential investment each fell by 38% a/q, while inventories were down far more.

Graph 55
Industrial production in the developed economies

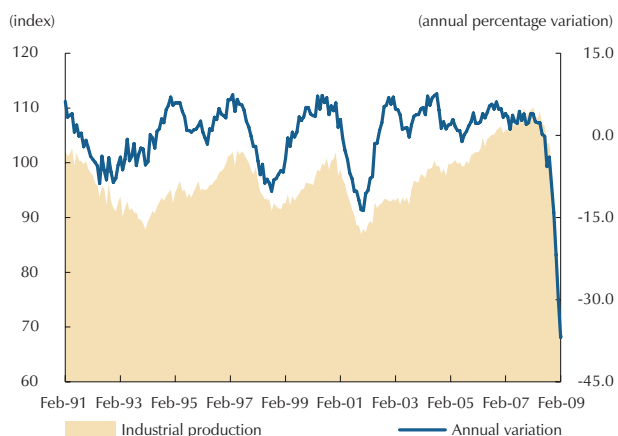
A. United States



B. Euro Zone



C. Japan



Source: Bloomberg.

a/q). There are no GDP figures on the Euro Zone and Japan for the first part of the year; however, the fourth quarter saw negative growth (-5.8% and -12.7% a/q, respectively). The indicators available for these economies suggest an equally sharp contraction in GDP during early 2009.

The industrial sectors in most of the developed and emerging countries have been particularly hard hit by the crisis. International trade has suffered dramatically as well. Until not long ago, it was a driving force of world economic growth.

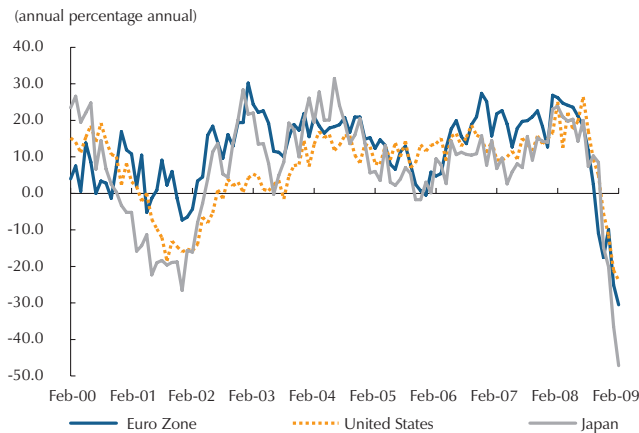
The crisis in industrial production in the developed economies has been profound and without equal in various decades. By March, the setback in the production indicators was considerable and, in many cases, it affected the earnings accumulated during the last ten years. For example, the annual decline in industrial production in the United States was 12.8% in March 2009. In fact, it is 13.4% less than the high point registered in December 2007 and is now at levels equivalent to those posted in 1999. The contraction in industrial production in the Euro Zone came to 18% in February and its levels are equal to those observed during the nineties. Japan is the most extreme case, with an almost 35% annual decline in industrial production by March. The level for that month was lower than any amount reported since 1983 (Graph 55).

As for commerce, the annual variation in nominal exports in dollars in February was -23% in the United States and -30% in the Euro Zone. The pattern in this variable for the Japanese economy is even more dramatic, which the annual decline being close to 48% in February (Graph 56).

Other indicators, apart from those for industry and international trade, have been hit hard as well. Retail sales are a case in point, having contracted at an annual rate of 9% in the United States during the first quarter of this year. However, during February and March, sales tended to stabilize and were not declining as sharply.¹⁵ A number of analysts interpret this as a sign the economy may be bottoming out.(Graph 57).

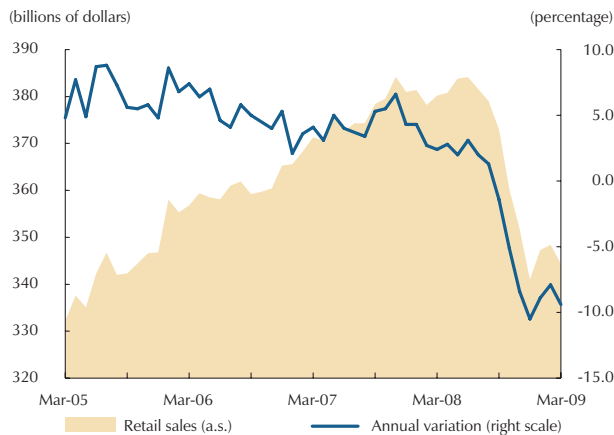
15 Retail sales are related to personal consumption patterns. The latest BEA information shows personal consumption in the United States was up by 1.5% a/q during the first quarter of 2009.

Graph 56
Exports of the developed economies



Source: Bloomberg and calculations by Banco de la República (Central Bank of Colombia)

Graph 57
U.S. Retail Sales



Source: Bloomberg.

Graph 58
U.S. Consumer confidence index
(conference board)



Source: Bloomberg.

As for the future, the depth of the economic recession in the developed countries and the intensity of its recovery will depend on what happens to the job market. In the United States, the drop in employment has been dramatic, as suggested by the figures available at March. Approximately three million jobs were lost in the United States during 2008 and another 2.1 million were eliminated in the first quarter of 2009. This is the largest loss in the history of job market statistics and raised the U.S. unemployment rate to 8.9% in March, which is the highest it has been since 1983. Unemployment in the other developed countries has begun to grow; however, the pace of job loss is less than in the United States. For instance, some markets in Europe are more rigid, which means the adjustment will be slower.¹⁶

Accordingly, if production continues to decline or reaches a prolonged standstill, further jobs may be lost and significantly so. Traditionally, this variable lags behind the production cycle.

