Presentation, summary and conclusions

- Annual consumer inflation was 8.0% in September, much the same as at the end of the second quarter (7.9%) but 1.2 percentage points lower than in September 2000 (9.2%). It was the lowest annual rate in any September since 1970. Consumer inflation has remained very stable since February, hovering around 8.0%. The accumulated rate for January to September was 7.0%, down from 7.7% for the same period last year.

- Prices rose by 0.7% over the third quarter, just as they had in the third quarter of last year but much more slowly than in either the first or second quarters of this year. This reflects the seasonal pattern of Colombian inflation, which has become more marked in the past two year, to the extent that about 60% of annual inflation is generated in the first half of the year.

- Food prices were most responsible for inflation in the third quarter, as they had been in the first half of the year, when the onset of the holding-back stage in cattle breeding had caused a surge in the prices of beef and other meat substitutes. These rose more slowly in the third quarter, which was to be expected, given their seasonal behavior, but they are forecast to continue to exert inflationary pressure in 2002, since the cattle-retention stage is expected to last another year.

- Education, which had also contributed largely to inflation in the first two quarters, no longer did so in the third. Neither did housing, clothing, health care, or culture and entertainment. The third quarter saw transport prices and diverse expenditures rising much more slowly and producing lower inflationary pressures. Transport prices have been going up more slowly since the beginning of the year, thanks to smaller rises in fuel prices.

- Annual inflation in tradables dropped over the third quarter, down to the rate of overall inflation (8.0%); it had been higher than the latter since 1999 but began to converge toward it from the beginning of this year. In contrast, inflation in nontradables went up slightly over the third quarter, running at 7.9% in September.

- Core inflation continued to decline over the third quarter. The three most reliable measures of core inflation calculated by the Banco de la República (non-food CPI, inflation nucleus, and the CPI excluding food staples, fuel and public services) averaged 7.0% in September, down from 7.6% in June. In September, none of these measures stood higher than overall inflation or the inflation target for 2001.

- Annual producer inflation converged with consumer inflation in September, at 8.0%, running 2.2 percentage points lower than in June and 4.9 points lower than a year earlier. Its steady decline from 11.1% in May brought it down to its lowest level in any September since 1970.

- The third-quarter drop in annual producer inflation resulted from smaller annual price changes in all PPI components, whether classified by origin of goods (domestically produced and consumed, and imports) or by ISIC economic activity (farming, mining, and manufacturing). This was possible thanks to lower prices in farming and mining, a smaller accumulated devaluation, and falling prices for the main internationally traded commodities.

- Forecasts by the Bank's Economic Studies Division (SGEE) suggest that inflation is highly likely to end the year close to the 8.0% target set for 2001. Similarly, on information to September, the central path of the transmission-mechanism model indicates that average inflation in the fourth quarter of 2002 will be 5.5%, much the same as the 5.3% rate forecast on information to June.

- The latest forecasts, like those reported in June, show an upward- sloping risk balance accompanying the central path projected by the transmission-mechanism model. The risk balance's upward slope captures greater uncertainty surrounding devaluation next year, in view of the world economic downturn and the possibility of a financial crisis breaking out eventually in some emerging countries. This uncertainty has definitely increased since the events of September in the United States. A new source of uncertainty taken into account in this Report is connected with the possible recurrence, from December this year, of the climatic condition known as El Niño, and its effect on food prices.

- According to the transmission-mechanism model's central path, non-food CPI inflation will be 6.8% in the fourth quarter of this year, and 4.4% in the fourth quarter of 2002. This year's fourth-quarter figure is close to the 6.5% core-inflation forecast calculated as the average of the three measures currently used by SGEE, employing alternative methods.

- Real-sector indicators available to date suggest that GDP growth in the third quarter was not much different from growth in the two previous quarters. This view is based on the fact that variables such as nontraditional exports and power consumption have remained stable. In addition, higher oil production between July and September, resulting from reactivation of the Caño Limón field, may have offset declining output in some other sectors, such as manufacturing. Prospects for growth over the rest of the year are not as good as they were thought to be in previous Reports, because of recent external events, sharply falling oil and coffee prices in recent months, unpromising behavior of manufacturing orders, and low expectation among manufacturers regarding the economic situation. Because of these factors, growth for 2001 as a whole is expected to be lower than the government's current target of 2.4%.

