



INFLATION REPORT

JUNE 2000

BANCO DE LA REPÚBLICA

PRESENTATION, SUMMARY AND CONCLUSIONS

⊠ Annual consumer inflation stood at 9.7% in June, identical to the first quarter but above inflation in June 1999 (9.0%). The new feature in the second quarter was negative monthly inflation in June (-0.02%), the first since August 1988. Current- year inflation in June was 7.0%, which is slightly above price growth during the first half of 1999 (6.5%) but below accumulated inflation in the first half of 1998 (14.1%). In the second quarter, unlike the first, inflation was not pulled up by food prices. On the contrary, in May and June, a seasonal recovery in food supply helped to slow price growth. The other item determining the behavior of consumer inflation in the first quarter; that is, services, remained an accelerating factor between March and June.

⊠ In the year as a whole, four market-basket components registered annual price adjustments in excess of average inflation: transport (18.4%), sundry expenditures (17.4%), health care (11.2%) and food (9.9%). These above-average increases in Consumer Price Index (CPI) groups are explained by higher prices for fuel (transport) and banking services (sundry expenditures), and by devaluation, which made items such as medicine (health) more expensive. Seasonal food shortages (foodstuffs) during the first four months of the year were also a factor. The only groups to experience price changes below total inflation were education (8.3%), housing (5.2%) and clothing (2.8%).

⊠ According to the alternate classification, the rise in inflation over the past twelve months is due to non-tradables. As a whole, they increased inflation by 2.2 percentage points. The 25.5% price rise in flexible goods (root crops, fruits and vegetables) was important and added 3.8 percentage points to the acceleration in overall inflation for the period. With an annual price variation of 9.4%, tradables had the opposite effect.

⊠ Annual producer inflation in June was 15.6%; that is, 1.9 percentage points higher than in March (13.7%) and 9.5 percentage points above the rate in June 1999 (6.1%). As with consumer inflation, prices for farm products in the second quarter, especially foods, ceased to exert upward pressure on producer inflation. The rise in producer inflation during the last three months is, therefore, explained mainly by added growth in the price of industrial goods. This is consistent with greater devaluation and the substantial rise in domestic gasoline prices.

⊠ With data to June, core inflation calculated by the Banco de la República, using the four traditional indicators, is 9% or 0.6 percentage points higher than inflation calculated with data

to March. This increase is the result of an upsurge in core inflation calculated by the trimmed mean and particularly by the asymmetric mean. With respect to the other two indicators, inflation excluding food dropped in the second quarter, while the inflation nucleus remained stable. As explained in this report, the rise in average core inflation in June does not necessarily reflect emergence of demand pressure; it is more a question of the temporary inability of asymmetric and trimmed mean indicators to measure this type of pressure accurately. In effect, the statistical procedures used to calculate these two indicators in June led to the exclusion of rental prices. Thanks to an extremely low annual increase, rental prices helped to temper core inflation measured in this way. The same problem did not occur with the inflation nucleus or inflation excluding food, which seems to suggest these indicators should be used to assess the actual behavior of demand-pull inflation. An average of the last two indexes shows core inflation may have dropped in the second quarter by about 0.2 percentage points.

✠ At the end of June, the monetary base 20-month moving average was 3.4% above the original corridor ceiling. As analyzed in this report, greater growth in more liquid monetary aggregates -monetary base and M1- is due to growth in the demand for cash, thanks to factors such as low interest rates and the "two per thousand" tax on banking operations. The increase, therefore, should not affect prices due to growth in aggregate demand beyond what is expected.

✠ During the month in question, the financial system's nominal and real loan portfolio continued to drop at rate similar to that of the previous month. The exception in the financial system is still the nominal loan portfolio of private financial institutions, excluding savings and loan corporations (CAVs) and mortgage banks; it continues to exhibit positive annual growth of around 4.5%. On the other hand, the nominal lending rate was 24.0% in June, similar to the rate in March (23.7%), while the nominal deposit rate edged up from 10.9% in March to 12.0% in June. In terms of real interest rates, this implies a second-quarter rise of 1.0 percentage points in the deposit rate during the last month and 0.4 percentage points in the lending rate. At June, these rates were 2.1% and 13.1%, respectively.

✠ The latest figures on the productive sector suggest the economy continued to expand in the second quarter of the year. This claim is based on the recent trend in indicators such as electrical power consumption, automobile sales, credit-card consumption, and temporary employment and overtime. Growth trends in industrial production and exports at May were also a factor. However, use of installed capacity remains low, as demonstrated by the Fedesarrollo and ANDI indicators, and no great demand pressure is anticipated in the coming months.

✠ In view of the statistical problems involved in calculating the asymmetric and trimmed means, core inflation forecasts for the rest of the year should eliminate fears of a possible upsurge in demand-pull inflation. With data to June, the forecasts for all four core-inflation indicators remain below the target of 10%.

✠ First-semester inflation is compatible with the target of 10% for the current year. To date, there are clear indications that the upsurge in inflation at the beginning of the year was a

temporary phenomenon, as foreseen by the Board of the Banco de la República, and was due largely to the food price cycle. As has been the case since May, these factors will have much less influence in the second half of the year.

✕ The slowdown in inflation during the last two months is particularly significant, as it occurred at a time of economic recovery. This reaffirms the possibility of economic recovery without sacrificing progress towards price stability, which is a fundamental goal of the current macroeconomic program.

✕ Although it is optimistic about meeting this year's inflation target, the Board has its eye out for possible inflationary pressures in 2001. Some have been identified already. One is the growing pace of devaluation in recent months. By making imported goods more expensive, this could alter prices to the extent permitted by recovery in aggregate demand. Furthermore, rapid growth in certain monetary aggregates, as with the monetary base and money supply (M1), could also exert pressure on prices in the medium term.

✕ Recognizing these and other factors in due time and technically assessing their possible effects through the use of forecast models has enabled the Board to take steps to prevent pressures of this sort from having an effect. It intends to do all possible to ensure that inflation in the year 2001 does not exceed 8% and to consolidate what is now being accomplished; that is, economic recovery in an atmosphere of price stability.

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I N F L A T I O N R E P O R T

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CONTENTS

I.	PRICE INDEXES	8
	A. CONSUMER PRICE INDEX	8
	B. PRODUCER PRICE INDEX	12
II.	DETERMINANTS OF INFLATION	14
	A. MONETARY AGGREGATES, INTEREST RATES, AND EXCHANGE RATE	14
	B. SUPPLY AND DEMAND	19
	C. WAGES AND EMPLOYMENT	25
	D. CAPACITY UTILIZATION	27
	E. THE FISCAL SITUATION	28
III.	MEASURES OF EXPECTATIONS	35
	A. MAIN RESULTS	35
	B. FORECASTS BY INVESTMENT BANKS AND BOND RATING AGENCIES	38
IV.	INTERNATIONAL CONTEXT	40
	A. GENERAL ASPECTS	40
	B. COMMODITY PRICES	42
	C. FINANCIAL OUTLOOK	44
V.	INFLATION FORECASTS	47

PRICE INDEXES

A. CONSUMER PRICE INDEX

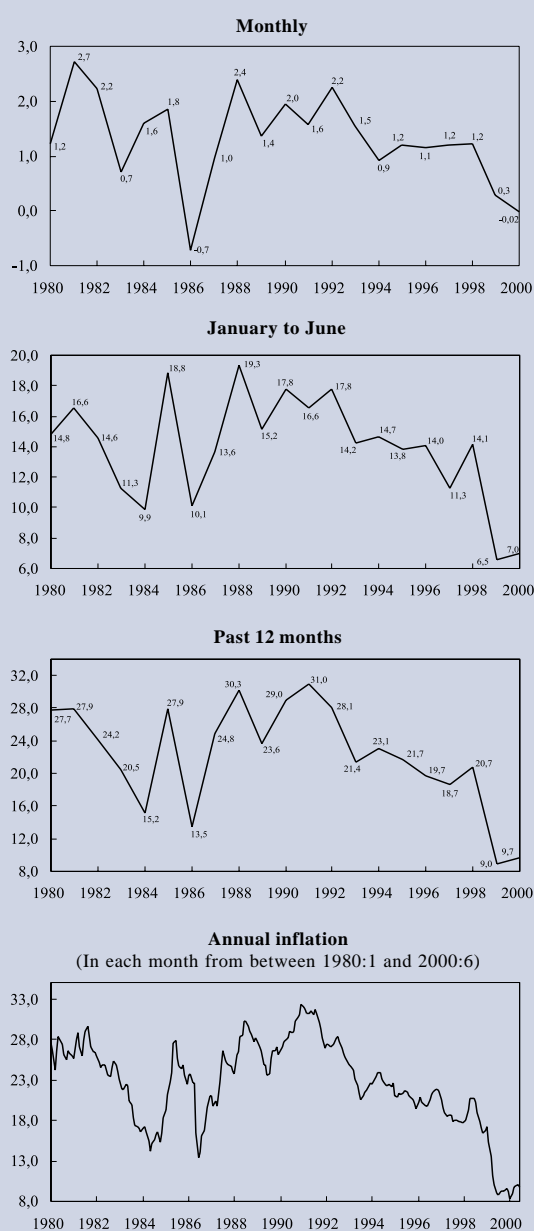
Overall Performance

Inflation measured as annual change in the Consumer Price Index (CPI) was 9.7% in June, up 0.7 percentage points from the rate in June 1999 and identical to inflation at the end of the first quarter in 2000 (Figure 1 and Table 1). This marks 14 months of consumer inflation at or below 10%. Year-to-June inflation was 7.0%, slightly above the first half of 1999 (6.5%) but well below accumulated inflation for the first half of 1998 (14.1%). In line with the seasonal pattern of inflation in Colombia, the second-quarter variation in accumulated prices (1.5%) was much less than in the first (5.4%). The novelty during the second quarter was monthly inflation in June, which was negative (-0.02%). The country had not seen a drop in prices since August 1988, when monthly inflation was -0.2%.

In the first quarter of this year, consumer inflation edged up from 8.3% in January to 9.7% in March. As mentioned in the March report, this increase was led by a substantial rise the price of food (especially potatoes), by growing domestic fuel prices brought on by the increase in international oil prices, by revised public utility rates and the elimination of subsidies to these items, and by seasonal increases in school fees and financial services.

Annual inflation, in contrast, was extremely stable in the second quarter, registering levels around 10%. This is explained by slower price increases for certain

FIGURE 1
CONSUMER PRICE INDEX
(PERCENTAGE CHANGE TO JUNE)



Sources: DANE; calculations by the Banco de la República.

TABLE 1
INFLATION INDICATORS
(PERCENTAGE CHANGE TO JUNE 2000)

	Monthly			Year to June			Annual		
	1998	1999	2000	1998	1999	2000	1998	1999	2000
I. CPI	1,2	0,3	(0,0)	14,1	6,5	7,0	20,7	9,0	9,7
Food	2,0	(0,4)	(0,7)	21,7	5,6	7,9	30,0	0,3	9,9
Housing	1,1	0,4	0,2	9,1	4,2	3,6	15,9	11,4	5,2
Clothing	0,8	0,1	0,4	4,5	2,1	1,7	8,5	5,3	2,8
Health care	1,2	1,0	0,6	15,4	11,0	7,2	20,2	16,0	11,2
Education 1/	1,0	0,2	0,1	16,2	9,5	7,5	19,1	10,5	8,3
Transport	0,2	1,2	0,1	14,2	11,0	10,7	20,3	16,8	18,4
Sundry expenditures	1,1	0,6	0,5	10,6	11,2	12,4	18,4	20,9	17,4
II. Core Inflation 2/	0,9	0,6	0,3	10,8	7,0	6,6	17,7	11,5	9,0
CPI excluding food 3/	0,9	0,6	0,3	10,8	7,0	6,6	16,7	13,0	9,6
Nucleus 4/							17,3	11,9	8,9
Trimmed mean 5/							18,6	10,9	8,7
Asymmetric mean 6/							18,3	10,3	8,7
III. PPI	0,8	0,6	0,6	12,2	4,9	7,6	17,6	6,1	15,6
By economic use or destination									
Intermediate consumption	0,1	0,9	1,0	9,6	4,1	6,7	12,1	6,6	15,2
Final consumption	2,1	0,3	(0,2)	17,4	5,6	8,4	26,3	3,5	15,4
Capital goods	0,2	0,9	2,0	7,7	5,5	9,5	14,7	12,1	20,2
Building materials	(3,1)	0,9	1,3	3,4	7,3	6,3	10,8	16,7	13,3
By origin									
Domestically produced and consumed	0,9	0,5	0,1	13,1	4,9	7,1	17,7	5,4	13,8
Imported	0,2	1,4	2,2	5,6	4,5	9,4	16,9	11,4	21,4
Exported 7/	(1,4)	5,2	2,5	(0,4)	7,7	11,4	7,0	12,7	31,1
By industrial origin (ISIC)									
Farming, forestry & fishing	2,0	1,0	(2,3)	21,3	3,6	5,6	20,9	(6,0)	13,9
Mining	(5,6)	4,5	4,7	(9,6)	25,2	16,4	(0,3)	27,1	22,0
Manufacturing	0,5	0,4	1,3	9,5	4,9	7,9	16,8	10,6	15,9
IV. Other core inflation indicators									
CPI excl. food, services and transport 8/	0,9	0,4	0,2	10,2	5,8	4,9	15,3	10,9	6,9
Median 9/							15,7	8,1	5,5

1/ Starting in January 1999 a new CPI methodology divided this group into education, and culture and recreation. For purposes of price monitoring, it was decided to leave them together as a single group.

2/ This is the average of the four core-inflation measures calculated by the Banco de la República.

3/ CPI excluding all items of the food group.

4/ CPI excluding 20% of the weight of the items that showed the greatest price volatility between January 1990 and April 1999.

5/ The weighted mean trimmed by 5% in each tail, calculated by the CPI-60 methodology. In this connection, see Luis Fernando Melo et al. Un análisis de las medidas de inflación básica para Colombia, mimeo 1997, Banco de la República.

6/ The asymmetric mean trimmed by 15% in the left tail and 13% in the right tail, calculated by the CPI-60 methodology.

7/ The total PPI does not include exported goods. It is calculated from the weighted sum of domestically produced and consumed goods and imported goods.

8/ The total CPI does not include primary foodstuffs, state services (utilities in general), and transport.

9/ The weighted median of the entire basket, calculated by the CPI-60 methodology. In this connection, see Melo (1997).

Sources: Banco de la República - SGEE, DANE's PPI and CPI Lists.

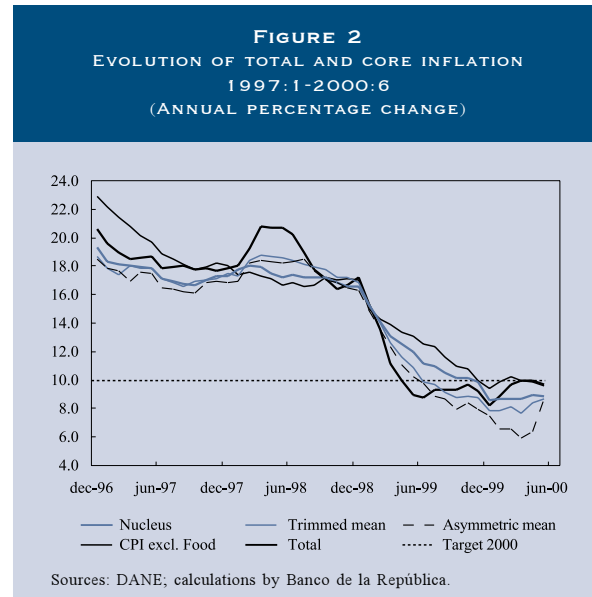
items. Education and banking services are an example; the prices of these services tend to change only during the first quarter of the year. The same is true of unprocessed foods (root crops, vegetables, legumes and fruits), which saw a drop in prices during the second quarter (-3.9%), thanks to June harvests.

Several factors favored the downturn in inflation during the first half of the year, one being less wage pressure in the public and private sectors.

In the second quarter of 2000, the average of the four core-inflation indicators (CPI excluding food, inflation nucleus, trimmed and asymmetric means¹) edged up 0.6 percentage points from 8.4% in March to 9.0% in June. The rise in average core inflation was due to contrasting movements in individual indicators and does not necessarily reflect a build-up in demand pressure. On the one hand, inflation excluding food declined in the second quarter by 0.6 percentage points. On the other, the trimmed mean and the asymmetric mean rose by 0.6 and 2.1 percentage points, respectively, while the inflation nucleus remained relatively stable, with an increase of just 0.2 percentage points (Table 1 and Figure 2).

The increase in the trimmed and asymmetric means is explained by the fact that rentals were excluded when calculating the CPI. Usually, when both these indicators are constructed, the items registering sharp annual changes in CPI are excluded each month. In June, items such as the CPI for rentals, with small annual changes (2.0%), ceased to be part of these indicators. The result was a rise in core inflation. Such was not the case with the other indicators (CPI excluding food and the nucleus), as volatility² is the criterion for exclusion. This implies calculating the indicators over a somewhat lengthy period, not for one month, as with the trimmed and asymmetric means. Furthermore, volatility can be demonstrated

¹ For a more detailed description of these core-inflation measures, see Notes 3-6 to Table 1.



with empirical evidence, as in the case of CPI excluding food, or with statistical evidence, as in calculation of the inflation nucleus. In the case of the latter, rental prices were part of core inflation, since they were not highly volatile.

None of the core-inflation indicators at June surpassed the inflation target for the year 2000, and none was above observed inflation (Table 1).

As to annual consumer inflation by city, Cucutá registered the highest rise in prices (11.6%) (Table 2), followed by Barranquilla (11.2%) and Pasto (11.1%). At the end of the second quarter, the cities with the lowest annual inflation were Cali (8.5%), Villavicencio (8.8%) and Cartagena (9.2%).

Performance of the Main Components

Consumer prices performed well between April and June, due to a drop in the price of potatoes (-3.3%) and other fresh fruits (-11.1%). These items contributed the least to quarterly inflation. Those contributing the most to second-quarter inflation include all services; that is, fuel, electrical energy,

² An item's deviation (average square root error) in relation to annual CPI change for a specific period with respect to average annual inflation.

residential telephone service, public transportation and sewage disposal. As a whole, they accounted for nearly 40% of the growth in prices during the period.

As to annual inflation at June, price adjustments in the four market-basket groups exceeded average inflation: personal transportation (18.4%), sundry expenditures (17.4%), health care (11.2%) and food (9.9%). Transport was affected by constant hikes in fuel prices, which placed the price of transportation above average inflation. With annual increases above 25%, banking services explain the trend in sundry expenditures. In health care, the largest increases pertain to medicines and related items (16.6%) and to private health insurance (10.7%). The substantial increase in root crop prices (70.2%) explains the CPI food increase in the last twelve months. The only groups registering price adjustments below observed inflation were education (8.3%), housing (5.2%) and clothing (2.8%).

