

## INFLATION IN DECEMBER AND THE OUTLOOK

- ✧ In 2004, the inflation target (5.5%) was met and non-food inflation saw a substantial decline. The downturn in non-food inflation was associated with the following factors:
  - ✧ The exchange rate appreciation and its impact on the reduction in tradables inflation.
  - ✧ The absence of major demand pressures, which halted the acceleration in inflation for non-tradable goods and services during the second half of 2004.
  - ✧ Lower inflation expectations.
  - ✧ An absence of major cost pressures.
- ✧ These factors neutralized the upward effect on non-food inflation originating from the prices of fuel and regulated goods and services. The decline in inflation and the fact that the inflation target was met helped to lower inflation expectations.
- ✧ The period since September 2004 has seen two important macroeconomic changes in comparison with the initial forecast: namely, the exchange rate appreciation and a possibly wider output gap.
- ✧ The increase in nominal appreciation of the peso led to a real peso appreciation, not only against the dollar but also against the various baskets of relevant currencies. The acceleration in peso appreciation during the fourth quarter is explained primarily by capital inflows other than foreign direct investment (FDI). This phenomenon is part of a weakened dollar worldwide and the movement of private capital towards emerging economies.
- ✧ As of the fourth quarter of 2004 and for 2005, the external context has become far more uncertain. Assuming there will be no abrupt corrections in the U.S. external deficit, there might be gradual increases in short-term interest rates in that country, outflows of private capital from the U.S. economy (accompanied by a continued weakening of the dollar) and moderate reductions in world growth and commodity prices.
- ✧ The peso might depreciate in 2005 compared with the levels observed at the end of 2004. However, the behavior of the exchange rate during 2005 is particularly uncertain, given the volatility of the international context.
- ✧ The exchange rate scenario for 2006 and for the mid-term is more difficult to predict. On the one hand, nominal and real peso depreciation is feasible, given the deterioration in the

current account that would result from the drop in oil prices and in oil export volumes. However, there is a lot of uncertainty about how capital flows will behave. In a scenario of capital inflows equal to or higher than in the past year, the current account deficit could exceed that of recent years.

- ✧ The economy grew by 2.4% in the third quarter. This was far less than expected and below the rate of growth since mid-2003 (above 4%). This could be due, in part, to temporary events such as the trucking strike in September (which lasted until October), the decline in coffee supply and in gold and nickel production, and not as many working days. Also, investment in civil works was low. However, the decline in economic growth was accompanied by a slowdown in consumption, which does not rule out the possibility that demand will continue to weaken.
- ✧ The rapid rise in investment in recent years suggests an expansion in potential gross domestic product (GDP). Weakened demand and the likely growth in “potential GDP” indicate the “output gap” might have widened at the end of 2004, easing inflationary pressures.
- ✧ The stabilization in non-tradables inflation during the second half of 2004 (following an increase in the first six months of the year) is coherent with the assumption of a wider output gap. However, it also could be the result of a decline in inflationary expectations.
- ✧ Further exchange rate appreciation in 2004 and the forecast for 2005, the possibility of a wider output gap and the decline in inflationary expectations would be coherent with meeting the inflation target for 2005 (between 4.5% and 5.5%), and with the range announced for 2006 (between 3.5% and 5.5%), in the presence of a lower interest rate path than contemplated in earlier reports.
- ✧ The inflation forecasts confirm this, even with the price shocks that could occur in 2005, such as an increase from 7% to 10% in the value added tax (VAT) on some items in the family market basket, possible above-inflation increases in prices for fuel and regulated goods and services, and the likelihood of moderate El Niño weather.
- ✧ The Board of Directors of the Central Bank (BDCB) has expressed its concern about the trend in real peso appreciation, due to the negative impact it could have on production in some tradables sectors and on developments concerning the balance of payments, specifically the current account. A shortfall in the balance of payments might eventually necessitate abrupt changes in the exchange rate to cope with a setback in capital flows to emerging economies. This would have a perverse effect on inflation and productive activity.
- ✧ Based on these considerations, the BDCB continued to implement policies in the last quarter of 2004 to ease the degree of exchange rate appreciation.
  - ✧ Banco de la República accumulated US\$1,503 million (m) in international reserves during the final quarter of 2004. This was done through discretionary purchases and accounts for 52% of all international reserves accumulated during the year.
  - ✧ On 17 December 2004, the Board of Directors lowered the Bank’s intervention interest rates to 6.5% for expansion auctions and 5.5% for contraction auctions. In all, this comes to a reduction of 25 basis points (bp).

- ✘ The Board of Directors closed its contraction windows (auction and Lombard) on 21 December and ratified its decision to intervene in the exchange market at its discretion.
- ✘ Despite the additional purchase of dollars, monetary expansion has been coherent with the monetary program, thanks to a lower net repo balance and an increase government deposits with Banco de la República.
- ✘ These measures have led to a drop of nearly 50 bp in the inter-bank interest rate (TIB) since the end of the year, with 25 bp of this decline attributed to the Bank's intervention rates.
- ✘ The possibility of maintaining the current stance of monetary policy for the coming quarters will depend fundamentally on the actual and anticipated trend in the exchange rate and aggregate demand.
- ✘ If the inflow of capitals were to continue during 2006, without an accelerated closure of the output gap, it would be feasible to continue the current monetary policy and to meet the inflation targets. However, if high depreciation is forecast for 2006 (due to less capital inflows), it would be difficult to maintain short-term interests rates at their current levels and to comply with the inflation target for 2006.
- ✘ For the time being, the international scene is expected to be characterized by a gradual adjustment in the U.S. external deficit that implies no abrupt changes in world growth, commodity prices or capital flows to emerging markets. In this context, if a fiscal policy conducive to a reduction in the ratio of the debt to GDP is maintained, there should be no sharp reversals in the flow of foreign capital towards Colombia.
- ✘ These figures and observations suggest the possibility of leaving interest rates unaltered during the coming months. Nevertheless, as has been indicated repeatedly, there is considerable uncertainty about several relevant aspects such as the output gap and the international context. This necessitates a frequent macroeconomic review of the situation and the macroeconomic forecast.
- ✘ Major changes in the macroeconomic situation or in the forecast could lead to important changes in the stance of monetary policy.

Board of Directors, Banco de la República