- Next year the economy is bound to weaken if the global downturn becomes deep and long and if, in addition, there is no lessening of internal security problems. Particularly if, at the same time, the economies of Venezuela and Ecuador show little or no growth, given that demand from these countries has so far been a major driving force of industrial production in Colombia. All these circumstances could limit the positive effect of lower domestic and foreign interest rates on the country's economy.

✠ Poor performance by the real sector is confirmed by recent months' decline in capacity utilization relative to a year earlier, which has left present levels well below historical averages. Consequently, no strong inflationary pressures are expected from demand during the rest of this year or early next year.

✠ Satisfactory inflation behavior allowed the Banco de la República to take a number of measures in the first half of this year to provide the market with ample liquidity. Such measures included notably: (1) reducing the Bank's intervention rates by 50 basis points in early March; (2) adjusting the reference line to accommodate a higher demand for cash that resulted from modification of the transaction levy; and (3) raising the pre-set amounts of liquidity Repos to avoid large interest-rate fluctuations and to offset the freezing of Treasury funds in the Banco de la República. Moreover, to improve the payments system, additional Repo operations were authorized to make it easier for banks to cover shortages in their accounts with the Banco de la República in the process of check clearance.

✠ The Bank continued to pursue this line of action in the third quarter, reducing the structure of intervention rates three times by a total of 200 basis points. Reduction of intervention rates led to a drop in both lending and deposit rates in the market. The average interbank rate was 9.3% in September, 2.1 percentage points lower than in June. The deposit rate dropped by 0.8 percentage points between June and September, to 11.9%, while the average lending rate calculated by the Banco de la República edged down by 0.1 points, to 18.5% in September.

✠ Throughout the third quarter, the monetary base remained below the reference line set in June by the Bank's Board of Directors. In September, in particular, the base's 20-day average ran 2.3% below the reference line's. To provide the economy with liquidity the Board began in August to make final purchases of TES[1] Treasury paper1 and to raise substantially the amounts set for auctions of reserve-building options.[2]

✠ The financial system's loan portfolio continued to shrink in nominal terms over the third quarter. A breakdown, however, shows the loan portfolio of non-mortgage banks still growing at annual rates slightly above inflation, while the mortgage banks' portfolio continued to contract, but at a much slower pace during this period.

✠ The Bank's inflation-forecasting exercise confirms that this year's 8.0% target is very likely to be met, and that reaching a 6.0% target by the end of 2002 is feasible. But a high degree of uncertainty surrounds these scenarios for the following reasons: (1) annual food inflation has risen recently, and it may continue to do so next year because the climatic condition known as El Niño is highly likely to recur; (2) the exchange rate may become less stable next year, because the current-account deficit is

[1] By October 12, final purchases of Treasury paper totaled 60 billion pesos.

[2] The amount approved for reserve-building options in the third quarter was $210 million (compared with $90 million in the second quarter), but options worth only $130 million were exercised in July and September.

expected to widen, and the government may find it difficult to finance the fiscal deficit, given the present climate of international uncertainty, and (3) inflation expectations in Colombia continue to have a large adaptative component, reflected particularly in labor agreements, so that inflation is still characterized by a high degree of inertia.

✠ In any case, output indicators continue to show a slow, though stable, rate of growth in Colombia, while the latest forecasts of world economic performance point to a faster slowdown than was initially expected. These circumstances work against any inflationary pressures occurring next year.

✠ In view of the foregoing, the Board of Directors decided at its meeting on October 12 to continue the strategy of constantly providing liquidity to the economy through final purchases of Treasury paper, and set an amount of 100 billion pesos to be so provided up to the end of November, over and above the 60 billion furnished up to October 12. To this end, too, the Bank is to hold an auction of reserve-building options for $140 million. The Board also decided to reduce all the Bank's intervention rates by 25 basis points, effective from October 16, 2001. These rates now stand as follows: the Lombard expansion rate at 13.25%, the Lombard contraction rate at 6.75%, the auction expansion rate at 9.25%, and the auction contraction rate at 8.25%. The Board expects these measures will lead to further drops in market interest rates.

The Board of Directors,

Chairman
Juan Manuel Santos Calderón
Minister of Finance and Public Credit

Directors
Carlos Caballero Argáez
Sergio Clavijo Vergara
Salomón Kalmanovitz Krauter
Fernando Tenjo Galarza
Leonardo Villar Gómez

Governor of the Bank
Miguel Urrutia Montoya