Alternative Classification: Groups Accelerating or Slowing Inflation

Table 3 and Figure 3 show an alternative classification used to identify factors that contribute to inflation.³ This classification divides the CPI basket into tradables⁴ and non-tradables, with the latter divided further into indexed,⁵ flexible⁶ and cyclical items. CPI flexible items experienced a major price adjustment in the first four months of

³ In constructing this alternate classification, it was necessary to fit the old CPI basket (CPI-60) into the new one (CPI-98). This involved some loss of information and gave a variation in observed CPI somewhat different from DANE'S official figure given by DANE.

⁴ Tradables: textiles, footwear, tobacco, beverages, cereals, dairy produce, cooking fats, drugs, vehicles, electrical appliances, etc.

⁵ Indexed items: rent, fuel and utilities, education, transport, and other items.

⁶ Flexible items: root crops, plantains, vegetables, legumes, and fruit.

⁷ Cyclical items: meat and its by-products.

TABLE 2
CONSUMER PRICE INDEX, TOTAL AND BY CITY
(PERCENTAGE CHANGE TO JUNIO)

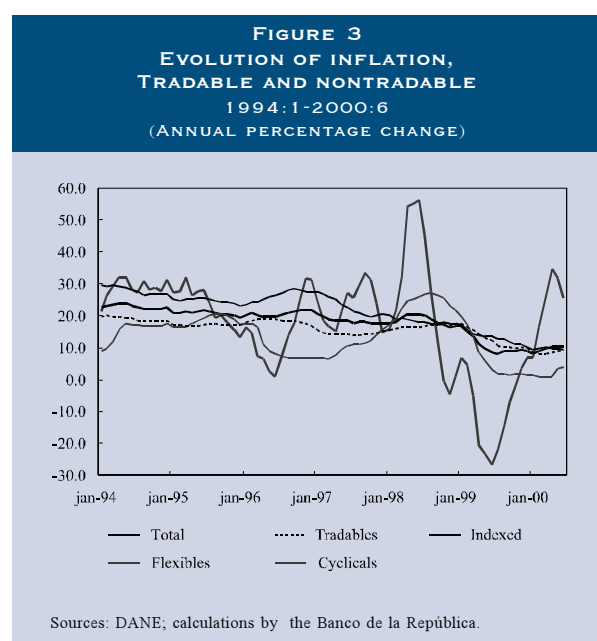
	Monthly			Year to June			Annual		
	1998	1999	2000	1998	1999	2000	1998	1999	2000
Total	1,2	0,3	(0,0)	14,1	6,5	7,0	20,7	9,0	9,7
Bogotá	1,0	0,4	(0,1)	13,9	7,3	7,5	20,1	10,1	9,4
Medellín	1,2	0,0	(0,2)	14,1	6,2	6,1	22,3	9,1	9,8
Cali	0,9	0,1	0,1	10,9	4,9	5,9	17,0	8,2	8,5
Barranquilla	1,1	(0,0)	0,6	13,8	5,4	6,8	19,4	8,4	11,2
Bucaramanga	1,6	0,3	(0,2)	14,5	6,9	7,7	20,4	7,4	10,9
Manizales	1,5	0,2	0,1	13,2	6,1	6,8	20,2	8,6	11,0
Pasto	1,5	0,6	(0,4)	14,4	7,6	7,7	26,2	11,0	11,1
Pereira	1,9	0,1	0,2	13,5	6,5	6,3	19,6	8,9	10,2
Cúcuta	1,3	0,7	0,1	17,4	6,7	8,3	24,9	9,4	11,6
Montería	1,6	0,4	0,3	15,6	5,8	7,5	20,9	8,8	10,3
Neiva	1,4	0,2	0,1	12,3	6,9	7,1	18,9	8,2	9,2
Cartagena	0,8	0,2	0,1	15,6	6,2	7,5	20,8	8,4	9,2
Villavicencio	2,0	0,5	(0,4)	17,1	6,2	7,0	25,1	5,0	8,8

Sources: DANE's lists; calculations by the Banco de la República - SGEE.

the year, followed by more moderate growth and closing with an adjustment of 25.5% in June. Indexed items (9.6%) and tradables (9.4%) followed a path similar to total nationwide inflation during the six months, while cyclical items (4.2%) remained below average inflation, even though prices began to climb in the second quarter.

According to this classification, price growth in the last twelve months (1.4 percentage points) is due to

non-tradables, which raised inflation by 2.2 percentage points. In this group, flexible items registered the largest price adjustment (25.5%), adding 3.8 percentage points to total inflation. In contrast, adjustments in the price of tradables over the last twelve months reduced inflation by -0.9 percentage points.



B. PRODUCER PRICE INDEX

Overall Performance

Producer inflation, measured as the annual change in the Producer Price Index (PPI), rose by 15.6% in June, up by 1.9 and 9.5 percentage points on producer inflation at the close of the first quarter of 2000 (13.7%) and on inflation observed in June 1999 (6.1%). The PPI showed an increase of 7.6% in the first six months of the year; that is, 2.7 percentage points above PPI growth observed in the first quarter of 1999 (4.9%). The monthly PPI variation in June 2000 (0.6%) was equal to that of June 1999 (0.6%) but below the variations registered in June 1997 (2.1%) and 1998 (0.8%). (Table 1 and Figure 4).

TABLE 3
CONSUMER PRICE INDEX, ALTERNATE CLASSIFICATION 1999-2000
(TO JUNE)

Items	Change		Contribution Entire Year 1/		Contribution To acceleration 2/
	1999	2000	1999	2000	2000-1999 % points
Total	8,7	10,0	8,7	10,0	1,4
Tradables	12,1	9,4	4,5	3,6	(0,9)
Non-tradables	6,6	10,4	4,2	6,4	2,2
Indexed	13,5	9,6	6,2	4,6	(1,6)
Flexibles	(26,6)	25,5	(2,3)	1,5	3,8
Cyclical	3,3	4,2	0,3	0,3	0,1

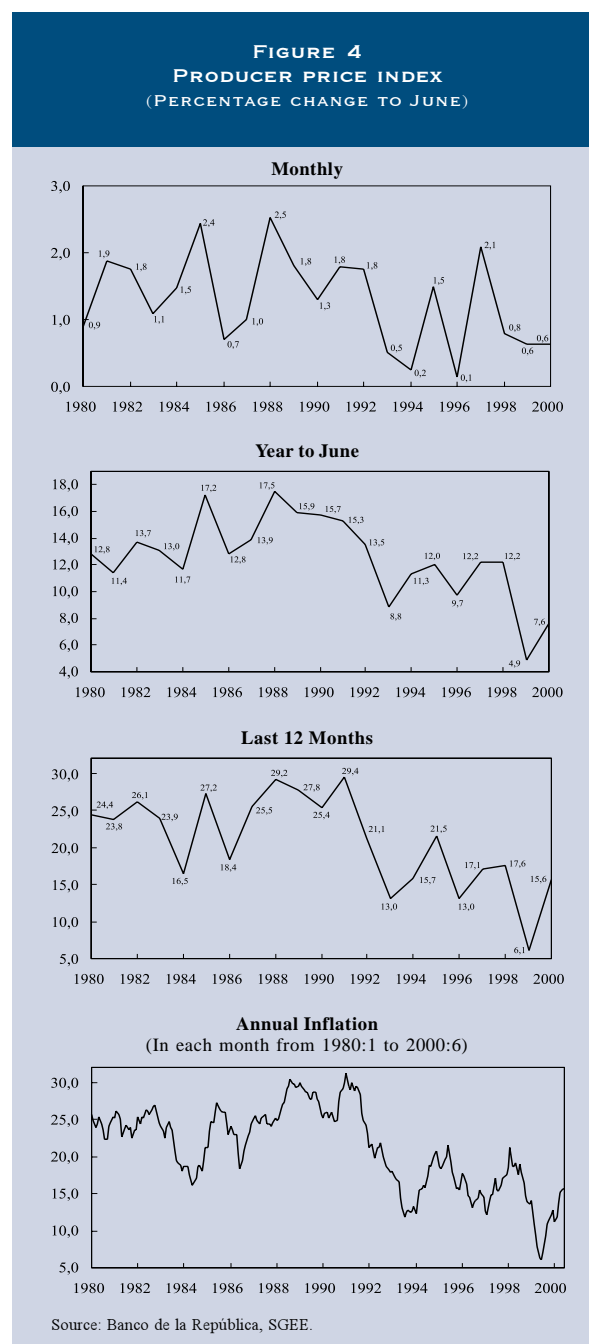
1/ Total inflation is not necessarily observed inflation, since constructing this classification necessitated fitting the old CPI basket (CPI-60) into the new one (CPI-80). Some information was lost in the process.

2/ The contribution to reducing inflation is the difference between each item's contribution to inflation in 1999 and 2000. The apparent lack of consistency between figures is due to rounding.

Sources: DANE's lists; calculations by the Banco de la República - SGEE.

According to classification by origin, the largest 12-month price increase corresponds to imports. Prices in this group rose throughout much of the first half of 2000, from 16.1% in December 1999 to 21.4% at the end of June. Devaluation in the first half of the year (14.2%) clearly accentuated the expansion in import prices. Goods produced and consumed domestically rose in price by 13.8%, more than eight percentage points up on the rate a year earlier (5.4%). In the PPI basket, domestically produced and consumed goods were affected by a substantial increase in food prices from February to June 2000, which lifted prices in this group by more than 3.0 percentage points. However, food-producer price pressure eased considerably as of May.

According to classification by ISIC, mining registered the poorest price performance, with 22.0% annual growth at June. This was due primarily to higher oil prices at the end of 1999 and the beginning of this year. Yet, the annual PPI change in mining was moderate, to the point of having declined by 12.5 percentage points between February and June. The same was true of farm prices; their growth declined by nearly 5.0 percentage points between the first and second quarters of 2000. The industrial PPI registered a 12-month increase of 15.9% at the close of the first six months, 3.8 percentage points up from the first quarter (12.1%).



DETERMINANTS OF INFLATION

A. MONETARY AGGREGATES, INTEREST RATES, AND EXCHANGE RATE

This section focuses on the evolution of monetary and exchange variables, and supply and demand in the economy.

1. Monetary Aggregates

The performance of monetary aggregates is analyzed by examining evolution of the monetary base, money supply, the broader monetary aggregate (M3-plus-bonds) and the loan portfolio in the financial system.

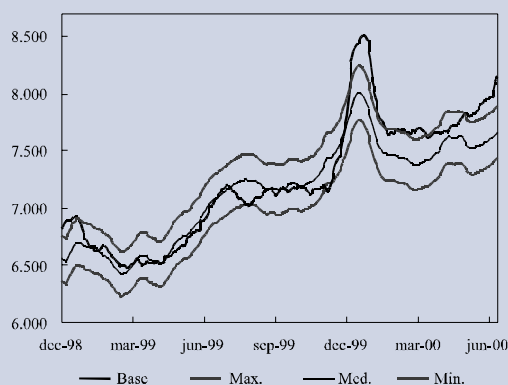
Monetary Base

At June 30, the monetary base totaled 8.369 billion pesos, with a 12-month growth rate of 16.2% and a 20-month daily moving average 3.4% above the indicative corridor ceiling (Figure 5). The anticipated limits of the base were exceeded because the average growth in cash holdings at the end of the quarter (27.9%) was above that contemplated implicitly in the corridor ceiling (20.6%) established by the Board of the Banco de la República. Rapid growth is a characteristic of the recent period, particularly since mid-1999 (Figure 6). Under these conditions, added growth of the base might not be a source of inflationary pressure.

M1 Money Supply

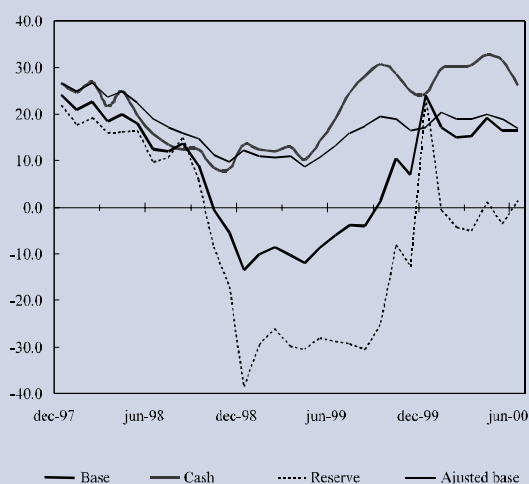
The M1 balance at June 30 was 12.766 billion pesos, with a 12-month variation of 34.1%. In the same

FIGURE 5
MONETARY BASE
20-MONTH DAILY MOVING AVERAGE
(BILLIONS OF PESOS)



Source: Banco de la República, SGEE.

FIGURE 6
MONETARY BASE AND ITS USES
(ANNUAL PERCENTAGE CHANGE IN MONTHLY AVERAGE)



Source: Banco de la República, SGEE.

month, annual growth in the average balance rose to 35.6%, compared with 32.9% in March. This was due solely to an increase in checking account growth, from 34.9% to 42.2%. As noted earlier, there was less of a rise in cash holdings during the period (Figure 7).

M3-Plus-Bonds

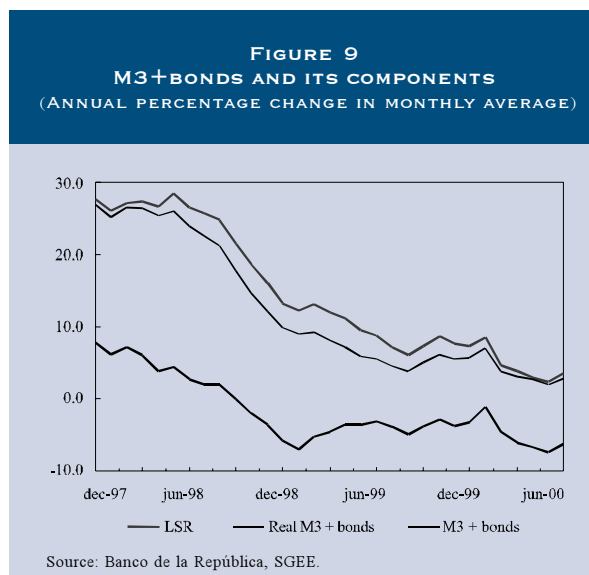
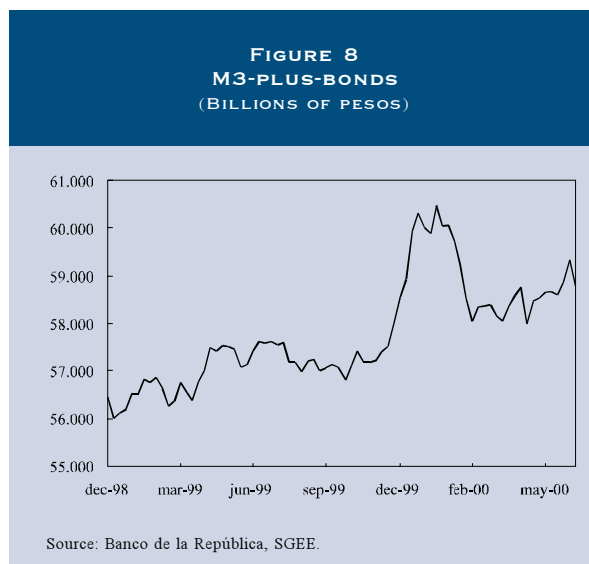
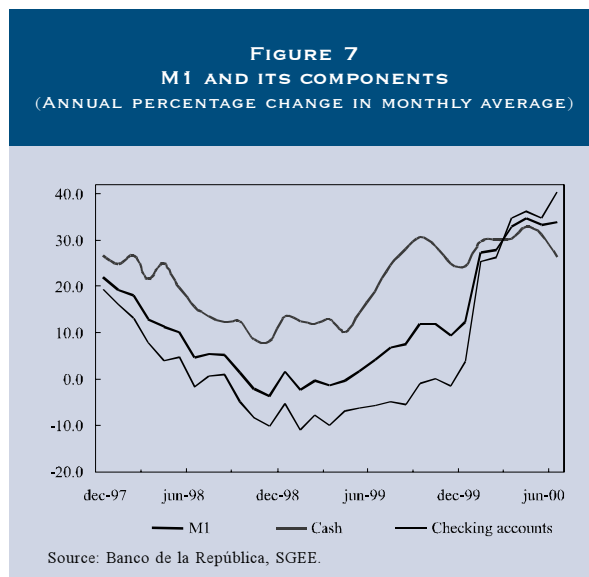
The broader monetary aggregate (M3-plus-bonds) totaled 53.414 billion pesos at June 30, with a 1.4% annual increase (Figure 8). Annual growth in the average balance slowed in June (2.6%) compared with March (3.1%), thanks to less of an increase in liabilities subject to reserve requirements (LSR) (Figure 9): 3.7% in March, compared with 3.1% in June. The downward trend in LRS is largely the result of reduced savings account growth (3.2%, down from 13.1%) and occurred despite less contraction in certificates of deposit (CDs) (-1.8 %, down from -6.5%). Added annual growth in checking accounts, as mentioned earlier (Figure 10), was also a factor.

The average M3+bond multiplier declined from 7.708 to 7.221 between March and June. This reduction was associated with an increase in cash and reserve ratios (from 0.092 and 0.050 to 0.100 and 0.053, respectively) (Figure 11).

Credit

The total net balance of domestic and foreign currency loans by the financial system was 47.682 billion pesos at June 30, with -7.4% annual variation and -5.5% between January and June. In domestic currency, the annual variation was -5.1%, in foreign currency -25.8%. The annual variation in the dollar equivalent of foreign currency loans was -39.7%.

Annual growth in the average balance of gross nominal domestic-currency loans for the entire financial system was less in June than in March (-3.5%, down from -2.9%). Excluding savings and loan associations (CAVs), the average balance of these loans (for the rest of the system) continued to decline in the second



quarter, registering an annual nominal variation of -1.9%, down from that observed three months earlier (-1.3%). As to CAVs, the annual variation in gross domestic- currency loans went from -11.1% in March to -11.5% in June (Figure 12).

In real terms, the average balance of gross domestic-currency loans by the financial system fell from -11.5% in March to -12.0% in June. Excluding CAVs, the rest of the other loans declined from -10.0% to -10.6% (Figure 13).

The rate of growth corresponding to net loans by mortgage banks, both private (Group C) and public (Group D), also slowed between March and June. The loan portfolio of the private financial system, excluding state mortgage banks (Group A), which is the only portfolio registering real growth to date, also continued to decline during the quarter. However, the downturn in the domestic-currency loans of the public financial system, excluding state mortgage banks, (Group B) was less in June than in March (Figure 14).

Part of this reduction is explained by debts written off with restructuring of the financial system by Fogafin, as of mid-1999, and mortgage relief ordered under Housing Law 546 of 1999. By March, the financial system had rid its balances of 4.410 billion pesos corresponding to financial reconstruction and 1.412 billion in mortgage relief. In all, these operations could have accounted for up to 11.6 percentage points annual growth in the net loans.