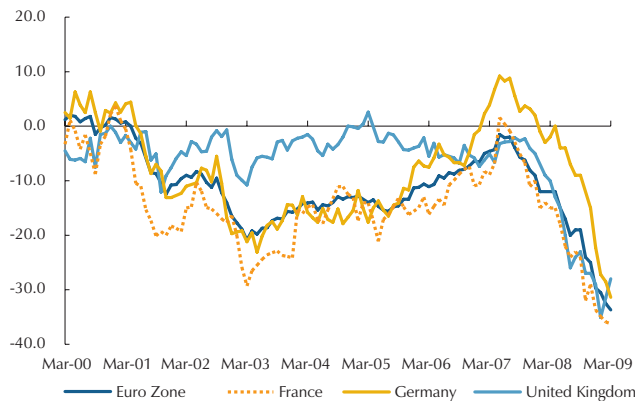
Given what has been described so far, the current situation in the developed economies is characterized by a generalized loss of consumer and investor confidence. The result has been a dramatic reduction in spending levels (Graphs 58 and 59), reinforced by a significant increase in restrictions on lending. Nevertheless, in the face of this adverse outlook, the last month and a half witnessed several spurts of optimism that were reflected in better financial and stock market performance (see Chapter II). These signs of optimism are supported, in part, by a slight rise in the indicators of consumer confidence and business sentiment in April,¹⁷ and by less of a drop in real variables (such as retail sales, as mentioned earlier).

Given this outlook, governments and central banks have continued to intervene in an effort to stabilize the financial markets and to stimulate the economy. In the United States, government aid and the Obama

16 Unemployment in the Euro Zone was 8.9% in March 2009, having increased 1.7 pp compared to the low point last year, which also was in March. In Japan, unemployment was 4.8% in March, which amounts to an increase of 1.0 pp above its minimum in October 2008.

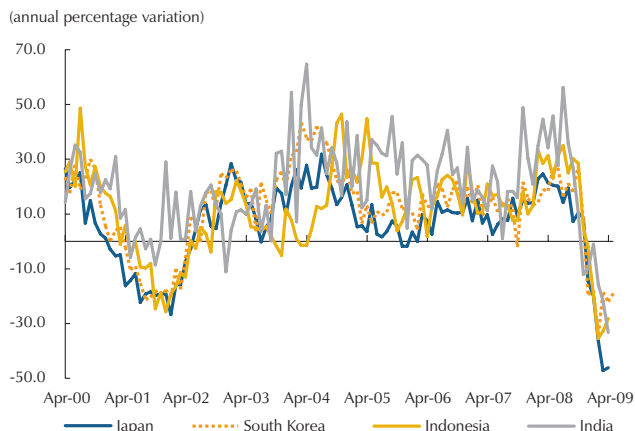
17 Despite some improvement in the consumer and business confidence indicators, they are historically low and continue to suggest reduced spending. As such, it is important to be careful about not overstating these figures, since the market may be overreacting to them.

Graph 59
European consumer confidence index



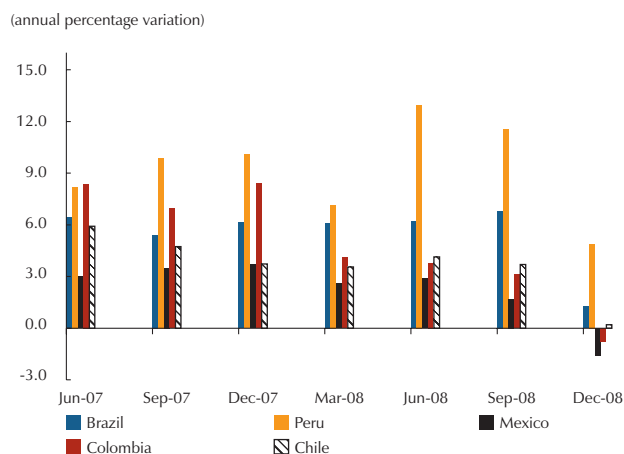
Source: Bloomberg.

Graph 60
Exports in dollars from several asian economies



Source: Bloomberg.

Graph 61
GDP of several Latin American countries



Source: DANE; Bloomberg.

administration's fiscal stimulus package are expected to help curb the downturn in economic activity and to lay the basis for economic recovery during the second half of the year. However, recovery will be slow in the beginning and will occur only if the financial markets stabilize.

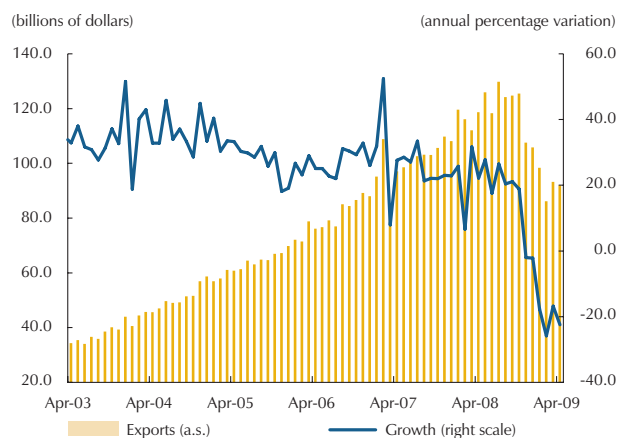
Moreover, the efforts of governments with respect to monetary and fiscal matters, which have favorable repercussions in the short term, may go against macroeconomic stability and their currencies in the long run. Also, it is important to remember the imbalances being created by these programs are adding to existing deficits of major proportions, particularly in the United States. For example, at the monetary level, it is uncertain how and when the Fed and other central banks will retrieve the massive amounts of money they injected into the economy in past quarters. On the fiscal front, recent spending efforts will require a great deal of maneuvering on the part of governments to arrange for new resources, which likely will mean higher taxes.