2. Interest Rates

At the close of June, the average deposit rate measured by the DTF was 12.0%, up from that at the end of March (10.9%). The average lending rate closed at 24.0%, similar to the rate in March (23.7%). The difference between both rates was 12.1 percentage points, down by 0.7 points compared with the

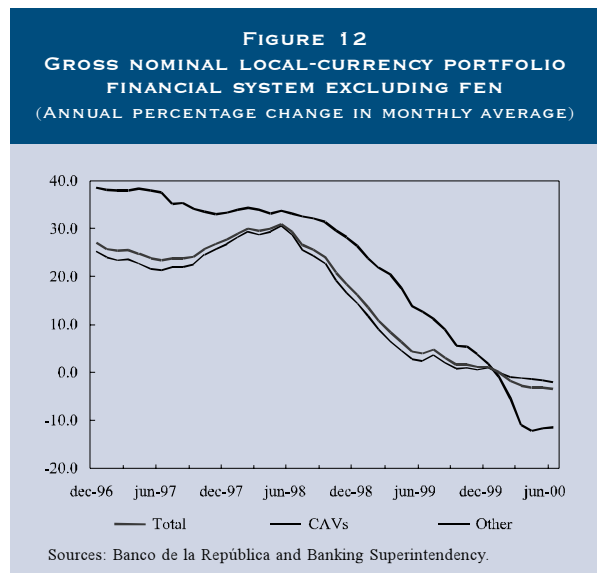
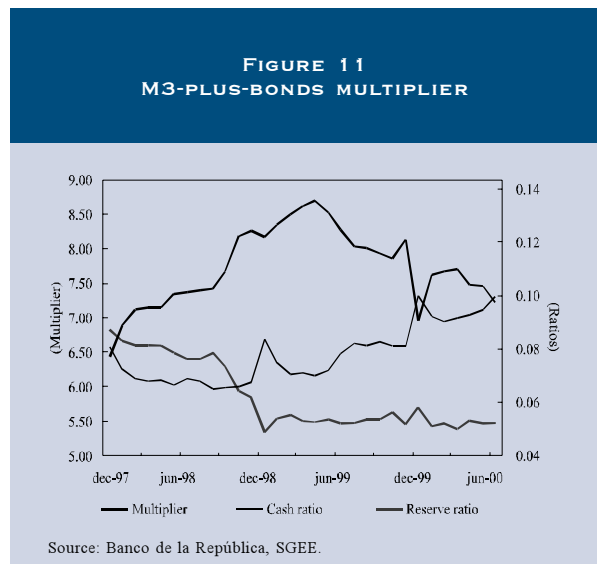
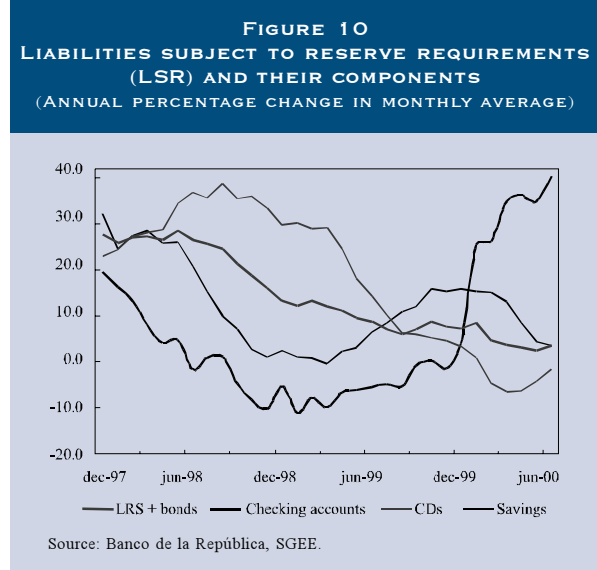
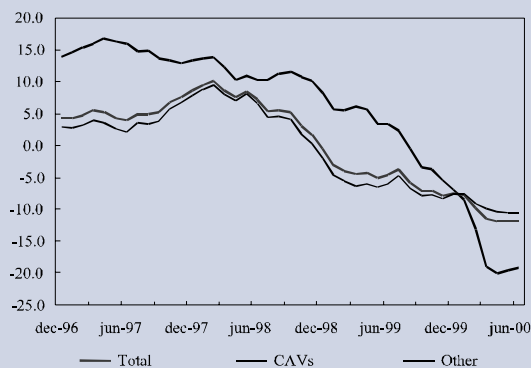
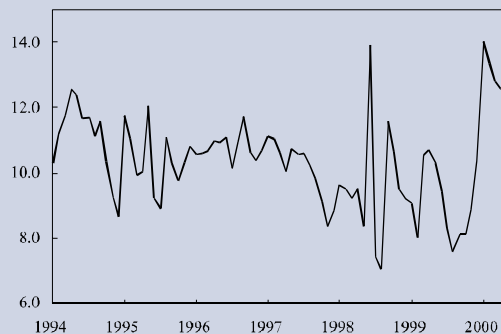


FIGURE 13
GROSS REAL LOCAL-CURRENCY PORTFOLIO
FINANCIAL SYSTEM EXCLUDING FEN
 (ANNUAL PERCENTAGE CHANGE IN MONTHLY AVERAGE)



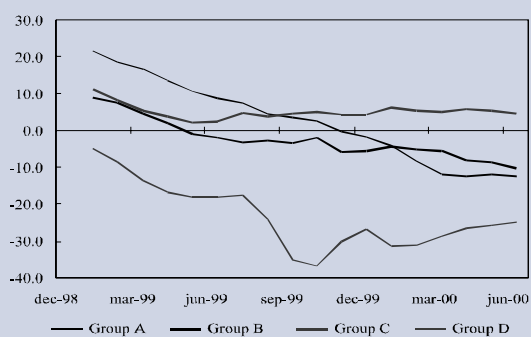
Sources: Banco de la República and Banking Superintendency.

FIGURE 16
LENDING AND DEPOSIT RATES DIFFERENTIAL
FINANCIAL SYSTEM
 (PERCENTAGE)



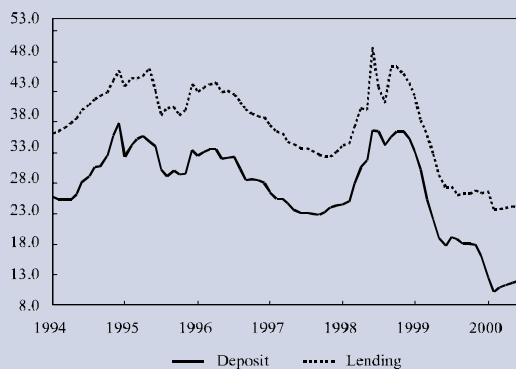
Sources: Banco de la República and Banking Superintendency.

FIGURE 14
TOTAL DOMESTIC-CURRENCY PORTFOLIO
 (ANNUAL PERCENTAGE CHANGE IN MONTHLY AVERAGE)



A: Private sector excl. private cavs, Davivienda & Colpatría. B: Public sector excl. mortgage banks. C: Private CAVs plus Davivienda and Colpatría. D: Public mortgage banks.
 Sources: Banco de la República and Banking Superintendency.

FIGURE 15
DEPOSIT AND LENDING RATES
 (ANNUAL EFFECTIVE RATE)



Sources: Banco de la República and Banking Superintendency.

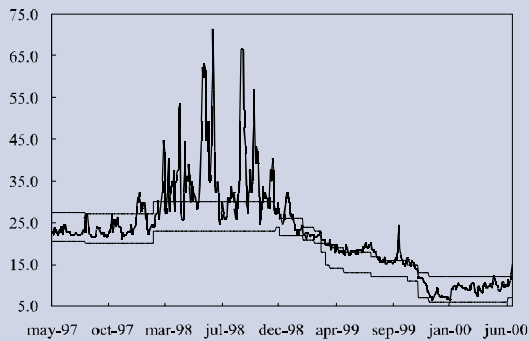
previous quarter (Figures 15 and 16). The interbank interest rate averaged 10.8% in June as opposed to 9.4% at the end of March. However, it was 15.0% during the final days of June (Figure 17).

In real (ex-post) terms, the deposit rate went from 1.1% at the end of the previous quarter to 2.1% at the close of June. The real lending rate increased from 12.7% to 13.1% in the same period (Figure 18). However, both rates stayed below average historical levels.

Figure 19 shows evolution of the yield curve measured by the Banking Superintendency Basic Rate (TBS)⁸ for different maturities over the past nine months. Interest rates for all maturities had declined by February 2000. Rates for different maturities began to rise as of March and, in June, were 9.4% for short maturities (30 days) and 13% for one-year maturities. Although the yield curve in the last month was not as steep as in the two preceding months (Figure 19), it was high enough to suggest the possibility of an upsurge in interest rates during the coming months.

⁸ The Banking Superintendency Basic Rate (TBS) is the average rate for term deposit certificates and term savings certificates, of different maturities, in the entire financial system, as reported by the Banking Superintendency.

FIGURE 17
INTERVENTION BAND AND INTERBANK RATE (TIB)
1997:5-2000:6
(PERCENTAGE)

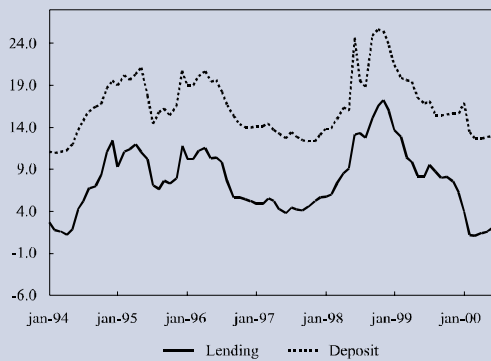


Sources: Banco de la República and Banking Superintendency.

Spot and forward curves over the last nine months are illustrated in Figure 20. The spot curve (thick line) shows an approximate two-percentage-point increase in the 90-day rate over the last five months, as was expected according to the forward curves obtained in previous months.

Each point on the forward curves (thin lines) shows agent expectation with respect to the current 90-day rate (first point), within 30 days (second point) and so on up to 360 days. These curves have sloped upward in recent months or become U-shaped, implying the market expects the 90-day TBS to continue to rise in the next six months.

FIGURE 18
REAL DEPOSIT AND LENDING RATES,
FINANCIAL SYSTEM
(PERCENTAGE)

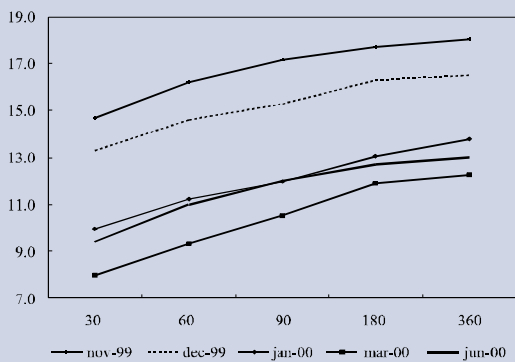


Sources: Banco de la República and Banking Superintendency.

Yield Differentials

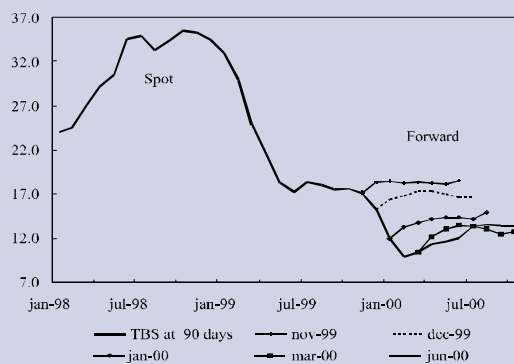
This section focuses on the difference between external and internal yields. The external yield is defined as the yield local investors expect to obtain on dollar-denominated investments. It is calculated on the basis of the external interest rate of reference and devaluation expectations. For this purpose, devaluation expectations are the devaluations implicit in the financial system's forward dollar sale contracts (80 to 100 days). The external rate of reference is the 90-day Libor. The domestic rate of reference is the DTF rate.

FIGURE 19
TBS INTEREST RATE FOR DIFFERENT MATURITIES
CALCULATED BY THE BANKING SUPERINTENDENCY
(PERCENTAGE)



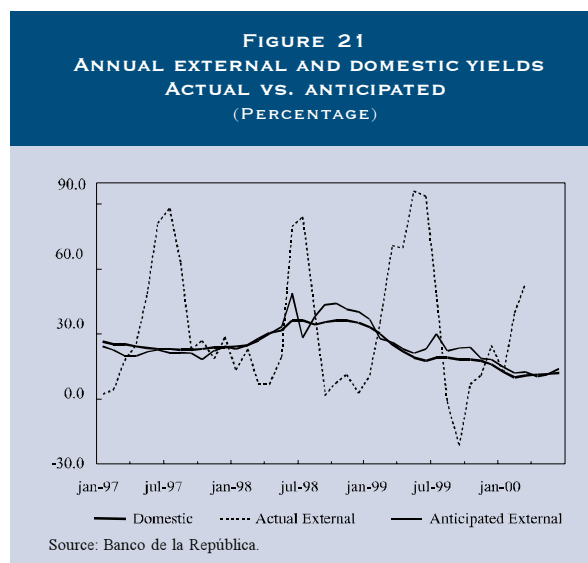
Sources: Banking Superintendency.

FIGURE 20
90-DAY TBS PROJECTION
(PERCENTAGE)



Source: Banking Superintendency.

Figure 21 compares anticipated external yield with return on domestic investments (measured by the DTF rate) and observed (ex-post) external yield, which has a three-month lag. In June, anticipated external yield was slightly above domestic yield, following two consecutive months in which the anticipated yield on domestic investments was greater. As shown in Figure 21, actual external yield has picked up in the last three months, due to nominal devaluation of the peso. In other words, agents who made dollar-denominated investments at three months maturity secured yields of up to 53%, which is well above those observed for investments in pesos.

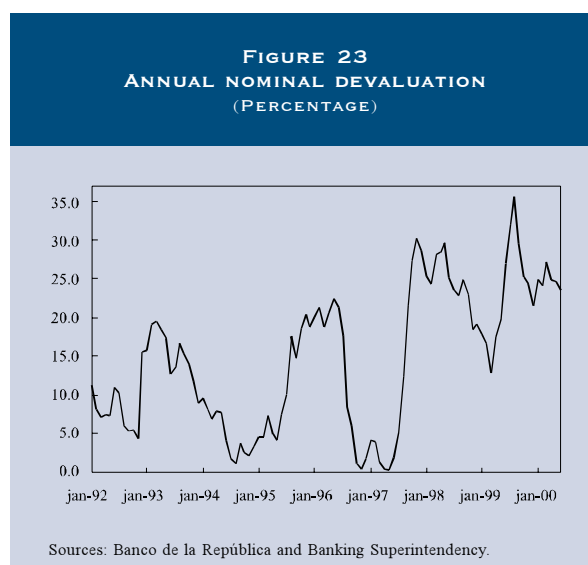
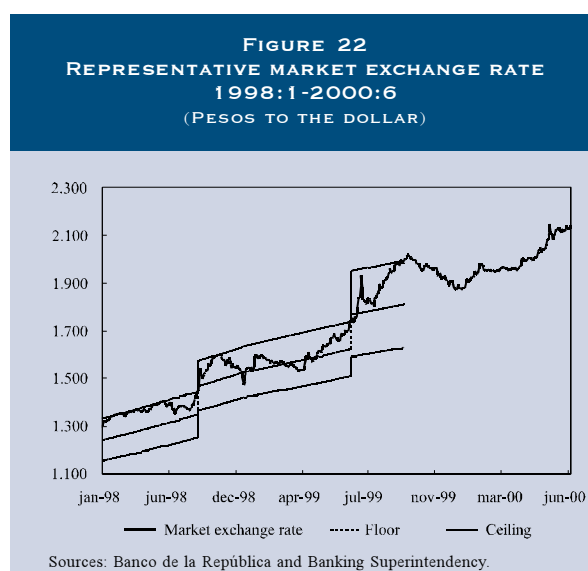


3. Exchange Rate

The exchange rate, which was 1,951.6 pesos to the dollar at the end of the preceding quarter, showed a strong tendency towards devaluation in the last quarter. This raised the dollar to 2,139.1 by the end of June. Annual devaluation was 23.5%, as opposed to 14.2% in the first six months of 2000 (Figures 22 and 23).

Real Exchange Rate

The real peso exchange rate, measured by the RERI-1 (1994=100), an index constructed with Colombia's producer price index and those of its 20 trading partners, stood at 117.6 in June, on average. This indicator shows 10.9% annual devaluation and 6.1% in the first six months of 2000 (Figures 24 and 25). However, using the RERI-3 (1994= 100), which is based on the CPI, annual devaluation at June is 15.6% and 6.2% for the year to date (Figure 26).



B. SUPPLY AND DEMAND

1. General Considerations

First-Semester Results

Calculations released by DANE in the second quarter on GDP growth in the first three months of the year

show an increase of 2.2% in gross domestic product (GDP) compared with the first quarter of 1999 and 1% with respect to the preceding quarter. This is the first positive annual growth observed in the last six quarters and indicates the Colombian economy has begun to recover (Figure 27).

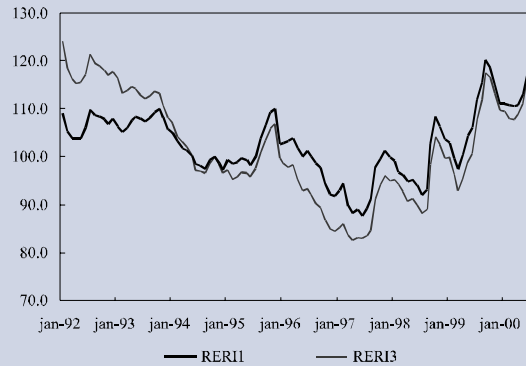
Available information on the second quarter shows the economy continued to expand. However, a moderate slowdown in certain sectors, such as manufacturing and commerce, is not to be ruled out. The fact that these sectors are less dynamic does not imply diminished growth in the economy as a whole, as their performance could be offset, in part, by the expected improvement in agriculture. Although there are no figures on farm production to date, supply has recovered substantially, as evidenced by a major drop in the prices of staple food. There also are indications of a recovery in coffee production. Being a highly important product, coffee is a determining factor in agricultural performance.

Continued economic growth in the second quarter at a pace similar to that observed in the first three months of 2000 is predictable, given the trend in several indicators of economic activity. Indicators such as energy consumption in April and June showed positive signs. For example, annual growth in power consumption in the second quarter was positive for the first time in many months. As to energy plus gas consumption, annual growth was positive in the months for which data is available (April and May), although less so than in the first quarter (Figure 28).

Automobile sales also point to continued economic recovery. In the second quarter, they rose at an annual rate of 13%. This is an improvement compared with the first quarter, when the increase in annual sales averaged just 1.3% (Figure 29).

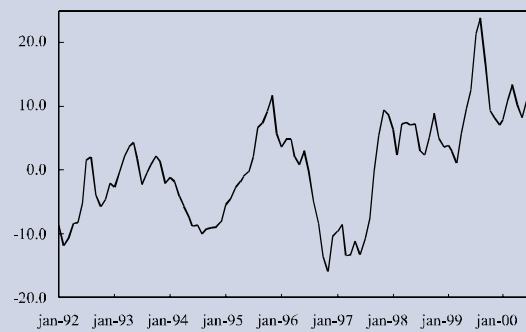
There are other indicators of continued growth throughout the second quarter, such as credit-card

FIGURE 24
REAL EXCHANGE RATE INDEX
RERI-1 AND RERI-3 (1994 = 100)
 1992:1-2000:6



Sources: Banco de la República, SGEE.

FIGURE 25
REAL ANNUAL DEVALUATION, RERI-1 (1994 = 100)
 1992:1-2000:6
 (PERCENTAGE)



Source: Banco de la República, SGEE.

FIGURE 26
REAL ANNUAL DEVALUATION, RERI-3 (1994 = 100)
 1992:1-2000:6
 (PERCENTAGE)



Source: Banco de la República, SGEE.

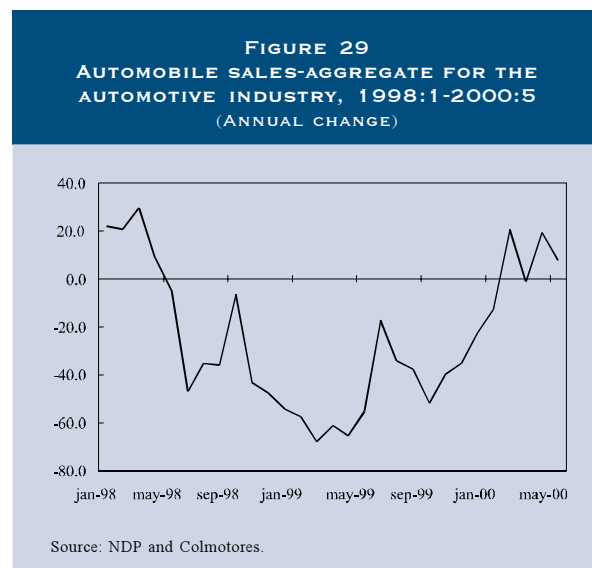
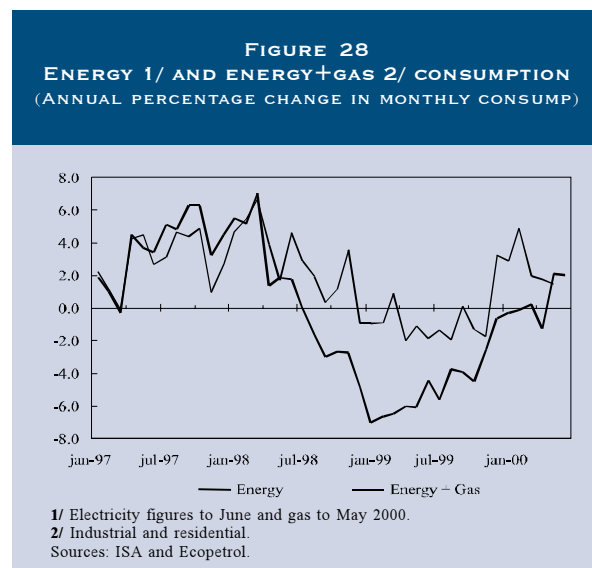
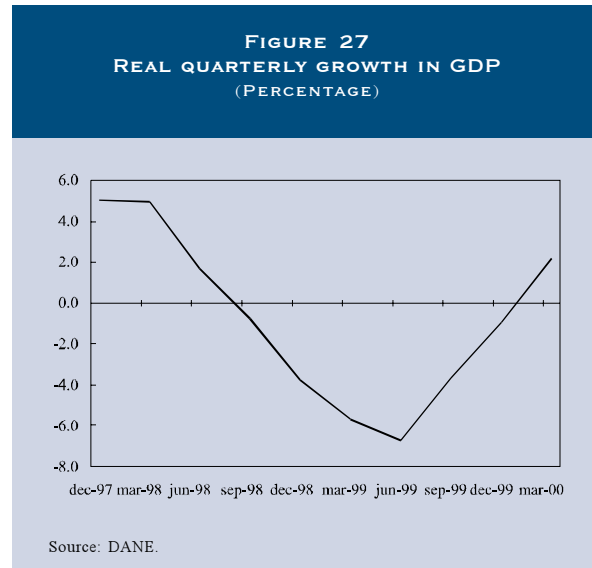
sales at June, which are discussed later, and the trend in industrial overtime, at least in manufacturing. Overtime rose by 22.0% in the first five months of 2000: a major increase considering the sharp contraction in this variable throughout 1999. This trend is not unusual during the initial phase of economic recovery. As with temporary work, companies use overtime to minimize labor costs when the force of demand is uncertain. Overtime also is sensitive to changes in economic conditions. Accordingly, a positive trend in this indicator up to May heralds acceptable performance for the sector (Figure 30).

Variables such as non-traditional exports continued to show positive signs in April and especially in May, maintaining the strength of a crucial source of demand, primarily for the industrial sector. The average annual increase in non-traditional exports was 10.4% in April and May, which is less than growth in the first quarter but significant, as exported value is now equivalent to the maximum values observed in the months leading up to the recession. With an average annual increase of 16.1% in April and May, non-traditional industrial exports were particularly important. Most industrial production sectors contributed to the surge in non-traditionals, but particularly chemicals, textiles and clothing, machinery and equipment, plastic and rubber products (Figure 31).

Growth Prospects

Economic conditions appear to be right for a continuation of positive growth rates in the second half of the year. Uncertainty now centers on whether or not the current rate of growth can be maintained or even improved, or if, in contrast, the momentum observed up to now will ease and expansion will be slower in the months ahead.

A business opinion survey conducted by Fedesarrollo shows favorable trends. Orders and stock in the manufacturing sector, for June, continued the trend of previous months, implying good prospects for

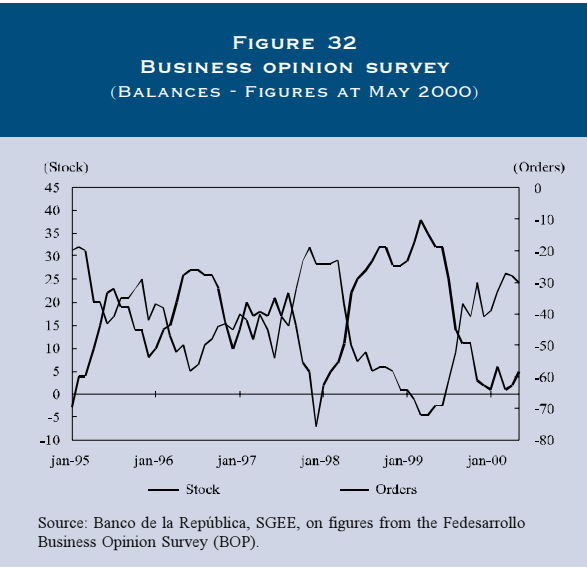
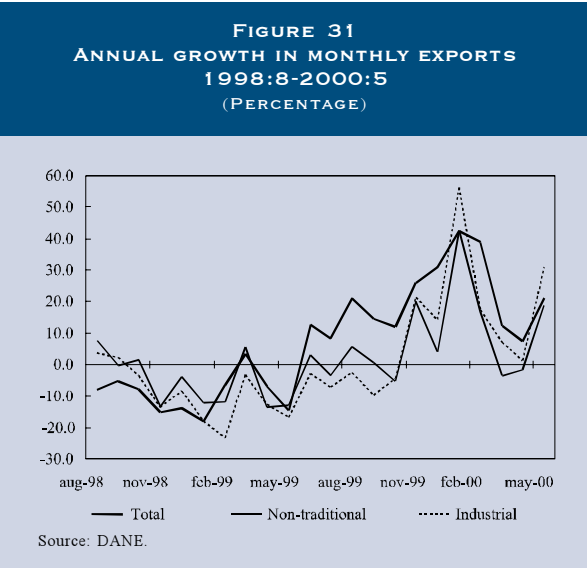
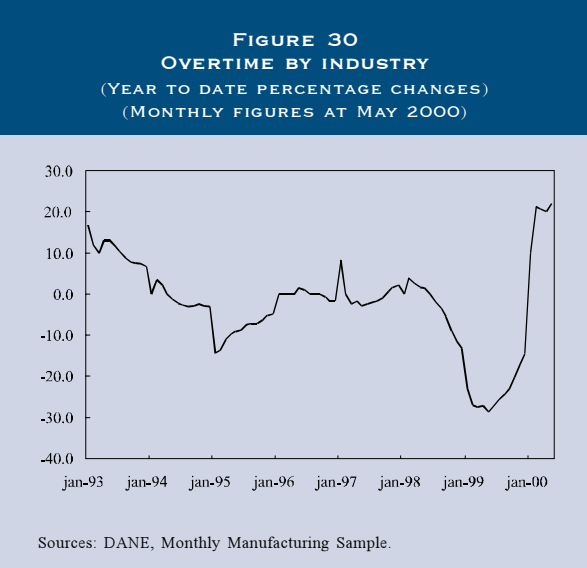


industrial growth in the coming months. Although orders slowed somewhat in the last two months, this was not enough to warrant talk of a change in trend. In the case of stock or inventory, May witnessed a sizable upsurge but this was a temporary phenomenon explained by seasonal patterns (Figure 32).

At present, there are a number of factors in the Colombian economy that not only favor continued growth at rates similar or better than those observed in the first months of the year but allow for optimism about the possibility of achieving the 3% growth target. One of the more significant factors is low interest rates. The recovery of neighboring economies also is an element, as is stable growth of the developed economies and a competitive exchange rate, all of which ensure good conditions for guaranteed growth in non-traditional exports. Moreover, good prices for Colombian exports have increased terms of trade, with a positive impact on earnings.

However, circumstances detrimental to growth are still present. If they persist or increase, growth is likely to slow in the months ahead. Credit is a case in point, since it is linked to the health of the financial system and to consumer and investor confidence in future economic conditions at mid-term. As noted in the section on financial indicators, credit performance remains extremely poor. This is undoubtedly because of problems with supply and demand, the latter due to apathy among potential borrowers. Prolonged economic growth clearly requires more dynamism in terms of credit and cannot be financed entirely with individual funds, as many companies have done up to now.

In principle, devaluation should contribute to growth. However, if it abruptly pushes the real exchange rate beyond its level of long-term equilibrium, it can be a deterrent. The result is undesirable inflationary pressure, making it difficult to keep interest rates down, in the long run, and encouraging capital flight.



Accordingly, if it were to continue, the devaluation trend of recent weeks would not be a good sign. Recent devaluation of the peso is related to another factor analyzed extensively in the chapter on the international context. This concerns the possibility that interest rates in the United States and Europe will continue to rise, in order to halt a possible surge in inflation. Growth in external interest rates tends to heighten expectations of devaluation. If proven to be true, these can lift domestic rates, for the reasons explained earlier.

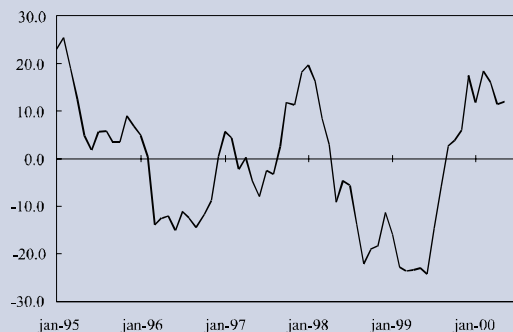
Variables related to law and order are another factor that affects devaluation and the confidence of consumers and investors at home and abroad. As evidenced by the business climate in May, these variables seem to have influenced the way agents perceive the economic situation at present and in the future (Figure 33). Doubts about the passage of structural reforms affecting public finances operate in the same direction.

2. Gross Domestic Product (GDP)

Growth figures for 1999, as revised recently by DANE, show a 4.3% decline in the economy last year, which is slightly less than the original estimate. This change was due to a correction in growth rates for most branches of the economy, but particularly to less of a calculated contraction for industrial manufacturing and financial and other services (Table 4).

As to economic performance in the first quarter of 2000, DANE figures show industrial growth (8.9%) as being the primary basis for economic recovery. Other sectors registering above-average growth were electricity, gas and water, transport and commerce. Agriculture, mining and community services showed signs of positive but limited growth. Activity in the financial and building sectors declined (Table 4).

FIGURE 33
BUSINESS CLIMATE
(FIGURES AT MAY 2000)



Source: Banco de la República, SGEE, on figures from the Fedesarrollo Business Opinion Survey (BOP).

3. Industry

According to the DANE Monthly Manufacturing Sample, industrial production in the year to May including coffee processing, rose at an annual rate of 10.4%. This is positive compared with historical growth of the sector and is above the first-quarter figure. The ANDI Joint Industrial Opinion Survey also shows continued industrial growth in the second quarter. With information to April, it calculates year-to-date growth at 8.5% (Figures 34 and 35).

Most branches of industry registered an important positive increase during the first five months of the year, as was the case in late 1999. The more dynamic industries continue to be those producing intermediate goods, capital goods and construction materials. In contrast, growth in the consumer goods industry was much slower, probably due to the poor performance of processed foods. Less activity in the processed food industry has two explanations. The demand for processed foods is more stable. This was the subsector jeopardized the least by last year's recession. As a result, its current levels are not much different from historically high levels and its recovery has to be slower, particularly at a time when there continue to be major problems with demand. Contraction in the other sectors was more pronounced. Therefore, growth can be greater without implying they are anywhere near peak production in 1998. Secondly,

exports, which explain much of the recovery in industry during the first half of the year, have not been an accelerating element in the food industry.

4. Consumption

Slow growth in the production of industrial consumer goods (1.4% in the year to April) is a sign that demand remained weak in the first half of the year. DANE figures show 2.3% annual growth in the first quarter of 2000, which is similar to growth reported for the economy as a whole but below that observed, for example, in investment demand.

Credit-card sales in current pesos, an indicator of demand for consumer goods, showed positive growth in April and May 2000, with a major improvement, particularly in May, when annual growth was 18.1%. However, during the year as a whole, nominal growth in credit-card sales stayed below inflation, which means the indicator continued to decline in real terms (Figure 36).

Moderate, current-year growth in this aggregate is explained by factors such as high unemployment. Increased growth definitely will depend on a recovery in employment. This will take time, considering that labor-intensive sectors such as construction remain immersed in a serious recession, which is expected to last until the end of the year. If past recessions are any indication, recovery in industrial employment after a serious economic crisis takes years to accomplish.

At any rate, the trend to date in imports of consumer goods is assurance that consumption will continue to grow at a positive rate throughout the second quarter and in part of the third. Annual growth in accumulated consumer imports at April was 5.8%. This was due largely to imports of durables, which rose by 20%.

5. Investment

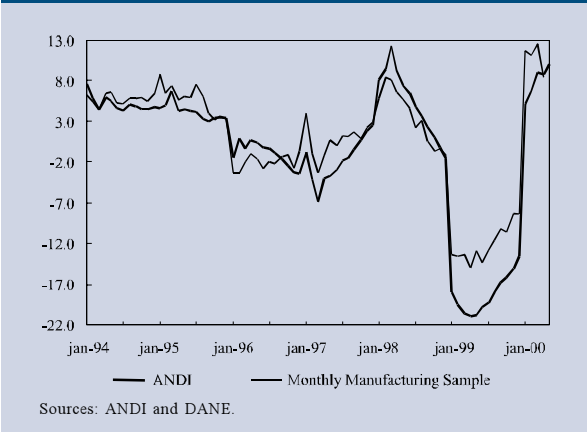
According to DANE, there was a 10.7% increase in gross capital formation during the first quarter of 2000, compared with the same period in 1999. This

TABLE 4
REAL GROSS DOMESTIC PRODUCT
BY BRANCHES OF ECONOMIC ACTIVITY
(ANNUAL PERCENTAGE CHANGE)

	1999 Calculation		2000
	Previous	Current	I Quarter
GDP	(4,5)	(4,3)	2,2
Agriculture, forestry, hunting & fishing	(0,4)	(0,2)	1,5
Mining and quarrying	6,6	4,9	1,4
Electricity, gas & water	(3,8)	(3,5)	4,1
Manufacturing industry	(12,8)	(12,4)	8,9
Construction	(24,3)	(24,3)	(6,1)
Commerce, repair, restaurants & hotels	(8,9)	(8,9)	2,8
Transport, storage & communications	(3,0)	(2,9)	2,8
Financial , insurance, real estate & employ service institutions	(7,3)	(6,1)	(1,0)
Social, community & personal services	4,3	4,0	1,4
Charged banking services	(25,1)	(23,3)	(7,3)

Source: DANE

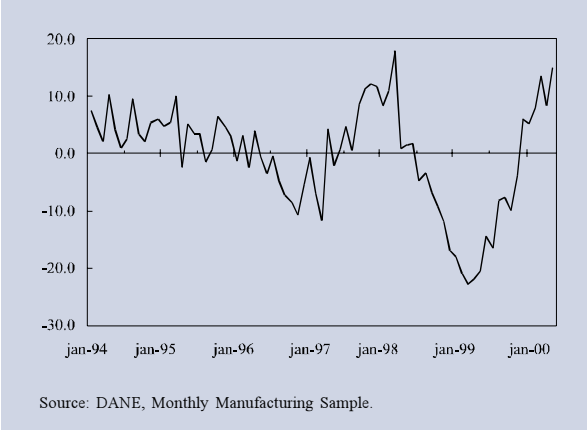
FIGURE 34
REAL INDUSTRIAL PRODUCTION INDEX
 (ANNUAL PERCENTAGE CHANGE YEAR TO DATE)
 (DATA AT MAY 2000)



demand fell sharply at the end of 1998 and throughout 1999, resulting in current levels that are very low, despite high current-year growth. Investment demand was the spending component with the most growth in the first quarter of 2000, well above the rise in other components such as exports.

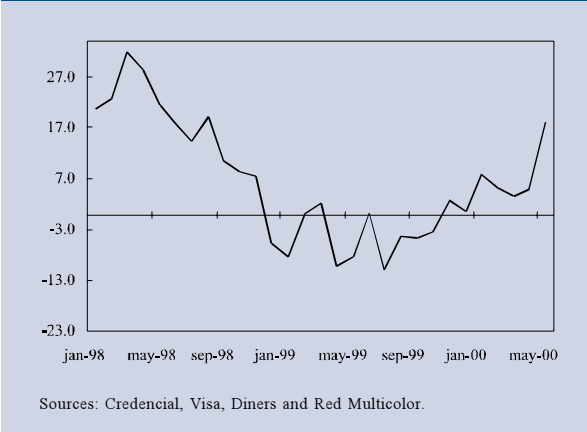
The increase in investment demand is likely to continue in the second quarter and the beginning of the third, but at a slower pace. Rising uncertainty over economic and political conditions in March and April may have prompted businessmen to postpone or limit their investment plans. Furthermore, the trend in imports of capital goods, a variable akin to investment performance, was far from satisfactory in April, the last date for which information is available. In fact, imports of this type fell by 19.8%, compared with the already low level of April 1999. Although monthly import performance has been highly irregular throughout the year and the growth rate in April does not necessarily signal a break in trend, it does lower accumulated imports of capital goods for the first four months (Figure 37).