As for the emerging market economies, at the end of 2008 the effects of the crisis were most noticeable in the Eastern European countries, many with large current account deficits. During the fourth quarter of 2008, a number of Asian countries with very open economies were affected by a sharp drop in the demand for their exports. This situation continued during the first quarter of 2009 (Graph 60).

In Latin America, the slowdown has been substantial as well and economic growth this year is expected to be extremely low or even negative in most countries. In fact, GDP grew very little in a number of countries at the end of last year (Graph 61). Although there is no information on the first quarter, the figures at hand show a sharp drop in industrial production and exports during January and February, especially in Mexico and Brazil, which are the two largest economies in the region.

Among the emerging market economies, the most encouraging signs are coming from China. The impulse in that country originates with local demand and appears to be related to the fiscal stimulus program. Annual growth in industrial production accelerated during the first quarter of 2009 and GDP was up by an annual rate of 6.1% during that period, which is less of a slowdown

Graph 62
Chinese Exports^{a/}



a/ Seasonally adjusted series
Source: DANE.

than in the fourth quarter. Although China's exports are declining (Graph 62), the pace of that reduction is less, and there has been some recovery in raw material imports.

The emerging market economies have been hit hard as well. Nevertheless, because they have less debt and their financial systems are more solvent,¹⁸ they have a better chance of stimulating their consumption and recovering quicker than the developed economies. Also, a quick recovery in the Chinese economy may help to keep terms of trade at the current levels or even slightly higher for the Latin American countries.

Given the context described above, the growth forecasts for Colombia's major trading partners were revised downward for the purpose of this report. In

the case of the United States, the Central Bank's new forecast is between -2.0% and -3.5% with -2.5% being the central forecast. In the December edition of this report, the range was between -1.5% and -2.5%, with -2.0% as the central forecast. The central forecast would imply a major reduction in GDP during the first quarter and a much small drop during the second, with slow recovery as of the third quarter. In this scenario, inflation will continue to decline and might even be negative. Growth in Europe is expected to be between -2.0% and -3.3% with a central forecast of -2.5%. In the central forecast, the outlook for growth in Venezuela and Ecuador during 2009 would be 0% (Table 10).

The projections on commodity prices were modified as well. So far this year, there has been an upward pattern in commodity prices, more than what was anticipated in earlier editions of this report. The price of West Texas Intermediate (WTI) is expected to fluctuate within a range of US\$40.3 to US\$56 a barrel during 2009; the central forecast is US\$48. These projections are associated with the forecasts for growth in the United States (Table 11).

In short, the recession in the developed countries is deeper than was anticipated in earlier editions of this report, and there seems to be little possibility of a quick recovery. Private consumption in those countries should not help much, given the high level of household borrowing, the worsening job market and the problems facing the financial system (the credit crunch). However, the fiscal programs may help to curb the drop during the next two quarters. There is considerable risk of less world growth this year than is implied by the central forecast, particularly because of what is happening in the United States, Japan and Europe, and due to the restrictions on trade and on the free movement of productive factors that may emerge in various countries (see Box 2, page. 65).

18 This applies only to Asia and Latin America, since some Eastern European countries are heavily in debt.

Table 10
Changes in real growth forecasts for Colombia's trading partners

	2006	Observed		Projections 2009 ^{a/}
		2007	2008	
Major trading partners				
United States	2.8	2.0	1.1	(-2.5 and -3.5)
Euro Zone	2.8	2.6	0.8	(-2.0 and -3.3)
Venezuela	10.3	8.6	4.8	(1.5 and -2.2)
Ecuador	3.9	2.5	6.5	(1.0 and -1.0)
Other partners				
Japan	2.4	2.1	-0.6	-5.5
China	10.4	11.2	9.9	(7.2 and 6.0)
Peru	7.6	9.0	9.8	(4.2 and 3.0)
Mexico	4.8	3.2	1.3	-3.9
Chile	4.3	5.1	3.2	-0.4
Argentina	8.5	8.7	7.0	-1.3
Brazil	3.8	5.4	5.1	(1 and -0.3)
Bolivia	4.8	4.6	6.2	2.3
Developed Countries	3.0	2.7	0.9	-3.3
Developing Countries	7.9	8.3	6.1	2.0
World Total	5.1	5.2	3.2	-0.8

a/ The forecast range is based on an optimistic scenario (top of the range) and a pessimistic scenario (bottom of the range)
Source: Datastream, Consensus, IMF and Banco de la República (Central Bank of Colombia).

Table 11
International prices

Product	2005	2006	2007	2008	Projection for 2009 ^{a/}	
					Scenario A ^{b/}	Scenario B
Coffee (ex dock) (USD/pound)	1.20	1.18	1.26	1.44	1.00	1.45
Oil - WTI (USD/ barrel)	56.6	66.1	72.3	99.9	40.3	56.0
Oil (USD/barrel)	49.8	58.3	66.2	90.2	37.6	52.3
Coal (USD/ton)	47.8	48.0	50.8	83.4	45.0	61.0
Ferronickel (USD/ pound)	2.4	3.6	5.5	3.4	1.3	1.7
Gold (USD/troy ounce)	445.0	604.6	696.9	873.0	800.0	935.0

a/ Balance of payments estimated at April 2009.

b/ Scenarios A and B are the pessimistic and optimistic scenarios, respectively.
Source: Calculations by Banco de la República (Central Bank of Colombia).

B. BALANCE OF PAYMENTS

In 2008, the current account deficit (CCD) as a share of GDP was 2.8%, which is similar to what it was in 2007. The outcome for 2008 is explained by a 25.5% annual increase in total exports and a 20.6% rise in imports. Moreover, remittances from Colombian workers residing outside the country registered a positive increase of 7.8% compared to 2007, despite less growth in the economies where most of those remittances originate.¹⁹ However, the remittance of profits by companies in Colombia with foreign interest was important during 2008 (3.5% of PIB), particularly outlays from the oil sector, which registered an annual increase of 64%. Accordingly, the current account deficit was amply financed with FDI inflows, which accounted for 4.4% of GDP.