FIGURE 35
REAL MONTHLY MANUFACTURING PRODUCTION
 (ANNUAL PERCENTAGE CHANGE)
 (DATA TO APRIL 2000)



On the positive side are imports of intermediate goods, primarily for industry and farming. The fact that they continued to register positive annual growth for April could mean the drop in imports of capital goods is temporary and that businessmen continue to receive the sort of demand incentives that will allow them to maintain their investment plans for the remainder of the year.

FIGURE 36
CREDIT-CARD SALES, ENTIRE SYSTEM AT MAY 2000
 (NOMINAL ANNUAL PERCENTAGE CHANGE)



C. WAGES AND EMPLOYMENT

1. Industrial Wages

In the 12 months to May, the average readjustment in the nominal industrial wage was 15.2%, which is slightly below the rate observed at the end of 1999

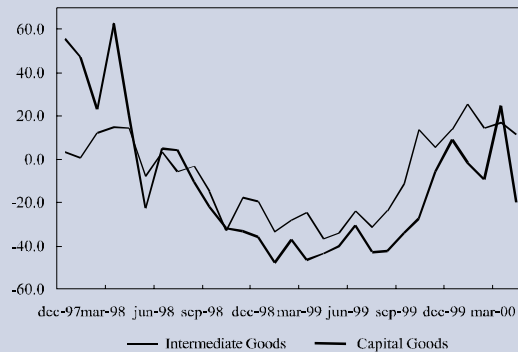
(15.9%). Nominal wages for industrial workers were readjusted at rates two or three percentage points below those of May 1999 (Figure 38). Inasmuch as inflation has declined by more than six percentage points during the same period, real wages have risen (Figure 39).

The increase in real industrial wages may seem paradoxical in light of currently high levels of unemployment. Yet, it can be explained by the fact that productivity per worker has grown considerably over the past year, allowing for an increase in real wages without punishing company cost structure. In this case, it would be more appropriate to analyze the trend in labor costs with a measure of real unit labor cost (CLU) or real wage adjusted on the basis of productivity. As illustrated in Figure 40, the real CLU for industrial workers has fallen sharply in the last eighteen months, staying well below the real wage in periods of more robust growth, despite a slight upsurge in April. Also during the past year, as noted earlier, companies relied more and more on overtime to expand production. This strategy raises the wages of industrial workers but in exchange for more work, something that is impossible to identify in the traditional wage indicator of the DANE survey.

2. Employment

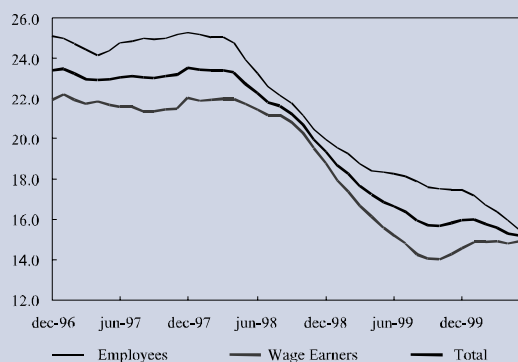
The latest information on employment comes from the DANE Monthly Manufacturing Sample. Overall employment in the industrial sector continued to decline in the first five months of the year, as it has for several years running. Yet, temporary monthly employment showed positive and rising annual growth rates between January and May (Figure 41). This is normal in recovery periods and reflects the use overtime as opposed to hiring new employees on a permanent basis. If recovery continues, temporary help should be replaced by permanent employees.

FIGURE 37
ANNUAL GROWTH IN MONTHLY IMPORTS OF
INTERMEDIATE AND CAPITAL GOODS
1997:12-2000:4
(PERCENTAGE)



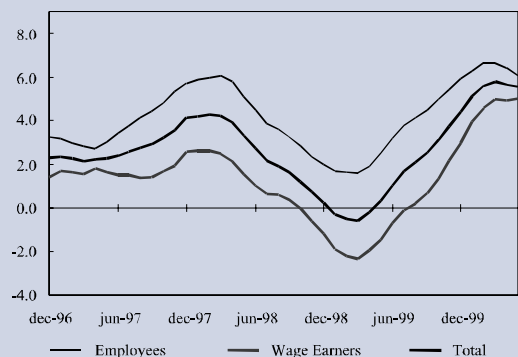
Sources: DANE - Manifests.

FIGURE 38
NOMINAL WAGE - MANUFACTURING INDUSTRY
(PERCENTAGE CHANGE OVER ENTIRE YEAR)
(DATA TO MAY 2000)



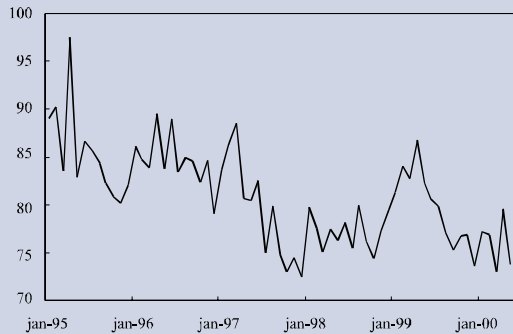
Source: DANE, Monthly Manufacturing Sample.

FIGURE 39
REAL WAGE - MANUFACTURING INDUSTRY
(REAL PERCENTAGE CHANGE, 12-MONTH ACCUMULATED)
(DATA TO MAY 2000)



Source: DANE, Monthly Manufacturing Sample.

FIGURE 40
REAL UNIT LABOR COST INDEX
FOR INDUSTRIAL WAGE EARNERS
 (DATA TO MAY 2000)



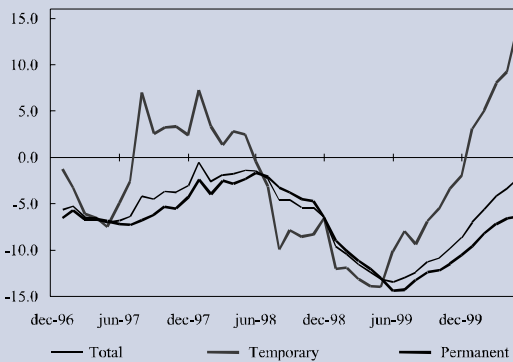
Source: DANE, Monthly Manufacturing Sample.

CUADRO 5
PERCENTAGE OF NEGOTIATED WAGE-INCREASE
BENEFICIARIES
 (JANUARY-JUNE 2000)

One-year Negotiated Increases				
<9	9,23	[9,25-12]	>12	
11,1	31,9	49,2	7,8	
Two-year Negotiated Increases				
<11	>12	CPI	[CPI-CPI + 3]	[LMW-LMW+3]
8,2	1,5	56	30,9	3,4

LMW = Minimum wage established by law.
 Sources: Ministry of Labor and Social Security.

FIGURE 41
ANNUAL GROWTH IN THE MONTHLY
INDUSTRIAL EMPLOYMENT INDEX
 (DATA TO MAY 2000)



Source: DANE, Monthly Manufacturing Index.

3. Negotiated Wage Increases

Table 5 contains figures from the Ministry of Labor on one-year and two-year negotiated wage increases. The top half of the table shows the percentage of workers covered by one-year settlements reached between January and June 2000. Many of these one-year negotiated wage increases (31.9%) were equal to inflation observed the year before (9.23%), but most were in the 9.25% to 12% range. Only 7.8% of the settlements imply increases above 12%. As in the previous report, information at the close of June, shows a significant drop in wage increase ranges for most workers covered by settlements,

compared with information in December 1999. Accordingly, the indication is that indexing processes have been adjusted gradually to the downturn in inflation.

The bottom half of Table 5 shows the percentage of workers covered by two-year wage increases negotiated between January and June 2000. Most of these settlements (56%) are equal to the rise in current-year inflation measured by the CPI; 30.9% are two-year increases between CPI and CPI plus three points, and only 8.2% involve increases under 11%.

The April- June period saw a broader range in which one-year and two-year wage increases were negotiated, compared with January-March (Table 6). This might mirror growing expectations among workers with respect to inflation, which is consistent with the performance of other inflation expectation indicators presented in this report.

D. USE OF INSTALLED CAPACITY

Indicators of installed capacity utilization in industry remained below historical averages throughout the

CUADRO 6
PERCENTAGE OF NEGOTIATED
WAGE-INCREASE BENEFICIARIES

January-March, 2000				
One-year Negotiated Increases				
<9,23	9,23	[9,25-11,0]	>11	
4,2	56,9	24,4	14,5	
Two-year Negotiated Increases				
<12	CPI	[CPI-CPI+3]	[LMW-LMW+3]	
6,5	63,9	29,2	0,4	

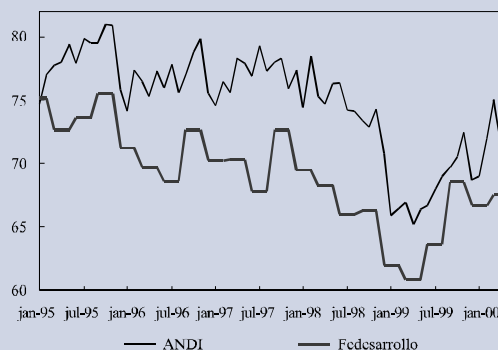
April-June, 2000				
One-year Negotiated Increases				
<9,23	9,23	[9,25-11,0]	>11	
18,3	7,3	36,8	37,1	
Two-year Negotiated Increases				
<12	CPI	[CPI-CPI+3]	[LMW-LMW+3]	
10,1	65,6	24,3	0,0	

LMW = Minimum wage established by law.
 Source: Ministry of Labor and Social Security.

second quarter. In April, the ANDI indicator declined for the first time this year, possibly due to seasonal factors. The Fedesarrollo indicator picked up slightly between February and May (Figure 42).

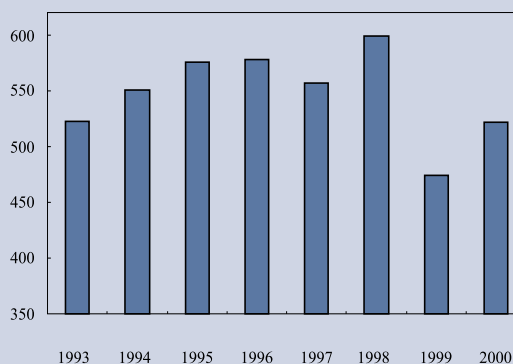
The rise in growth rates for the industrial sector in the first four months of the year does not mean production has returned to levels observed prior to the recession. In fact, it is not surprising that industry and other sectors hit hard by the recession are now showing signs of positive growth. This has occurred in the economies of Latin American and southeast Asia after a serious recession, and is explained by low levels of production during the recession. Such is the case in Colombia's automobile sector, where average sales during the first five months of the year amounted to only 40% of those observed in 1997. This also has been true of industry as a whole; accumulated production in the first four months of the year was equivalent to 86% of production in 1998 and is the lowest in the last six years (Figure 43).

FIGURE 42
USE OF INSTALLED CAPACITY
 (DATA TO MAY 2000)



Note: ANDI, figures to April.
 Sources: ANDI and Fedesarrollo.

FIGURE 43
REAL MANUFACTURING PRODUCTION IN THE FIRST
FOUR MONTHS OF EACH YEAR



Source: DANE, Monthly Manufacturing Sample.

E. THE FISCAL SITUATION

At the end of May, the central government showed an operational deficit of 2.852 billion pesos, which is 1.7% of annual GDP.⁹ Compared with figures for the same period in 1999, income rose by 20.3% and expenditures by 17.7%. Among income items, tax receipts surged by 33.1%, while non-tax revenue dropped by 21.4%. The tax items showing

⁹ Using the IMF methodology, the accumulated deficit is equivalent to 0.8% of GDP.

particularly strong growth were income tax and the domestic VAT (33.6%) and import duties (28.7%). The growth in tax receipts reflects the upsurge in economic activity, as well as changes in the tax calendar and a reduction in amount of time banks have to transfer tax collections to the Treasury Department. The drop in other non-tax income was related to a reduction in profits transferred by the Banco de la República (Table 7).

In terms of expenditure, interest on the debt rose by 40.1%, operating costs by 12.7% and investment by 9.8%. The increase in operating costs came primarily from transfers, which showed a 15% rise compared with the same period in 1999. The behavior of this item reflects the government's decision in early 2000 to cancel most of the budget lag in transfers to the departamentos, districts (*situacion fiscal*) and municipalities, which had accumulated in 1999. There were no transfers to the Educational Loan Fund during

the first five months of the year. According to the government's timetable, these transfers are to be made during the second half of the year. In contrast to payments via transfer, personal services and general expenses rose by only 4.5% and 3.6%, respectively. This reflects government efforts with respect to fiscal adjustments intended to lower the deficit in the public sector to levels compatible with macroeconomic stability. On the other hand, net borrowing, represented primarily by debt service guaranteed by the nation, amounted to 245 billion pesos.

As to financing, official figures show 1.408 billion pesos in net foreign credit and 2.934 billion pesos in net domestic credit. A total of 5.105 billion pesos in government bonds (TES) were sold during the period, with 2.957 billion pesos of this amount by way of agreed investments and 1.637 billion pesos by auction. Sales of debt reduction securities (TRD) amounted to 134 billion pesos.

TABLE 7
EFFECTIVE CENTRAL GOVERNMENT OPERATIONS
(BILLIONS OF PESOS)

	January-May			% Change	
	1998	1999	2000	1999 / 1998	2000 / 1999
I. Total Revenue (A+B)	6.587,6	8.464,4	10.186,0	28,5	20,3
A. Tax revenue	6.049,7	6.479,4	8.625,0	7,1	33,1
Income tax & domestic VAT	4.065,6	4.692,6	6.269,0	15,4	33,6
Customs & external VAT	1.722,8	1.235,0	1.590,0	(28,3)	28,7
Gasoline	252,5	283,8	331,0	12,4	16,6
Other	8,8	268,0	435,0	2.945,5	62,3
B. Non-tax and other revenue	537,9	1.985,0	1.561,0	269,0	(21,4)
II. Total Expenditures (A + B + C + D)	10.383,6	11.074,1	13.038,0	6,6	17,7
A. Interest payments	2.316,8	2.216,4	3.105,0	(4,3)	40,1
B. Operating costs	6.869,1	7.853,8	8.848,0	14,3	12,7
C. Investment	1.083,4	764,9	840,0	(29,4)	9,8
D. Net loans	114,3	239,0	245,0	109,1	2,5
III. Deficit (-) or Surplus (+) (I - II)	(3.796,0)	(2.609,7)	(2.852,0)	(31,3)	9,3
IV. Financing	3.796,0	2.609,7	2.852,0	(31,3)	9,3
A. Net external credit	1.626,4	1.502,4	1.408,0	(7,6)	(6,3)
B. Net domestic credit	2.044,9	2.063,3	2.934,0	0,9	42,2
C. Privatizations and other	124,7	(956,0)	(1.490,0)	(866,6)	55,9
V. Deficit as a percentage of GDP	(2,7)	(1,7)	(1,7)		

Source: Fiscal Policy Council (CONFIS).

THE 2 X 1,000 TAX AND MONETARY POLICY

Deterioration in the principal indicators of the financial system and the limited availability of fiscal revenue to alleviate its problems, prompted the central government to establish a mandatory contribution of 2 x 1,000 on all financial transactions implying checking or savings account withdrawals.¹ In addition, a contribution of 1.2 x 10,000 was established for all transactions on the interbank market.

This type of tax on financial transactions is not well known internationally. However, it has been used temporarily by several Latin American countries as a source of fiscal revenue to tackle specific problems. In 1994, Venezuela adopted a 0.75% levy on all withdrawals of deposits held by the financial system. A similar measure was enacted in Argentina and Peru, but eliminated quickly due to the distortions it caused in the financial market. Brazil and Ecuador offer the most significant examples of this tax. In 1996, Brazil introduced a 0.2% levy on withdrawals from the financial system by the public, (the rate was increased to 0.38% several years later). Ecuador created a 1% levy on withdrawals by the public and on operations involving securities, term deposits with the financial system, foreign remittances or transfers, and other transactions.²

The tax in Colombia has undergone several important changes since its introduction. The 2 x 1000 levy applied initially to transactions involving an outlay in cash, in check or some other form, drawn on resources deposited in checking and savings accounts. In addition, a proportional rate of 1.2 x 10,000 was introduced on interbank market operations conducted in pesos and in dollars, and on portfolio buy-backs or securities transferred with a repurchase agreement, except operations conducted between financial agents and the Banco de la República and Fogafin. In March 1999, due to a Constitutional Court ruling, the levy on interbank market transactions in pesos and dollar was raised to 2 x 1,000. In August of that year, the tax on interbank market operations in pesos was eliminated. The last major change occurred early this year, when the 2 x 1,000 tax was extended to transfers between checking and savings accounts owned by the same person.

Introduction of the tax on savings and checking accounts and the levy on interbank market transactions in Colombia had a number of repercussions. First, it modified the make-up of financial-asset portfolios. In trying to avoid the levy, agents increased the demand for tax-free assets (e.g., cash) and reduced the use of assets or means of payment subject to taxation (e.g., checking accounts and checks). For example, introduction of the 2 x 1,000 tax raised the demand for cash as of November 1998 (Figure 1(A)). Growth of this aggregate increased sharply from an annual rate of 7% in November 1998 to average rates of 27.5% between June 1999 and May 2000. This was well above what was expected, given the recession. The increased use of cash occurred at the expense of other means of payment, checks being one example (Figure 1(B)). Monetary base corridors and certain monetary policy transmission channels have been distorted as a result. Moreover, added demand for cash has expanded the monetary base beyond the limits anticipated by monetary authorities, placing it at the corridor ceiling³ for the year to date. In principle, this might seem to have an inflationary impact. However, as it constitutes a change in the way agents maintain their assets rather than increased willingness to spend, this "imbalance" in the corridor goal of the monetary base has no effect on inflation.

FIGURE 1 (A)
CASH/M2
FIVE-MONTH MOVING AVERAGE
(PERCENTAGE)

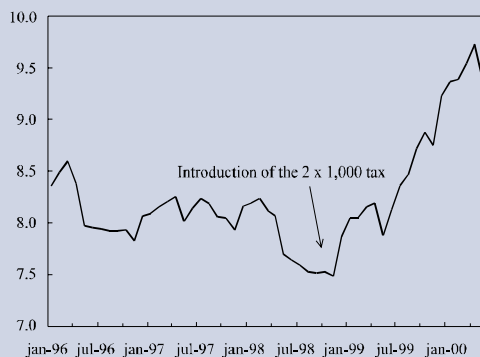
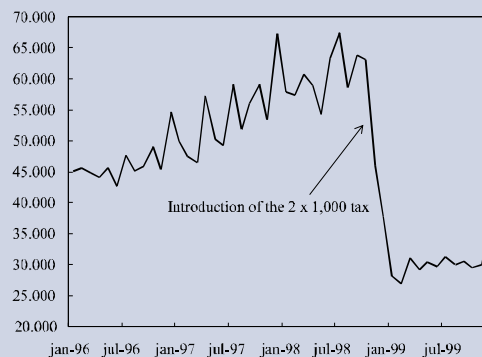


FIGURE 2 (B)
VALUE OF CLEARED CHECKS
NATIONAL TOTAL
(BILLIONS OF PESOS)



The size of interbank transactions declined considerably with introduction of the interbank market tax, since levies of this type have more of an impact on assets with greater turnover (Figure 2 (A) and (B)). Prior to implementation of the 2 x 1000 tax, the average amount negotiated daily on the interbank market in dollars was US\$185 million. Once the tax was in place, this amount declined to US\$70 million. The size of transactions on the interbank market in pesos fell sharply during the period from February to August 1999, while the 2 x 1,000 levy was in effect (Figure 2 (B)). Preliminary estimates suggest that a 2 x 1000 tax on transactions between financial agents generates an annual surcharge of 62% on interbank market transactions. In other words, with this tax, an agent who uses to the interbank market on each of the 240 working days in a year to satisfy short-term liquidity requirements would incur an additional cost of 62 cents for every peso traded.⁴ Due to this fact and because Banco de la República operations are not subject to the tax, the Bank was obliged to substitute the functions of the interbank market through expansionary operations for financial agents requesting short-term liquidity, besides having to receive and remunerate the temporary liquidity surpluses of some financial agents.

FIGURE 2 (A)
DAILY AVERAGE AMOUNTS NEGOTIATED ON
THE INTERBANK MARKET IN DOLLARS
(MILLIONS OF DOLLARS)

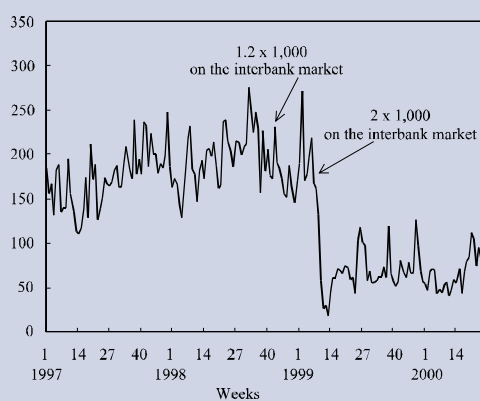
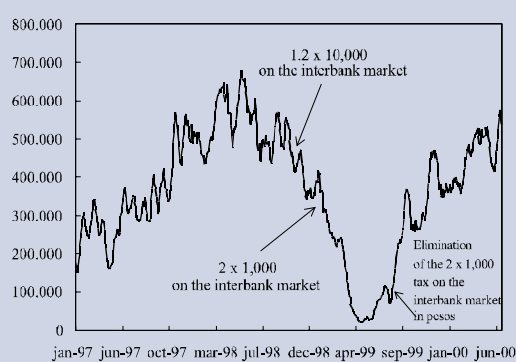


FIGURE 2 (B)
AVERAGE DAILY AMOUNTS NEGOTIATED ON
THE INTERBANK MARKET IN PESOS
(MILLIONS OF PESOS)



The monetary policy's credit channel also was affected by the 2 x 1,000 tax on interbank market transactions. Being obliged to rearrange their portfolios in favor of liquid assets (which, if needed, would be very expensive on the interbank market), financial agents reduced the capacity for increased loans to the public. This is another factor that could explain the standstill in credit as of 1998.⁴

¹ Initially, this tax was to be in force until 31 December 1999. However, additional contingencies, such as the Armenia earthquake in January 1999, resulted in its extension to February 2001. The possibility of making this a permanent tax is now being debated.

² For more detailed information, see Lozano and Ramos (2000), *Borradores semanales de economía*, No. 143 and *Carta Financiera* (March 1999), No. 110.

³ The monetary base is the sum of cash and bank reserves. This corridor is set by the Board of the Banco de la República in light of the inflation target and expectations for other key economic variables.

⁴ See Urrutia (1999), *Revista del Banco de la República*, Editorial Note, June.

GAS CONSUMPTION AS AN INDICATOR OF ECONOMIC ACTIVITY

As with other institutions and analysts responsible for monitoring economic activity in Colombia, the Banco de la República normally uses electrical power consumption as a contemporary indicator of urban production throughout the country, and primarily as an indicator of industrial production. Information on electrical power demand generally corresponds to power supplied daily by ISA, which is not broken down according to the type of consumer. Nevertheless, use of this variable as an indicator of urban economic activity has two basic problems.

The first is permanent in nature and deals with the possibility of electrical power being replaced easily with alternative sources of energy. The productive sector and households in Colombia now have alternative sources of energy (gas and coal, among others). These permit a measure of flexibility in electrical power consumption, given variations in their price. In such cases, increases in the price of electrical power above those for alternate sources of energy lowers the demand for electricity without reducing urban production and economic activity. This has been a consistent problem in Colombia for the last two years, particularly in the case of demand affected by households. The elimination of subsidies to electrical power consumption should have made this source of energy more expensive than others, such as gas.

The second problem is more temporary but closely related to the first. It involves programs developed over the last two years to expand the gas distribution network in residential areas. These have facilitated, as never before, the use of natural gas in Colombia as a substitute for electricity. Coupled with a relative increase in the price of electrical power compared with gas, this helps to explain the recent behavior of the first variable, which showed no clear signs of recovery between late 1999 and April 2000, despite indications to this effect in industrial production and commerce.

As Figure 1 illustrates, electrical power consumption began to fall in mid-1998 and continued to do so throughout 1999, by an average of 6%. Although electricity consumption ceased to decline at the end of 1999, this did not give way to outright growth in the first months of 2000. Significant positive annual growth in monthly consumption was observed only in April and May. During the year to date, average annual growth in this variable has been just 0.1%.

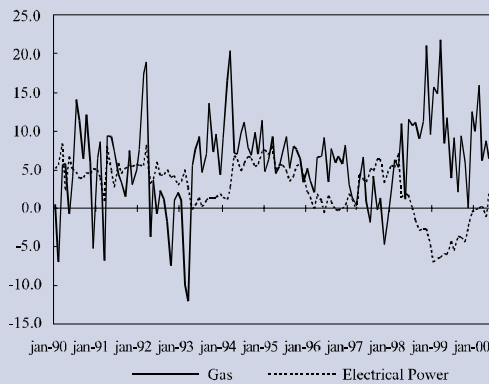
Gas consumption increased as of mid-1998 and throughout 1999 at rates well above those for electrical power consumption. Residential and industrial gas consumption slowed in the second half of 1999 but never declined, and picked up again at year's end (10% in December). This growth has continued during the course of 2000, with average annual monthly consumption rates on the order of 9.4%.

Developing a new indicator of energy consumption that includes natural gas and electricity requires converting both figures into common units. For this purpose, kilowatt hours of electrical power consumption were transformed into British thermal units (BTUs). Natural gas is usually measured in these units, so there is no need for conversion. In 1999, energy requirements (industry and consumption), measured in thousands of BTUs (MBTU),¹ were supplied in part

with natural gas (32%) and in part with electricity (68%). In 1995, these proportions were 27% and 73%, respectively. This highlights the importance acquired by gas in recent years as a source of energy.

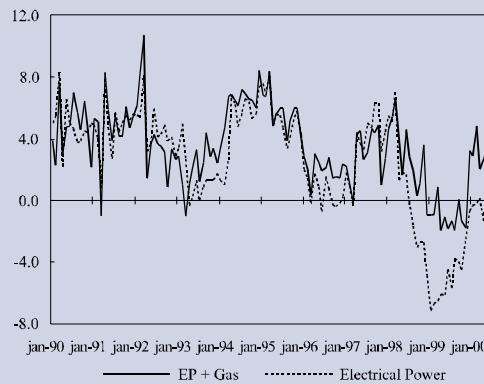
Figure 2 compares the indicator of original economic activity (electrical power) with a new indicator constructed by adding natural gas consumption for residential and industrial use to electrical energy consumption in MBTUs (EE + Gas). As of 1990 and up until mid-1998, both indicators showed similar growth rates. However, the trends in these indicators have been quite different ever since the second half of 1998, and particularly in 1999. The new indicator shows positive annual growth rates as of November 1999. For the most part, this coincides with the data in the DANE Manufacturing Sample, which denotes positive annual growth in industrial production since December 1999. Between January and May, the annual growth in aggregate monthly consumption of electricity and gas was 3.2%, which is well above consumption reported for electrical power alone.

FIGURE 1
ANNUAL GROWTH IN MONTHLY ELECTRICAL
POWER AND GAS CONSUMPTION
(INDUSTRIAL AND RESIDENTIAL) IN MBTU/DAY
(DATA AT MAY 2000)



Sources: ISA and Ecopetrol. Calculations by the Banco de la República.

FIGURE 2
ANNUAL GROWTH IN MONTHLY
CONSUMPTION OF ELECTRICAL POWER AND
ELECTRICAL POWER + GAS
(INDUSTRIAL AND RESIDENTIAL) IN MBTU/DAY
(DATA AT MAY 2000)



Sources: ISA and Ecopetrol. Calculations by the Banco de la República.

¹ One kilowatt hour is equivalent to 3,412 BTUs.

III

MEASURES OF EXPECTATIONS

This chapter contains the principal findings of a new survey of expectations being conducted as of April 2000 by the Economic Studies Division.¹⁰ As duly reported by the Banco de la República,¹¹ it is a quarterly survey designed to overcome problems of a methodological nature that were detected in the original survey. Inflation and GDP growth forecasts developed by outside analysts and bond rating agencies are included at the end of this section, along with a brief summary of the events they believe are affecting performance of the Colombian economy.

The new survey contains a series of questions intended to provide an understanding of how agents form their expectations. These questions make it easier to identify monetary policy transmission channels, to solve some of the sampling problems inherent to the previous survey, and to improve the questionnaire by making it clearer and simpler to answer. There are four main sections. The first contains questions on prices and anticipated wages. The second examines perceptions of monetary and credit conditions in the economy at the time of the survey and expectations for the near future (six months). The third polls expectations concerning interest rates and the exchange rate, while the fourth surveys economic activity and employment.

¹⁰ The new survey was designed by Hugo Oliveros and Enrique López, who are researchers with the Economic Studies Division (SGEE). It was processed by the SGEE Statistics Section. For additional details on the methodology, see López & Oliveros (2000), document presented to the Board of the Banco de la República.

¹¹ An introduction and the findings of the survey appear in *Reportes del Emisor*, No. 13 (June 2000).

The target population is comprised of top executives from the different economic sectors in Colombia's four major cities: Bogotá, Medellín, Cali and Barranquilla. The survey is divided into six economic sectors: *Industry and Mining, Financial Intermediation, Large Department Store Chains, Transport and Communications, Academics and Economic Consultants, and Unions.*¹²

It was designed with several objectives in mind, particularly the need to preserve the survey population over time, as much as possible, and to guarantee the representativeness of the findings in the aggregate and in each of the sectors.

The following are the principal findings of the survey, which was conducted in April 2000. The agents who responded to the questions had access to information available at March 2000. As additional surveys are conducted, efforts to analyze the findings will be enriched by the construction of statistical series on expectations. These can be used to determine whether or not expectations are met during the course of time.

A. PRINCIPAL FINDINGS

1. Prices and Wages

The first question in the new survey is designed to gauge agents' confidence in the 10% inflation target set by the Board of the Banco de la República for the

¹² The size of the survey (81 units in all) is based on a simple random sample of all the sectors surveyed. To arrive at a calculation by sector, a new simple random sample was done in which each sample is independent.

close of 2000. According to the weighted sum of replies, 33.3% believe the goal will be met; 66.7% do not (Figure 44). Unions demonstrated the least confidence: 90% of those surveyed said the target would not be met, as opposed to 43.8% of Academics and Consultants. The latter have more trust in the inflation target than any other group.

The next question deals with expectations of annual inflation at different terms. The replies are presented in Figure 45, which shows the average maximum and minimum ranges reported by all agents for each term. The agents anticipate 11.3% inflation at December 2000, with an anticipated maximum of 12.1% and a minimum of 10.5%. As illustrated in Figure 45, a slight upsurge is expected throughout the year, followed by a decline in the first months of 2001. Those anticipating the most inflation at December 2000 are Large Department Store Chains (13.2%). *Financial Intermediation* is the sector anticipating the least (10.75%).

According to Figure 45, inflation at June (9.7%) is less than what agents anticipated for that date early last April (10.3%). The actual figure is slightly above minimum anticipated inflation (9.6%).

Specific expectations of inflation, distinguished between agents who answered yes or no to the first question on confidence in the inflation target, are shown in Figure 46. Those who said the target would not be met, anticipate 12.0% average inflation by the end of 2000; those who believe it will be met anticipate 9.8% inflation at year's end. Actual inflation at June was below the rate anticipated by agents who, in first question, indicated the target for 2000 would be met (Figure 46).

Figure 47 shows the results of the question on average wage increase in 2000 and 2001. Those surveyed expect their companies to raise wages, on average, by 9.3%, which is equal to inflation at the end of 1999, and by 10.4%, on average, in the year 2001. The sector anticipating the least wage increase in 2000 was *Financial Intermediation* (5.7%); *Unions* expect the highest rise (11.3%).

FIGURE 44
CONFIDENCE IN THE 10% INFLATION TARGET FOR THE YEAR 2000

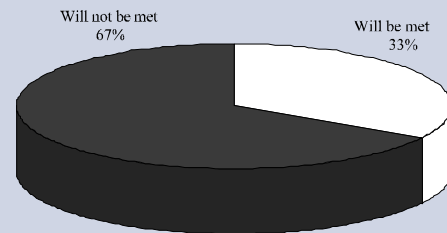
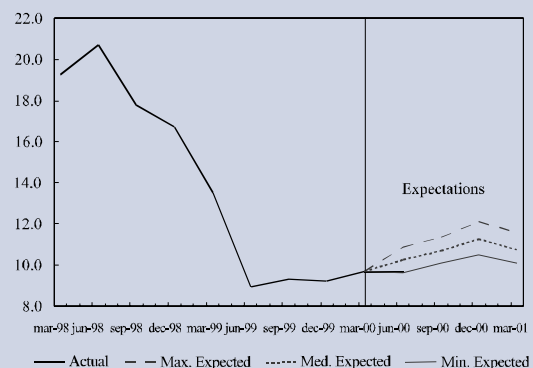


FIGURE 45
ACTUAL AND EXPECTED INFLATION (AT THREE, SIX, NINE AND 12 MONTHS)



2. Monetary and Credit Conditions

The questions in this section of the survey are intended to gauge agents' perception of actual conditions with respect to liquidity and availability of credit in the economy, and how these variables are expected to evolve in the next six months. The answers are shown in Figure 48. Fifty-two percent (52%) of those surveyed perceive current liquidity as high; 33% perceive it as low. Forty-nine percent (49%) of those surveyed believe liquidity in the economy will not change in the next six months; 33% believe it will exceed current levels and only 16% estimate it will be less.

FIGURE 46
INFLATION EXPECTATIONS DIVIDED BETWEEN THOSE WHO BELIEVE THE INFLATION TARGET WILL BE MET AND THOSE WHO DO NOT

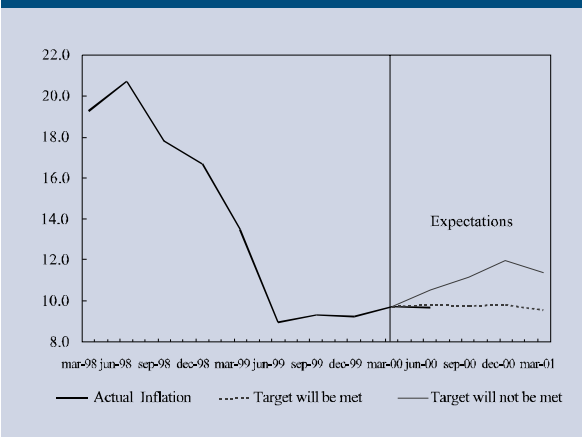
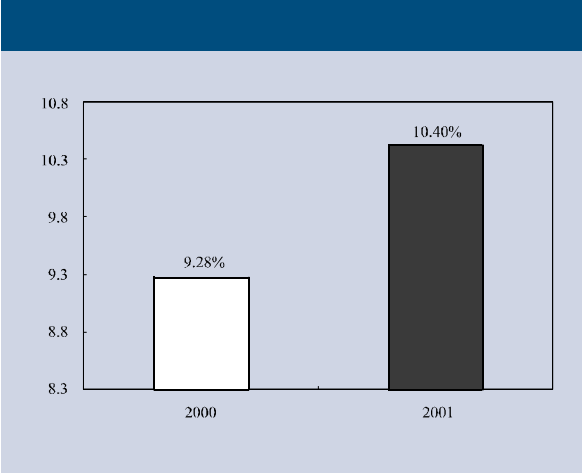


FIGURE 47
AVERAGE WAGE INCREASE IN 2000 AND 2001

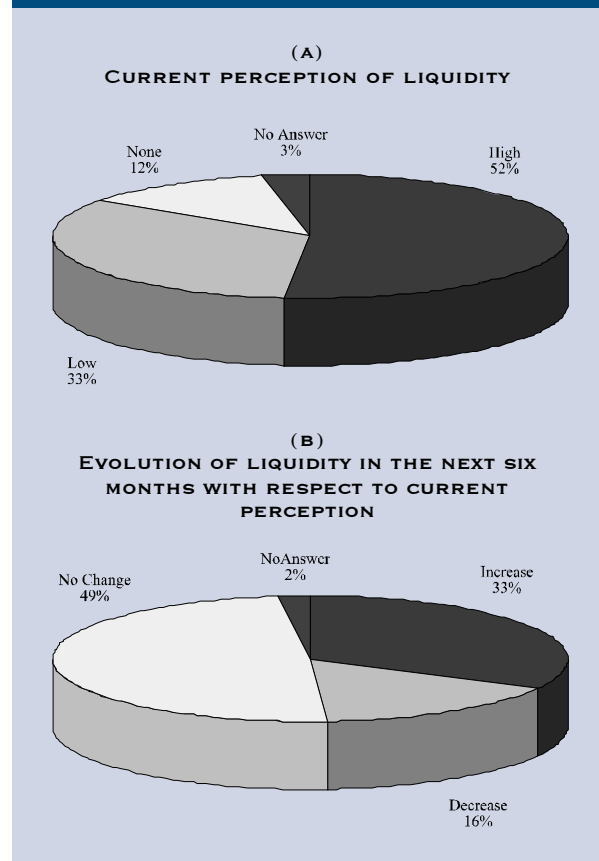


The answers concerning current availability of credit and its anticipated evolution are presented in Figure 49. Forty-eight percent (48%) of those surveyed perceive current credit availability as low, while 33% perceive it as high. As to future credit availability, 54% believe there will be no change in the next six months; 25% expect it to exceed current levels and 19% believe it will be less.