In 2009, given the considerable and persistent amount of uncertainty concerning the extent of the slowdown in the economy worldwide (particularly for Colombia's major trading partners such as the United States, Europe and Venezuela) and commodity prices (oil, coal, ferronickel and coffee), several different balance of payment scenarios consistent with the ranges forecast in the previous section were taken into account (Tables 10 and 11). In terms of financial flows, the expectation is that some foreign investment projects in Colombia will not be carried out due to the restrictions on access to capital markets. Consequently, there likely will be a reduction in capital flows to the country during 2009. The external resources the government has obtained already to finance the 2009 fiscal deficit were taken into account as well (US\$3.650 m, as announced by the Ministry of Finance and Public Credit).²⁰

As a result, it is feasible to expect a considerable decline in dollar revenue from total exports. The reduction, which could be between 19% and 28% in annual terms, would be led by fewer traditional exports. Purchases of imported goods are expected to fall as well, consistent with the slowdown in the Colombian economy. In this case, the annual reduction could be between 6% and 22%. Moreover, based on the models used to forecast workers' remittances, it is estimated the annual decline could be between 8% and 11%, depending on the extent of the economic slowdown in the countries where remittances originate (primarily the United States and Spain).

Accordingly, the Central Bank's forecasts show a larger current account deficit for Colombia in 2009. It could fluctuate between 3.1% and 4.3% of GDP, depending largely on how the world economic recession affects total Colombian exports. As for financing, the increased deficit would occur in a context of less FDI and less Colombian investment abroad.

19 These remittances account for 2.3% of GDP in 2008, 13% of merchandise exports and 46% of income from FDI.

20 However, the funding approved by the International Monetary Fund (US\$10.4 b) was not taken into account.

C. INTERNAL GROWTH

GDP performance during 2009 will be conditioned mostly by developments on the international front. The external crisis will continue to affect the Colombian economy through numerous channels, the main one being less external demand, which will influence the volume and price of exported goods and services. Deterioration in confidence is another channel and has a negative impact on both investment and consumption. At the same time, fewer remittances, coupled with less foreign investment, also will affect internal growth.

As mentioned in the preceding sections, the world economy and particularly the developed economies are expected to show some recovery as of the second half of 2009. In this environment, the Colombian economy will begin to feel the positive effects of world economic reactivation by the end of 2009. Moreover, it is assumed the slowdown in the Latin American countries will be less pronounced and lasting than the decline in the developed economies and that confidence will return more quickly in Latin America. This also should help to lessen the slowdown in the Colombian case.

The scenarios defined for the external sector and the balance of payments, as described in the previous sections, were taken into account when calculating the growth projections. Alternative scenarios for public spending with respect to both consumption and investment (civil works) were considered as well. As is customary in The Inflation Report, a growth range was estimated for the year, with limits that take the following into account:

- For the ceiling: a 2.0% decline in GDP in the United States during 2009, with higher international raw material prices than what those observed so far this year and with a current account deficit of 3.1% as a percentage of GDP. This scenario assumes a good deal of momentum in civil work, which will offset the contraction observed in 2008: approximately 12% growth during 2009 following -7.1% in 2008. The ceiling also contemplates more of an increase in public consumption compared to 2008: 4.5% in 2009 as opposed to 1.3% in 2008.
- For the floor: the recession in the United States would be more pronounced, with a 3.5% contraction in economic activity for 2009 as a whole. However, this still is compatible with some recovery at the end of the year. Moreover, international prices for the raw materials exported by Colombia would be lower than the average prices observed so far in 2009. The foregoing would be associated with a current account deficit of 4.3%. This scenario assumes more modest growth in civil works (6.0%), which is barely back to what it was in 2007. As for public consumption, the rates would be the lowest in the current decade (1.5%).

Both scenarios would be accompanied by a slowdown in private consumption and investment. There could be an annual decline in investment for the first time this decade. The slowdown in consumption would be associated with fewer remittances from abroad, the worsening job market, and added household decisions for precautionary savings. However, there are factors that could do a great deal to alleviate some of these adverse circumstances, such as the

expansion in government subsidy programs, lower inflation, income from good coffee prices, and the country's expansive monetary policy.

A significant boost to private investment in the past allowed the Colombian productive sector to expand its capacity, partly in response to the strong demand exhibited in earlier years. Given the present situation, and with weaker local and external demand, that capacity exceeds the amount of anticipated expenditure. As a result, a number of investment projects are expected to be postponed, further deepening the economic cycle.

External demand would be affected by the international crisis. Non-traditional exports would decline due to less external demand, while raw material exports (traditional exports) would increase in volume. This is according to information released by the major companies in these sectors. Thanks to the latter, and despite the drop in sales valued in dollars, none of the anticipated scenarios envisions a significant reduction in total exports in constant pesos. In fact, they might even increase slightly. A significant decline is expected for imports as well, primarily in response to fewer requirements for production, investment and consumption.

The primary risks to growth in 2009 continue to stem from the external situation. At any rate, it is important to point out that a recovery in all of the external scenarios contemplated in this report is expected for Colombia in the second half of the year.

The risks the internal front are estimated to be less. The growth forecasts, in particular, contemplate a solvent and stable financial system, which allows the credit channel through which monetary policy operates to continue to function.²¹ Some supply shocks, such as problems created by too much rain or by work stoppages in strategic sectors, could affect growth, but only to a limited degree.

Graph 63
Forecasts for GDP growth in 2009



Source: Banco de la República (Central Bank of Colombia)

On the occasion of this report, it is felt the agile way monetary policy has addressed the crisis in recent months could begin to produce dividends in terms of output growth during the second half of the year and especially in the fourth quarter. Moreover, there are the government's efforts to draft policies to support economic growth. However, limited program delivery and budget performance by local administrations in the past would add to the uncertainty about the effectiveness and timeliness of their spending.

Taking all these factors into account, the forecast for growth during the entire year was reduced compared to the forecast published in the report on the last quarter. As a result, the economy now is expected to grow within a range of -1.0% to 1.0%, as opposed to the previous range of 1.0% to 3.0% (Graph 63).

21 See the March 2009 edition of The Financial Stability Report published by the Central Bank of Colombia.

D. THE OUTLOOK FOR INFLATION

1. Forecasts

The inflation forecasts in this section take the following aspects into account.

- *The pattern of inflation by March.* The results for the total CPI were less than anticipated in the last edition of this report. This was due to a faster than expected decline in the annual variation in food CPI and, to a lesser degree, in regulated prices. However, the prices increases for the tradable and non-tradable CPI without food and regulated prices were higher than predicted.
- *More of an annual variation in the tradable CPI,* probably associated with the build-up in peso depreciation against the dollar during the first quarter of the year. The changes in the exchange rate were not fully anticipated in the forecasts constructed for the December edition of this report. Moreover, depreciation in the exchange rate during the fourth quarter of 2008 probably had more of an impact on domestic prices than in earlier circumstances and to a greater degree than was contemplated in the last edition of this report.
- *As for non-tradables,* the March results could have been underestimated due to stronger price indexing than was considered initially. High inflation at the end of last year and high expectations up until February helped to heighten this phenomenon, which affected the prices of a number of services, primarily health care and education. Sluggish demand was not enough to offset these upward pressures.
- *Up until mid-April, the peso showed a tendency to depreciation in the midst of high volatility.* At that time, the rate was close to COP\$2.400 per dollar, and cumulative depreciation since mid-December was 10%. The considerable degree of uncertainty about how the world economy will perform and the huge risks weighing on its recovery make it prudent to anticipate an equally volatile exchange rate. They also make it impossible to rule out depreciation in the future. The balance of payment scenarios outlined in an earlier section of this chapter take that possibility into account.
- *Information on the productive sector* at March shows an economy that continues to weaken more than was forecast in past reports. For the most part, this is due to the plunge in world demand, which continued to decline in the first three months of the year, surpassing predictions. The international crisis would have had more of an impact on Colombian exports and remittances than anticipated, making it necessary to reduce the forecasts for growth during the first half of the year and for all of 2009.
- Besides the contraction in growth, *idle productive capacity* in the Colombian economy has increased. As a result, the output gap was re-estimated and, if

the forecasts for growth prove to be correct, it would be in negative terrain during 2009 (as shown in Chapter I).

Given the foregoing, the consideration in this report is that conditions are right for inflation to continue to fall throughout the rest of the year. As was the case at the start of 2009, most of the relief is expected to come from food and regulated prices, and will be concentrated in the second quarter.

The drop in annual food inflation should be particularly large in May and June, inasmuch as the substantial increases reported during those same months last year are not likely to be repeated in 2009. Moreover, despite several hikes, international food prices are expected to remain well below the levels witnessed up to September 2008, thereby contributing to the decline in the annual variation in domestic prices. Relief for the price of certain perishables is expected due to good weather, which has led to a situation where growth in production has outpaced the increase in demand (dairy products appear to be the prime example.). Consequently, the forecasts for food tend to be lower in this report compared to the last edition.

The recent downward tendency in annual regulated CPI inflation should continue, in which case sizeable reductions during the next two quarters are to be expected. They would be slightly more than those forecast in the December edition of this report, thanks to the cut in fuel prices ruled by the national government as of May. The forecasts, however, still anticipate major price hikes for some public utilities, such as electricity, and for the reasons mentioned in Chapter I of this report.

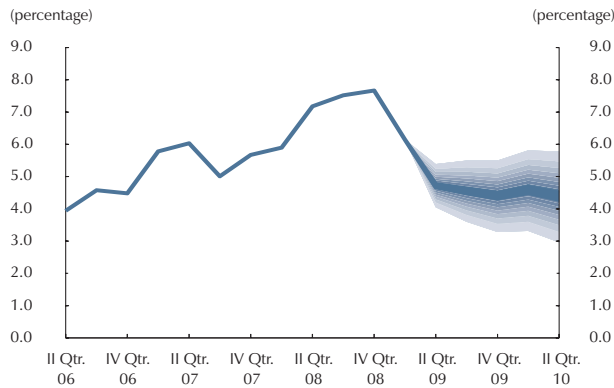
The forecasts for tradables and non-tradables, excluding food and regulated prices, are higher in this report, particularly with respect to the annual variation in the first group. The forecasts for tradables were propelled by the upward tendency registered during the first three months of the year, coupled with the build-up in depreciation throughout most of that period. As for non-tradables, the adjustments at the start of the year are expected to continue throughout the remainder of 2009, considering the inertia this series has displayed in the past. The forecasts take into account the fact that weak demand is expected to have only a minor impact on non-tradables in the next two or three quarters.

This being the case, a major reduction in total consumer inflation is anticipated up until the end of the year, which is not much different from what was forecast in the December edition of this report. Moreover, the bulk of that reduction would be concentrated in the next three or four months. As for the non-food CPI, the decline would be more gradual and less than was contemplated earlier (Graphs 64 and 65).