3. Interest Rates and Devaluation

This section surveys the interest rate anticipated at three, six, nine and 12 months. The DTF is the interest rate of reference used. Figure 50 shows the

FIGURE 48



historical DTF series from March 1998 to March 2000, and expectations as of that date. On average, as illustrated in Figure 50, the agents expect a slight climb throughout the year to 13.2%. Those anticipating the highest rise in the DTF during the current year are *Large Department Store Chains* (14.9% at year's end). The least increase in this variable (12.2%) is anticipated by *Unions*. At the end of June, the DTF was 12%, which is close to what agents anticipated for this date, on average, at the beginning of April (11.9%).

The next question deals with expectations for the nominal exchange rate in the same periods. Those surveyed believe it will continue to rise throughout the year at a more or less constant rate (Figure 51). Given data available at March, the agents anticipate a nominal exchange rate of 2,126 pesos to the dollar at the end of 2000, with an anticipated maximum

of 2.166 pesos to the dollar and a minimum of 2.089 pesos. If the nominal exchange rate at the end of 2000 coincides with the average anticipated by those surveyed, annual devaluation at December 2000 would be 13.5%.

As Figure 51 illustrates, the nominal exchange rate at June was above what agents anticipated in the April survey. They expected it to be 2,026 pesos to the dollar, on average; it closed at 2,139 pesos to the dollar.

4. Economic Activity and Employment

The first part of the section examines expectations for economic growth this year and the next. The answers to the questions point to 1.3% growth in 2000, with a minimum of 0.4% and maximum of 1.9%. Given data available to March 2000, the

agents anticipate 2.6% average growth for 2001, with a minimum of 1.8% and a maximum of 3.3% (Figure 52). By survey group, Unions expect the most overall economic growth for 2000 (2%) and *Financial Intermediaries* the least (1.1%).

The second question in this section deals with plans for company workforce expansion or reduction in the next six months and the coming year. In this respect, 47% of those surveyed foresee no changes in their workforce during the next three months, 28.4% intend to reduce it, and only 22.2% have plans for expansion. In terms of a year, 63% of those surveyed expect no changes in their company's workforce, 17.3% propose to increase it, and 17.3% plan a reduction (Figure 53).

B. FORECASTS BY INVESTMENT BANKS AND BOND RATING AGENCIES

The following are inflation and growth forecasts for the Colombian economy in 2000 and the year 2001, developed by investment banks and bond rating agencies. According to Table 8, average inflation forecast for 2000 is 11.2% as opposed to 9.0% in 2001. In terms of growth, these firms anticipate 2.6% growth, on average, in 2000 and 3.0% the following year. In general, investment banks and bond rating agencies are more optimistic in their forecasts for inflation and growth than the agents who were surveyed.

With respect to the future of the Colombian economy at mid-term, these firms are concerned primarily about the following.

- How economic recovery initiated in the first quarter of 2000 will be affected by the political crisis and uncertainty over the peace process in recent months, and how all this will influence investor confidence.
- Weakness of the financial system and how the high cost of capitalizing state-owned banks will affect

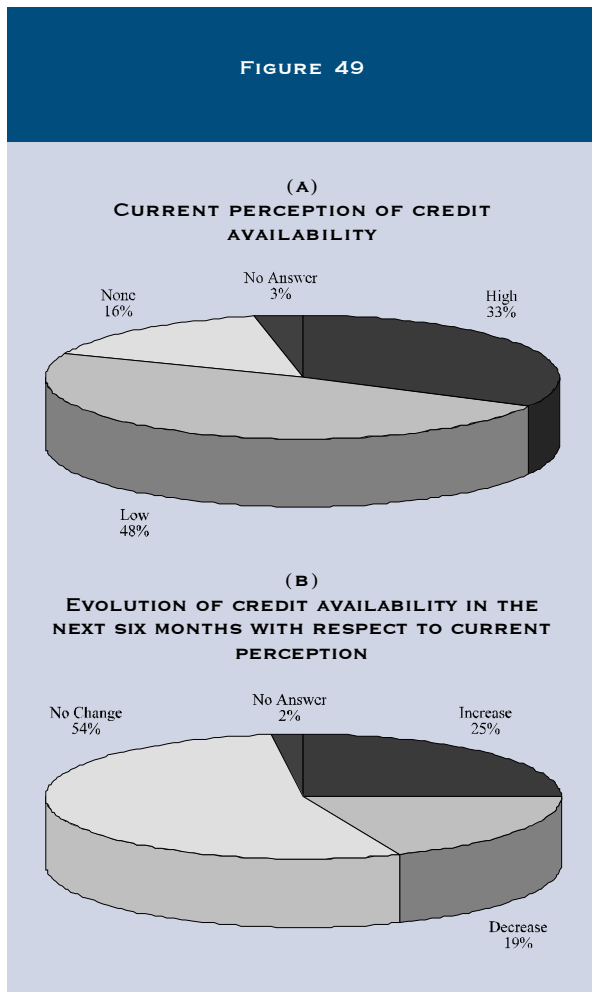


FIGURE 50
OBSERVED AND ANTICIPATED INTEREST RATE (DTF)
(AT THREE, SIX, NINE AND 12 MONTHS)
(ANNUAL EFFECTIVE RATE)

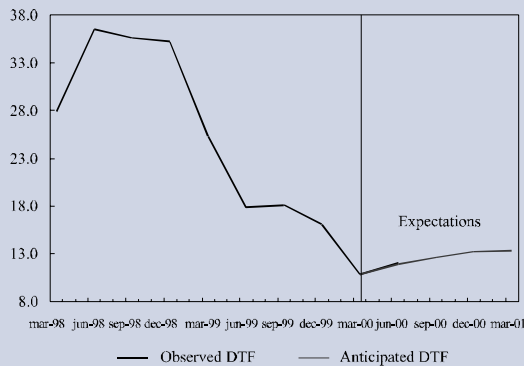


FIGURE 53
EVOLUTION OF COMPANY WORKFORCE
IN DIFFERENT PERIODS
(PERCENTAGE)

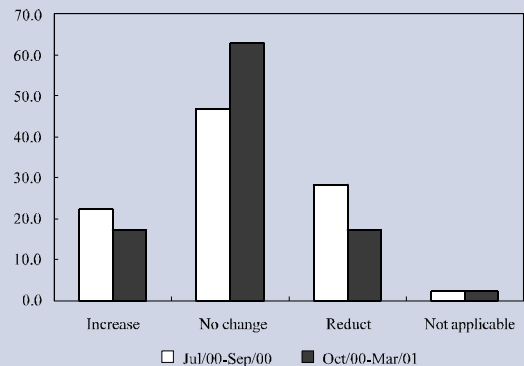


FIGURE 51
OBSERVED AND ANTICIPATED NOMINAL EXCHANGE RATE
(AT THREE, SIX, NINE AND 12 MONTHS)
(PESOS PER DOLLAR)

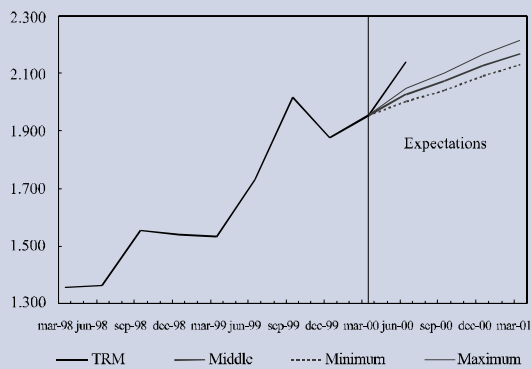
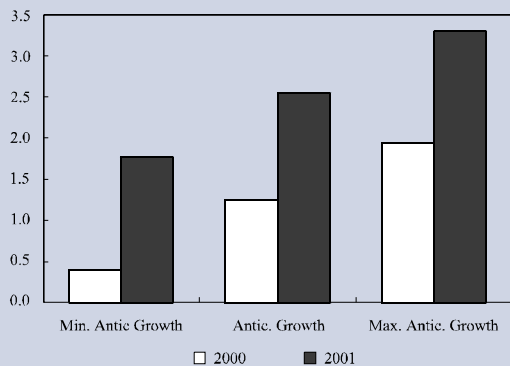


TABLE 8
FORECASTS BY INTERNATIONAL FIRMS

	Inflation 2000	Growth 2000	Inflation 2001	Growth 2001
Deutsche Bank	13,7	2,4	9,4	2,4
ING Barings	9,5	2,8	8,5	3,2
Goldman Sachs	9,6	2,0	9,0	3,5
WEFA	12,0	3,1	-	-
Average	11,2	2,6	9,0	3,0

Source: Banco de la República, Monetary and Reserves Division.

FIGURE 52
ANTICIPATED GDP GROWTH
(GROWTH RATE)



fiscal accounts and the goals for these accounts outlined in the agreement with the International Monetary Fund (IMF).

- The excessive volatility of the exchange market, which tends to overreact to events such as political news, changes in commodity prices and internal and external shocks.
- Uncertainty caused by the delay in passing economic reforms, particularly those of a fiscal nature, which must be approved by Congress in the second quarter of this year and the first quarter of 2001.

IV

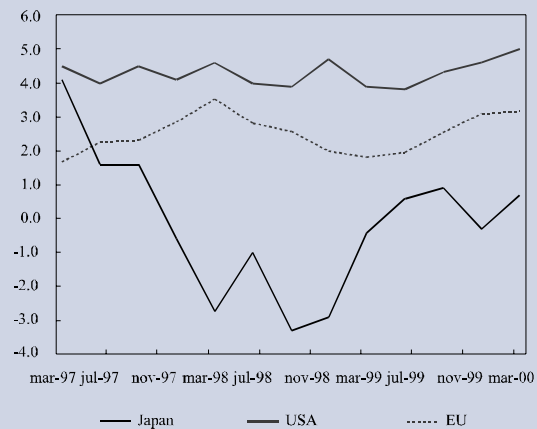
INTERNATIONAL CONTEXT

A. GENERAL ASPECTS

World economic conditions improved in the first half of 2000, as evidenced by positive performance of the developed economies and several emerging Asia and Latin American economies. The first quarter witnessed a significant upsurge in economic activity in the United States, the European Union (EU) and Japan (Figure 54). Available information on sales and the business climate indicates economic performance in the EU and Japan will be similar during the second quarter. A slowdown in the US economy is expected during the same period and would be the soft landing many hope for. Expectations of growth are based on the performance of several leading indicators as of April, particularly less of an increase in retail sales and residential building permits.

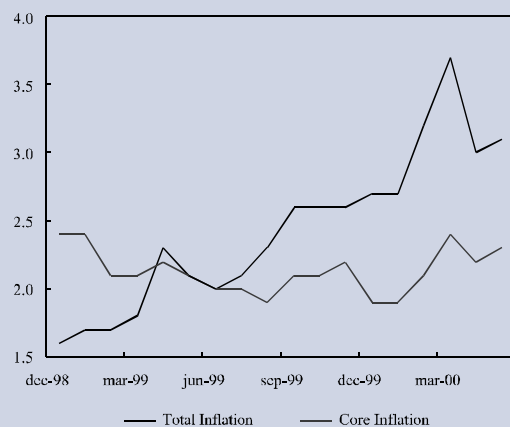
The latest estimates on US economic performance suggest 3.0% to 3.5% annual growth for the second quarter, which is less than that of the first quarter (5.0%). There also were several indications of a drop in inflation. Annual inflation, which showed troubling signs in February and March, with 3.7% in the latter, began to return to levels more in line with the implicit inflation goals of the Federal Reserve Bank (Fed). Annual inflation was 3.0% in April and 3.1% in May (Figure 55). However, the second-quarter decline might be due to a simple statistical phenomenon, since the consumer price index for the same period last year -on which annual inflation is calculated- rose more than expected, coinciding with the upswing in fuel prices. On the other hand, many analysts refer

FIGURE 54
ANNUAL GROWTH RATE: JAPAN, USA AND EU
1997:3 - 2000:3
(PERCENTAGE)



Fuente: Bloomberg.

FIGURE 55
TOTAL AND CORE INFLATION IN THE UNITED STATES
1998:12-2000:6
(PERCENTAGE)



Fuente: Bloomberg.

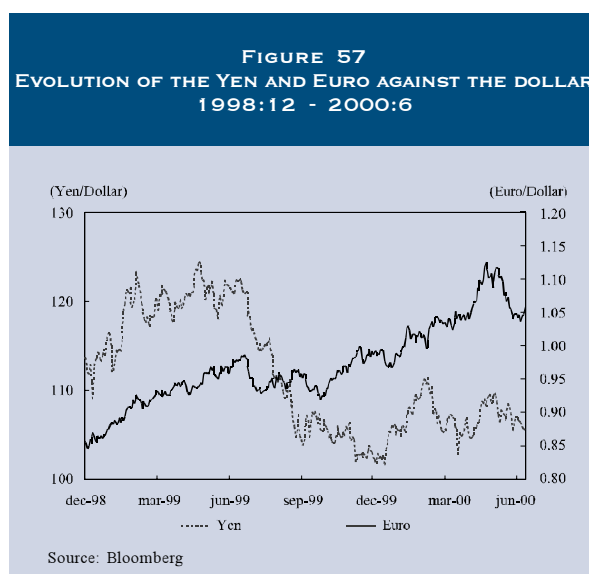
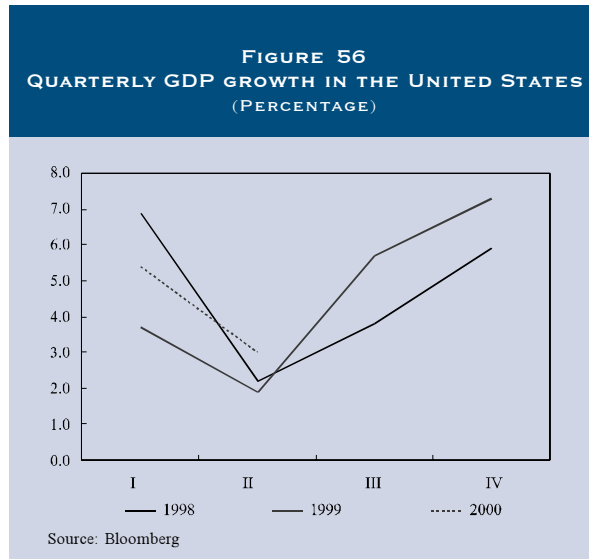
to the slowdown in the second quarter as a seasonal phenomenon and maintain that growth should pick up in the latter half of the year (Figure 56). However, the Federal Reserve Bank regards the signs of economic slowdown as indications of a halt in the long-term trends of the US economy, which is why monetary policy has not been altered. In fact, at a meeting on June 27 and 28 of this year, the Federal Open Market Committee left the rate on federal funds unchanged at 6.5% and does not expect to revise it until August.

Current forecasts for inflation and growth in the United States contain a fair amount of uncertainty. A number of analysts foresee 3.1% annual inflation at year's end, which is not much different from what they expected three months ago (2.9%). Expansion in the US economy this year is expected to be between 4.5% and 5.3%, with 5.0% average growth.¹³ If, in the months ahead, these expectations are confirmed by indicators of economic activity and growth, there should be no major adjustments in the interest rate set by the Fed.

The European Union showed strong signs of economic recovery. In fact, the European economy grew by 3.2% in the first quarter of 2000. Exports were decisive to this increase, having been favored by devaluation of the euro with respect to the dollar (Figure 57). Nevertheless, added devaluation could raise inflation, which would demand higher interest rates from the European Central Bank (ECB). However, although increased interest rates can halt devaluation of the European currency, they also can have an adverse impact on exports.

Therefore, the ECB is faced with the dilemma of having to offset the inflationary impact of added devaluation, without affecting the region's recovery rate. Following an increase of 50 bp in interest rates

¹³ These figures on inflation and growth in the United States are from a poll of international analysts conducted by *The Economist*. See *The Economist*, June 10-16, 2000.



during the first week of June, the ECB gave the impression that it will continue to raise interest rates as long as growth in private credit remains strong (11.4% year on year to April, as opposed to 10.9% in March) and provided there is inflationary pressure. The weeks prior to this decision saw a new trend towards devaluation, which will push interest rates up, if it continues.

The effects of a possible decision by the ECB would be felt in the second quarter of the year. The European Union registered accelerated growth in the second quarter, thanks to a sharp rise in corporate investments and exports, above home consumption.

Quarterly growth is expected to be around 5.0%, which is compatible with annual growth near 3.4% at December of this year.

The last few months witnessed a rise in EU inflation, from 0.8% in January 1999 to 1.9% in May 2000 (Figure 58). This was due to higher oil prices, as well as increased devaluation. Accordingly, the trend in the euro and oil prices throughout the remainder of the year will play an important role in the value of year-end inflation, particularly since transfer of devaluation to domestic prices is more feasible during times of economic growth. If these variables continue to behave as they did in the first two quarters, overall inflation for 2000 could be 1.8%.

Latin America also is showing signs of recovery, driven mainly by exports to the developed countries and higher world commodity prices (for oil and certain minerals). Devaluation of several currencies in the last 12 months has lowered the level of imports, favoring their substitution with domestically-produced goods. Short-term performance of the Latin American economies might also be affected by the tide of political uncertainty now facing several countries in the region.

In view of these circumstances, the region is expected to see positive growth in 2000, which should

accelerate in 2001 with the consolidation of producer and consumer confidence in economic recovery. Several major Latin American economies (Brazil, Mexico and Peru) should expand at rates above 3.0%. In the case of Mexico, the force of the US economy remains a decisive factor and explains 4.8% growth for this year. The Chilean economy is expected to regain the rate of expansion observed prior to last year's recession. The result should be rates on the order of 6.0%. As to Venezuela and Ecuador, which are the two main markets for Colombia's secondary exports, the forecast is for a positive growth of 3.5% and 0.4% respectively. However, these rates are not enough to regain the level of demand observed prior to the recession (Table 9).

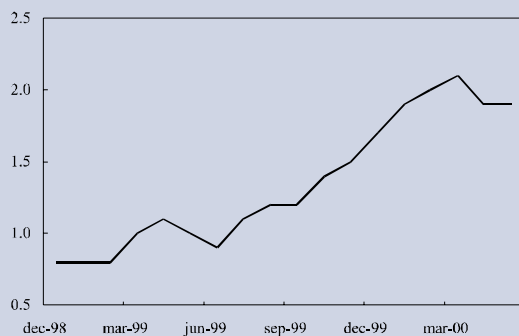
In view of this progress and performance by the developed economies, overall growth weighted by the volume of Colombian foreign trade is expected to be 4.0% in 2000. This exceeds the rate calculated in the previous inflation report (3.7%), with first-quarter figures, and is well above the rate in 1999 (1.5%). Coupled with appreciation of the Venezuelan currency, this circumstance favors Colombian export growth during the year.