In the longer term, the forecasts did tend to decline more than was expected in December. Essentially, this is due to less inflationary pressure from demand that was weaker than anticipated. A good portion of the reduction would be in the non-tradable CPI, although other CPI segments will be influenced by the contraction in economic growth. The central forecast assumes some pressure on prices from the exchange rate and does not consider supply

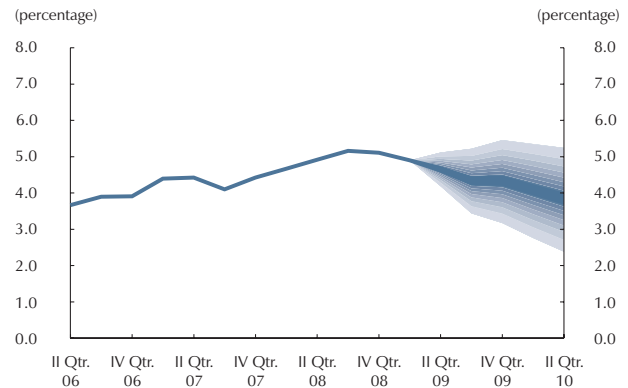
shocks that might affect food prices. The inflation results described in this section assume an active monetary policy that is designed to ensure the long-term targets for inflation will be met.

Graph 64
Fan chart for total inflation ^{a/}



a/ The forecasts are based on a monetary policy that is designed to ensure the inflation targets will be met in the long term..
Source: Calculations by Banco de la República (Central Bank of Colombia).

Graph 65
Fan chart for non-food inflation ^{a/}



a/ The forecasts are based on a monetary policy that is designed to ensure the inflation targets will be met in the long term.
Source: Calculations by Banco de la República (Central Bank of Colombia).

2. Risk Balance

The risk balance with respect to total consumer inflation and non-food inflation is presented in the fan charts shown in Graphs 64 and 65. The balance remains broad, considering the uncertainty surrounding economic growth worldwide and how it can affect the Colombian economy through a variety of channels, such as the exchange rate, food and fuel prices, revenue and demand.

Broadly speaking, our risk analysis shows that the probability of inflation being under the ceiling of the target range for 2009 is high and more so than was contemplated in earlier reports. As usual, the risk balance is constructed on the basis of the central forecast (the mode), which is situated in the lower part of the range for the end of 2009 (between 4.5% and 5.5%). In the central forecast, the upward and downwards risks offset one another, showing a partially symmetrical fan chart on this occasion.

The following would be the downward risks to total and non-food inflation.

- A more pronounced and prolonged external crisis than expected. A larger drop in world demand and a slower recovery would have more of an impact on internal demand and the price of tradables than was forecast. It could mean less GDP growth this year and in 2010, which would further expand surplus productive capacity and affect the pace of job creation, slowing inflation even more. This would be the case, provided the reduced prospects for world growth do not undermine confidence in emerging market economies like Colombia, affecting their currencies.
- Further exposure to the world crisis. In the fourth quarter of 2008, it became clear that the Colombian economy could be more exposed to

the international crisis than was anticipated initially. If this situation were to continue, the crisis necessarily will affect internal growth and inflation. The added exposure could have negative consequences for the country's financial system. So far, it has managed to stay out of the crisis

- The decline in inflation expectations could put off price hikes during the remainder of the year and particularly at the start of 2010, helping to slow inflation even more, particularly non-food inflation.
- Reduced costs and second round effects. In 2007 and 2008, it was argued that part of the CPI increase was the result of so-called second round effects; that is, the transfer of inflationary pressure on raw materials to total inflation, through costs. Using the same type of analysis, it is possible to suggest that the significant decline in raw material prices during the last two quarters could unleash a larger than expected drop in costs owing to second round effects that were not fully contemplated in the forecasts.

On the other hand, the upward risks would include:

- A possible rebound in international food and fuel prices. Recent weeks have witnessed an upturn in international prices for several commodities in response to signs that demand in China is recovering. If this tendency continues, it could revive pressure on costs and prices for imported goods, interrupting the drop in annual food and regulated price inflation forecast in this report.
- Supply risks: climate and a trucking strike. Exceptionally rainy weather is forecast for the first half of the year in Colombia. If this proves to be the case, it could have a negative impact on the production and marketing of staple foods. Up to now, the effect has been just the opposite in the case of dairy products. However, the risks are still there. On the other hand, the trucking strike could have implications for food prices in May

At the time this report was written, the Colombian peso was appreciating. This situation coincided with an increase in confidence in emerging market economies and with the announcement that the IMF had granted Colombia US\$10.4 b in contingency financing. These events were not fully taken into account in this report.

Box 2 PROTECTIONISM: OLD AND NEW RESPONSES TO THE WORLD CRISIS

Pilar Esguerra Umaña*

The world financial crisis has led to the adoption of new forms of protectionism compared to those used traditionally during economic slumps such as the one at present. Although there has been an important expansion in policies of this type, there also is a prevailing fear that an increase in tariffs or quantitative constraints on imports might have a negative impact on world trade similar to what was experienced during the financial crisis in the 1930s.

There is a consensus among the authors¹ who have studied the events of the Great Depression that the protectionist measures applied by the United States under the Smoot-Hawley Tariff Act² were primarily responsible for the drop in U.S. production and in world trade.

Signed into law on June 17, 1930, the Smoot-Hawley Act raised U.S. import duties on more than 20,000 products and, in doing so, elevated the average import tax from 13% to 16.6%. The focus was primarily on import duties for agricultural products. The Smoot-Hawley Act sparked a great deal of controversy at the time. As some of its critics had warned, it also prompted retaliation by countries that were U.S. trading partners, who adopted measures in response. As a result, imports of items with the highest tariffs dropped, as was intended, but so did U.S. exports, which plummeted by nearly 60% during the year after these measures were adopted. Because of its devastating effect on trade, the Smoot-Hawley Act is regarded as one of the principal causes of the Great Depression. The magnitude of the increase in customs duties applied by the United States and its principal trading partners is shown in Table B2.1.

Some authors such as Eichengreen (1986) take a slightly different view of the impact of the Smoot-Hawley Act on the Great Depression. Eichengreen says the measures themselves were not responsible for the drop in GDP and the rise in unemployment at the beginning of the 1930s in the United States, but instead had a very short-term beneficial impact on the economy of that country. The added protection prevented production from falling even

* The author is an advisor who works with the Economic Studies Division. The opinions expressed in this section are hers.

1 See, for example, Metzler (1976), Crucini and Kahn (2003) or Gordon and Wilson (1981).

2 The legislation takes its name from the two senators who sponsored it in the U. S. Congress. It also is known as the Hawley-Smoot Act.

Table B2.1
Customs duties applied by the United States and its principal trading partners

Country	Equivalent ad valorem tariffs	
	1920 - 1929	1930 - 1940
United States	13.0	16.6
Total imports	35.1	44.5
Other countries		
Trade weighted average	9.9	19.9
Canadá	13.4	15.2
France	7.1	21.0
Germany	7.2	26.1
Italy	4.5	16.8
United Kingdom	9.8	23.2

Source: Taken from Eichengreen (1986).

further and offset the impact of the serious negative shock produced by the drop in prices for commodities, which were the United States' major export products at the time.³ The unwinding in commodity prices aggravated the situation for farmers, who were unable to pay their debts to the financial system. Thus, in Eichengreen's opinion, the real culprit for the drop in economic activity was the external shock itself, coupled with the impact of the response measures adopted by the country's trading partners. Therefore, the effect of the Smoot-Hawley Act was worse in the rest of the world than in the United States. What occurred is traditionally referred to in economic literature as a typical example of beggar-thy-neighbor policies in which the action taken by one country has a negative impact on its neighbors or trading partners.

Therefore, it is important to distinguish between the short and long-term impact protectionist measures such as those adopted under the Smoot-Hawley Act can have on a country's economy. In the short term, a measure to protect the domestic market can become a palliative for the downturn in economic activity and the rise in unemployment resulting from an external shock. Obviously, this is true only in the absence of an external influence, as the situation is quite different when there are retaliations. However, as Hufbauer (2009) noted, it also depends on the industries that receive added protection. In the United States, for

3 Eichengreen also demonstrated that the increase in duties was not as pronounced for two reasons; at the time, products were subject to specific tariffs and the downturn in economic activity was accompanied by a deflation process.

example, with its recent economic stimulus measures (February 2009), the decision was made to protect the steel industry, which characteristically generates very little employment. The measure sparked criticism, as it is unlikely to have an important impact on job creation, but can do serious damage to the country's relations with its trading partners, including countries with which the United States has free trade agreements.

In the long term, depending on the length of time the measures are in place, the effect is detrimental to both economic activity and employment. This is because an increase in tariffs results in a deviation of resources towards the protected activities, generating inefficiencies and a clear anti-export bias.

Although there are different distinctions as to what happened with the protectionist policies in the 1930s, countries in this day and age have tried not to resort en masse to tariffs hikes as a way to stimulate local production, because of the damaging collateral effects such measures can have. This is due to the tremendous degree of globalization found in productive processes today, where a specialization of activities in different regions throughout the world is fundamental.

Consequently, only a few nations such as Ecuador, Argentina, Indonesia, India, Vietnam, the Ukraine, Russia and Turkey have increased their tariff and non-tariff barriers to imports in response to the crisis.⁴ However, new forms of protectionism not as obvious as raising tariffs have emerged in a more generalized way. An example are those contained in a number of packages designed to aid specific industries in developed and emerging countries by creating incentives to "buy national" instead of purchasing imported products. Granting subsidies and financial aid to domestic companies as opposed to foreign concerns is another veiled form of protectionism. Although different from merely raising tariffs, the short-term and long-term effects of such measures can be the same. They can lead to external responses and generate a great deal of inefficiency in the allocation of a country's resources by preventing efficient specialization as an answer to the crisis. In terms of their collateral effect, policies of this sort not only hinder world trade, which will be hit hard in 2009 and possibly in 2010, they also leave economic integration processes, even multilateral ones, very much up in the air at a time when they are needed to avoid a collapse in trade.

4 Russia limited automobile imports, Ecuador raised its tariffs on more than 600 products, Argentina placed limits on imports of auto parts, toys, footwear and leather goods, and Indonesia restricted imports to five categories of consumer goods; namely, textiles, footwear, toys, electronic products, food and beverages (World Bank, 2009).

For example, the fiscal stimulus package in the United States contains provisions that limit the use of iron, steel or aluminum goods and products thereof, including those from countries that have free trade agreements with the United States (e.g. the European Union, NAFTA and Japan). In response to such measures, those nations have included similar provisions in their own fiscal stimulus packages or have raised their tariffs on certain products coming from the United States, as Mexico did recently (for ninety customs items).

However, protectionist measures such as these have been accompanied by others intended not only to shield domestic goods and services, but also to avoid capital outflows. They are part of what can be called financial protectionism. Policies of this type are explained because one of the primary effects of the crisis has been a substantial drop in these flows worldwide. Commercial lending by banks is virtually paralyzed, having accounted for almost half of all international capital flows. Worldwide reductions in portfolio flows and in foreign direct investment are expected as well. It is important to emphasize that the drop in capital flows will have an important negative impact on growth in the emerging market economies.

Moreover, the heavy losses incurred by banks in the developed countries will mean fewer loans to their subsidiaries in emerging countries, thereby aggravating the shortage of capital. Also, the world is calling for new financial regulations that are likely to place more restrictions on such flows. For example, the Obama administration took a step in that direction when it proposed regulations that discourage capital flows from tax havens and by suggesting that U.S. companies located in those areas pay taxes in the United States. The fiscal stimulus packages adopted in the United Kingdom, Greece, France and Denmark also include provisions designed to have loans from financial institutions go only to national companies and to encourage a reorientation of credit towards national activities that are in crisis. Measures of this type, which affect the decisions banks make, could result in resources being earmarked ineffectively and could have a negative impact on the long-term growth of economies that adopt them, apart from the damage they can do to other countries.