B. COMMODITY PRICES

International commodity prices are fundamental to economic recovery in Colombia and throughout Latin America. Oil and coffee play a predominant role in this respect. The price of oil, which was US\$25 a barrel in April, reassumed its upward trend and averaged US\$30 a barrel in June (Figure 59). This increase was due to reduced stock in member countries of the Organization for Economic Cooperation and Development (OECD), even though the Organization of Petroleum Exporting Countries (OPEC) raised production quotas.¹⁴ In fact, OPEC has designed a

¹⁴ In June, OPEC decided to raise production quotas again by about 3.0%.

FIGURE 58
EUROPEAN UNION TOTAL INFLATION: ELEVEN COUNTRIES
 (PERCENTAGE)



Source: Bloomberg.

TABLE 9
ANNUAL GROWTH RATE AND FORECASTS FOR THE
MAJOR ECONOMIES

	1999	2000(*)
United States	4,1	4,8
Japan	0,3	1,9
European Union	2,3	3,8
Argentina	(3,0)	3,3
Brasil	1,0	3,6
Chile	(1,1)	6,4
Ecuador	(7,3)	0,4
Mexico	3,7	4,8
Peru	3,8	4,9
Venezuela	(7,2)	3,5

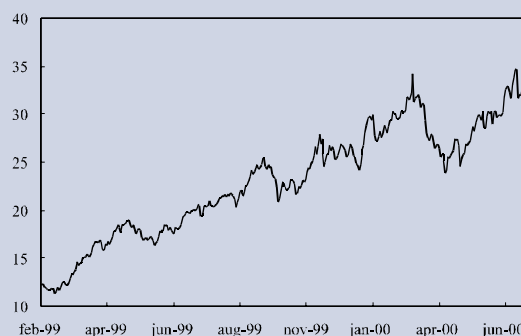
(*) Forecasts to December.
Source: WEFA, JP Morgan Forecasts, *The Economist*.

mechanism to alter production quotas if crude prices stay outside the range of US\$22 to US\$28 a barrel for more than 20 days. Trusting that the mechanism will be applied strictly, crude prices should remain within this range, at least for the rest of the year. If these expectations are confirmed, Ecopetrol anticipates the average price of Colombian crude to be US\$27 a barrel in 2000. This would imply a gradual decline in crude prices throughout the year, from US\$30 in June to US\$25 in December 2000.

Forecasts for oil prices are confirmed by the prices of futures contracts on the New York Stock Exchange (Figure 60). These dropped significantly, indicating that economic agents expect the availability of crude to increase during the course of the year. The contract to July 2000 closed in June at US\$32.50 a barrel. Six-month and 12-month contracts closed at US\$28.4 and US\$25.9 a barrel, respectively.

The average price of Colombian coffee on the New York Stock Exchange has fallen sharply during the course of the year, compared with December 1999.

FIGURE 59
WTI OIL PRICE
NEW YORK STOCK EXCHANGE, 1991:1-2000:6
(DOLLARS/BARREL)



Source: Bloomberg.

During this month, Colombian coffee was priced at US\$1.40 a pound, as opposed to an average of US\$.90 a pound in June 2000. The drop in international coffee prices can be explained by increased supplies of mild coffee, which have allowed stocks to accumulate worldwide. Despite the prospect of production quotas being imposed by major producers, the price of futures contracts has declined (Figure 61). This is consistent with expectations of larger harvests in Brazil and Colombia, and the coming of summer in consumer countries, which is associated with less demand for coffee.

In the second quarter of 2000, Colombian exports of other international commodities rose in relation to both the previous quarter and the second quarter of 1999. With data to April, the World Bank (WB) forecast a sizable upswing in nickel and banana prices, along with a reduction in the price of coal (Figure 62). There also are indications that sugar prices could pick up in the second half of the year.

Growing international demand and reduced stocks in producer countries explain the trend in nickel and banana prices. The anticipated decline in coal prices is the result of an increase in Colombian supply expected for the second quarter and an oil price slump forecast for the coming months. Oil is the primary substitute for coal.

FIGURE 60
WTI OIL FUTURES PRICE
NEW YORK STOCK EXCHANGE
(DOLLARS/BARREL)

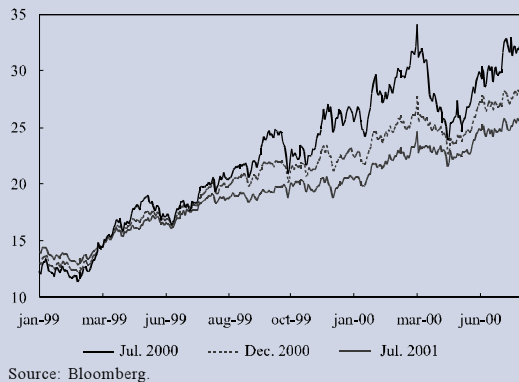


FIGURE 61
ARABICA COFFEE FUTURES
NEW YORK STOCK EXCHANGE
(US\$CENTS/POUND)

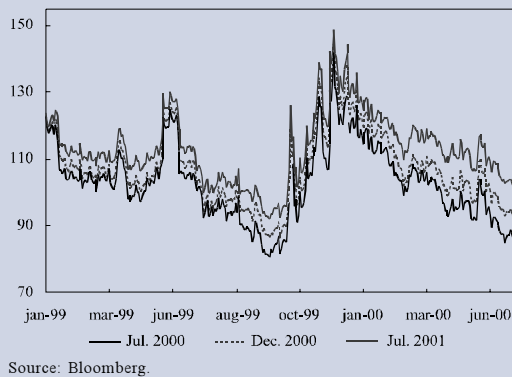
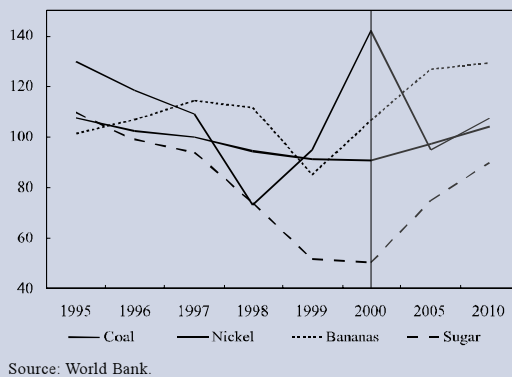


FIGURE 62
INDEX OF THE MAJOR COMMODITIES EXPORTED BY
COLOMBIA
(CURRENT DOLLARS)



C. FINANCIAL OUTLOOK

The international financial outlook remains strong in the second quarter, thanks to performance of the US economy. Rising inflationary pressures in the United States in March and April and the Fed's increase in interest rates to contain these pressures were decisive factors. Favorable inflation figures in May did little to alter the situation.

The financial outlook for emerging economies, particularly those in Latin America, was threatened by high consumer inflation in the United States in April, coupled with a 50 bp increase in intervention rates ordered by the Fed in May. Higher interest rates in the United States tend to have a negative impact on the way mid-term economic prospects for the region are perceived in international markets. There are two basic reasons for this phenomenon. First, high interest rates slow growth in aggregate demand in the United States, affecting regional exports to that market. Secondly, they make the region less attractive to international capital, compared with the alternative of the American market. This reduces the availability of foreign currency needed to guarantee sustained economic growth. Moreover, higher interest rates in the United States push up domestic interest rates in the region, slowing growth in domestic demand and the economy as a whole.

As mentioned in the preceding section, the economic situation in Europe, which is one of rising inflationary pressure brought on by devaluation of the euro, has done nothing to offset the negative impact of higher interest rates in the United States. The outlook is not encouraging, as many analysts are convinced the ECB interest rate will increase by at least 50 basis points in the second half of the year.

Higher interest rates in the United States and Europe, coupled with expectations of new increases in the

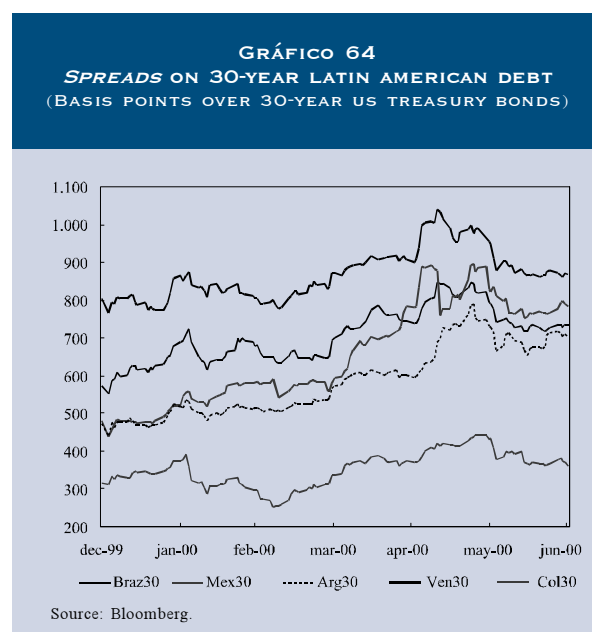
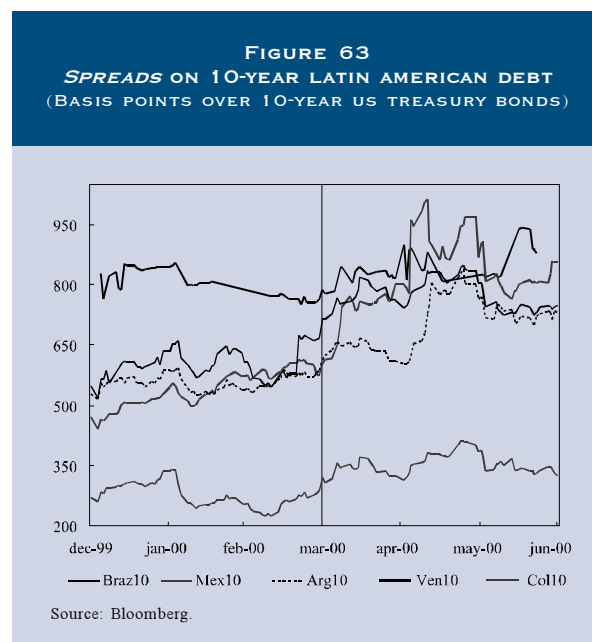
months ahead, widened sovereign-debt spreads for Latin America in the second quarter, especially in May. The average spread on 10-year debts for the major countries rose by 160 basis points. It was 664 basic points at the end of June, as opposed to 506 basis points, on average, at the close of the preceding quarter. The last three months saw an upsurge in 30-year spreads as well. At the end of June, the average for the region was 692 basis points, following 615 basic points at the end of the first quarter (Figures 63 and 64).

As to the major Latin American economies, the growing uncertainty associated with larger spreads had the least effect in Brazil, Mexico and Chile. Good news with respect to the fiscal front and inflation has helped the situation in Brazil. The Central Bank's decision to reduce the overnight loan rate by 100 bp was received favorably, since real rates continue to be perceived as high. All of this bolstered confidence in the country. In Mexico, financial stability of the economy during the last few years, favored by the force of exports, has allowed for some of the lowest spreads in the region. Even so, the country faced a special situation in recent months, owing to presidential elections. The markets are on hold until it becomes clear what the new head of state will do about important issues such as privatization, labor reform, financial market development and tax reform.

Debt spreads in Argentina, Peru, Venezuela and Colombia were influenced not only by higher interest rates in the developed countries but by political variables. Spending cuts in Argentina have been delayed for political reasons, affecting foreign investor confidence in the country. For example, in the last few months, the legislature has opposed key measures such as wage reductions for public employees. Furthermore, new figures on economic growth are weaker than anticipated initially. In Peru and Venezuela, the market's confidence in

possibilities for stable, long-term growth has also been affected by mounting uncertainty over the presidential succession.

Finally, in Colombia, recent clashes between the legislature and the executive branch, coupled with the slow advance of peace negotiations, has sparked uncertainty about the possibility of carry out the country's financial stabilization agreements with the IMF. This explains the jump in sovereign-debt spreads during April and May, which exceeded that of other countries



in the region. Although debt spreads shortened with clarification of the political situation in June, they are still high compared with the first quarter. How these spreads behave in the months ahead will depend on progress towards legislative reform of the fiscal and pension systems, among others, and the extent to which the goals of the IMF agreement are met.

The coming weeks hold little possibility of a major change in spreads throughout the region, as news of a slowdown in the US economy prompted the Fed to delay until August 22 a decision on higher interest rates. Naturally, this pause will be influenced by the behavior of the US economy in terms of production and inflation in July and August.

V

INFLATION FORECASTS

This section contains inflation forecasts for 2000 and 2001. To calculate the different statistical models used by the Banco de la República, it is assumed the economy will begin to recover this year, with positive growth levels. It also is assumed that monetary aggregates will remain consistent with the target of 10% inflation set by the Bank for the year 2000 and with financial programming for 2001 under the IMF agreement. As to devaluation, the assumptions contemplated in the inflation forecast imply a substantial increase in the real exchange rate during 2000 and its remaining constant throughout 2001.

The trend in prices on imported goods corresponds to devaluation anticipated this year and the next.

Given these assumptions, the models used by the Bank show 8% to 10% inflation at the end of 2000. They indicate further dispersion in 2001 and suggest inflation could be in the 7% - 11% range. The econometric models used by the Bank tend to overestimate inflation in long target periods, since it is difficult to incorporate the pronounced break in inflation observed in Colombia over the past year. As a result, they tend to echo earlier levels.

THE OUTPUT GAP AND ITS USE IN INFLATION MODELS

Both theory and empirical evidence point to a relationship between inflation and short-term economic growth. Known as the Phillips Curve, this relationship assumes that increased economic growth is accompanied by a rise in inflation, and vice versa. It is important for monetary authorities to understand the way this direct relationship operates, as it indicates at what level economic growth sparks inflationary pressures beyond those contemplated in inflation targets.

One way to determine when these inflationary pressures occur is by calculating the so-called output gap. This is understood as the difference between potential output; that is, what the economy is capable of producing if all existing resources are employed fully, and actual output. Potential output does not necessarily remain intact over time. For example, it increases by means of natural population growth and investment in physical capital. Supply shocks foreign to economic activity (natural disasters and a decline in fuel and energy supply) or long periods of disinvestment can provoke a drop in potential GDP. The output gap is the most important individual measure of the phase of the economic cycle at a given moment. Accordingly, it can be used as an indicator of current economic trends. A level of domestic output greater than the potential would be considered a source of inflationary pressure and serve as a warning to monetary authorities. A negative gap would have the opposite implications.

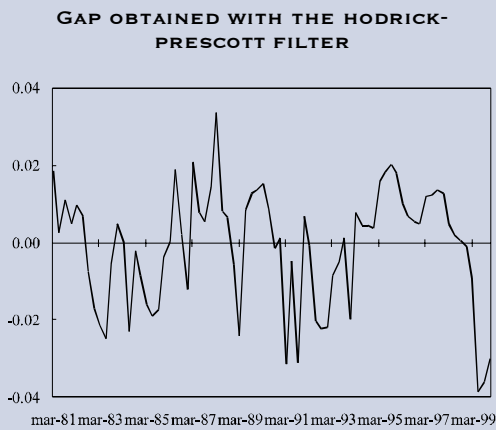
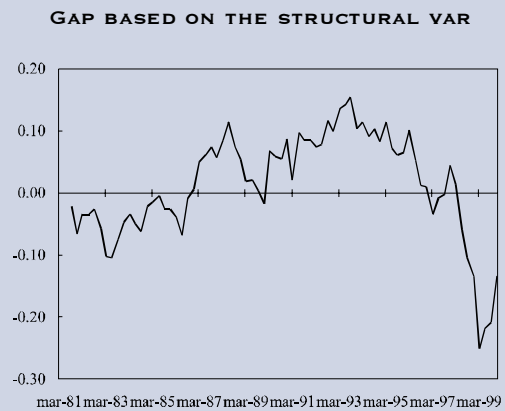
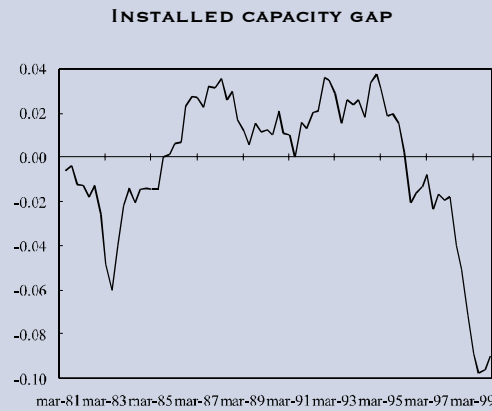
Calculation of the gap is a delicate process, given its importance as an indicator and the variables involved. Consequently, it is often the subject of much questioning. In the case of Colombia, there are specific problems to consider. First of all, calculating the gap requires at least a quarterly GDP series, which is difficult to estimate in this country. Existing quarterly GDP series have problems with the quality of information. There are currently two methods for calculating this series. One, which relies on rather precarious techniques, is used by the National Planning Department (DNP) to calculate quarterly GDP. The other, a more reliable method used by DANE, shows deseasonalized quarterly output, which is compatible with calculations based on national accounts. However, this series is only available as of 1995.

Secondly, it is important to calculate potential output correctly. To this end, the Banco de la República has developed and used a number of methods.¹ The one employed most frequently relies on filters to determine potential output. A filter can be defined as a statistical procedure used to identify a long-term pattern or tendency for any series. The Hodrick-Prescott and Kalman filters are used the most. Another method employs the indicator in the Fedesarrollo survey on use of installed capacity as a proxy variable of potential output. In general, this is done by calculating a moving average for the series in question. The use of multivariate methods for structural VAR-type economic series decomposition has been suggested as well. These call for imposing economically-backed restrictions of a long-term nature on self-regressive standard vectors.

The Banco de la República currently uses the gap as basic input for inflation forecasts. The effectiveness of these methods is assessed in light of their capacity to explain inflationary tendencies

in the past and to predict inflation in the future. Naturally, consideration is given to whether or not the series adequately describes the Colombian economic cycle.

The following are graphic representations of three gaps calculated for 1981-1999, using different methods. None of the three indicators are identical, even though they all describe certain phases of the cycle, such as last year's recession and the one in 1982.



¹ See López & Misas (1999), "Un examen empírico de la curva de Phillips en Colombia," *Borradores de Economía*, No. 117; Gómez y Julio (1999) "Output Gap Estimation, Estimating Uncertainty and its Effect on Policy Rules," *Borradores de Economía*, No. 125; López & Misas (2000), "La utilización de la capacidad instalada de la industria en Colombia: Un nuevo enfoque," Mimeograph.

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