At the same time, the world is experiencing a generalized use of controls on capital flows, particularly to halt the outflow of capital, while controls enacted in some countries to hamper the entry of capital are being relaxed. For example, countries such as Iceland, the Ukraine and Argentina have strengthened their exchange controls; others have imposed larger capital requirements on foreign banks, forcing them to purchase national financial assets.

Commercial and financial protectionism threaten to join forces with job protectionism. Persistent and growing unemployment in many developed countries has led to

protests and demands that seek to shield employment for national workers to the detriment of foreigners. For example, Malaysia has adopted measures that ban factories, stores and restaurants from hiring foreign workers. In addition, a number of countries have created incentives for immigrants to return to their home countries and, in many cases, they are doing just that. However, use of these programs is not widespread, since they normally include a commitment not to return for a period of up to five years. In any case, this new job protectionism that threatens to raise its head the world over will be another factor that affects remittances, leading them to decline due to the effect of the crisis. Countries whose emigrants are employed largely in activities such as the manufacturing industry and construction will be jeopardized the most.

This being the case and although it is not apparent that protectionism has been a generalized policy response to the international financial crisis, there are many veiled forms of protectionism that could be just as damaging as the Smoot-Hawley Act was in its day.

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ATTACHMENT

MACROECONOMIC FORECASTS BY LOCAL AND FOREIGN ANALYSTS

The following is a summary of the latest forecasts by local and foreign analysis on the main economic variables for 2009 and 2010. The analysts who were consulted had access to data at April 2009.

Table A1
Forecasts for 2009

	Real GDP growth (percentage)	CPI Inflation	Nominal exchange rate end of	Nominal DTF (percentage)	Fiscal deficit (% of GDP)	Unemployment in thirteen cities (percentage)
Local analysts						
Alianza Valores	(0.5)	4.3	2,540	6.0	(1.5)	13.5
ANIF ^{a/}	(0.5)	5.0	n.a.	6.4	(3.9)	14.0
Banco de Bogotá	0.5	5.0	2,500	5.5	(1.7)	13.2
Banco Santander	(1.0)	4.5	2,460	n.a.	(2.0)	13.0
Bancolombia	0.7	4.8	2,400	6.4	(4.0)	13.8
BBVA Colombia ^{a/}	(0.5)	4.3	2,543	6.4	(4.2)	13.0
Corficolombiana	0.0	4.4	2,374	5.3	n.a.	14.7
Corredores Asociados	(0.1)	4.0	2,150	5.5	(3.9)	15.0
Correval	0.7	4.4	2,470	6.0	(3.0)	13.5
Fedesarrollo	0.5	5.2	2,513	n.d.	n.a.	13.2
Average	(0.1)	4.6	2,439	5.9	(3.0)	13.7
Foreign Analysts						
Citibank	0.0	4.8	2,400	5.5	3.0	15.0
Deutsche Bank	0.3	5.0	2,550	n.a.	n.a.	14.0
Goldman Sachs	(0.3)	5.0	2,550	n.a.	(3.0)	n.a.
JP Morgan	0.5	5.5	2,594	6.0	(3.0)	n.a.
Average	0.1	5.1	2,524	5.8	(1.0)	14.5

n.a. not available

a/ The deficit forecast is for the central government.

Source: electronic survey.

Table A2
Proyecciones para 2010

	Real GDP growth (percentage)	CPI Inflation	Nominal exchange rate end of
Local analysts			
Alianza Valores	2.8	4.0	2,350
ANIF ^{a/}	2.6	4.5	n.d.
Banco de Bogotá	2.5	5.0	2,600
Banco Santander	2.2	4.8	2,245
Bancolombia	1.9	4.5	2,496
BBVA Colombia ^{a/}	1.1	3.8	2,786
Corficolombiana	1.9	4.0	n.a.
Corredores Asociados	1.5	4.2	2,300
Correval	2.0	3.9	2,537
Fedesarrollo	1.7	4.6	2,626
Average	2.0	4.3	2,492
Foreign analysts			
Citibank	1.5	3.8	2,350
Deutsche Bank	2.6	4.5	2,550
Goldman Sachs	2.5	3.8	2,600
JP Morgan	3.0	4.5	2,700
Average	2.4	4.2	2,550

n.a. not available

a/ The deficit forecast is for the national government

Source: electronic survey.

1. Forecasts for 2009

On average, the local analysts expect -0.1% economic growth as opposed to the 2.9% forecast in the last edition of the Inflation Report. The foreign firms consulted for this edition expect 0.1% GDP growth, on average.

As to inflation forecasts, the local analysis anticipate a 4.6% increase in prices by the end of the year, while the foreign analysts expect 5.1% inflation, on average. The first figure is near the floor of the target range set by the BDCB for 2009 (between 4.5% and 5.5%).

With respect to the exchange rate, the local analysts expect the representative market rate of exchange (TRM in Spanish) to average COP\$2,439 by the end of the year, compared to COP\$2,443 forecast in the survey conducted in January 2009. The foreign analysts expect the TRM to be near COP\$2,520 by the end of the year.

As for the country's benchmark DTF rate, both the local and foreign analysis forecast declines to very similar levels: 5.9% and 5.8%, respectively. Moreover, the analysts consulted for this edition expect the unemployment rate to increase. The local analysts anticipate 13.7% unemployment and the foreign analysts, 14.5%.

2. Forecasts for 2010

For next year, the local analysts forecast 2.0% growth; the estimate by the foreign analysts is 2.4%. As to inflation, the local analysts expect it to be slightly higher than what the foreign analysts are predicting (4.3% as opposed to 4.2%). In terms of the exchange rate, the local analysts are looking for it to average COP\$2,492. The foreign analysts expect it to average COP \$2,550.