[Monetary Policy Report]

A regular meeting of the Board of Directors of Banco de la República took place in the city of Bogotá D.C. on August 21, 2015. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; José Darío Uribe Escobar, Governor of the Central Bank; and co-directors Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, Cesar Vallejo Mejia, and Juan Pablo Zarate Perdomo.

The following is a summary of the vision of the technical staff at Banco de la República on the macroeconomic situation (section 1) and an overview of the main policy discussions considered by the Board of Directors (section 2).

Further detail on the macroeconomic situation prepared by the technical staff at will be presented in the Inflation Report for the second quarter of 2015 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. In the present report, the figures of global economic activity continue to reflect a weak dynamics of external demand, lower to the one recorded in 2014. In the United States, the economy would have continued to grow at favorable rates, while the euro zone is recovering, although at a rate somewhat lower than expected. In China, economic activity continues slowing down, and the major Latin American economies recorded low increases or setbacks in their output.

2. In the United States and the euro zone, long-term interest rates have decreased, but they continue at levels above the average recorded in 2014. In China, the yuan was devalued, and drops in the stock market from historically high levels persist. As for the United States, there is still high probability of an increase in the benchmark interest rate of the Federal Reserve, and the US dollar continues to strengthen.

3. The lower prospects of global growth, high levels of oil production and the increasing prospects for its supply once more generated falls in international oil prices. These new price levels are below the estimation by the technical staff for the average of 2015. Something similar happened with the prices of other mining commodities exported by Colombia. In this way, the fall in the terms of trade will continue to be important this year, with a negative and significant effect on national income.

4. Lower prices of commodities and weakness in external demand have reflected on the behavior of Colombia's external sales in US dollars. In the second quarter, exports continued recording important yearly falls (-32.6 %). In this period, the largest falls took place in external sales of mining origin (-43.3%), followed by the fall in exports of agricultural goods (-13.9%) and other sectors (-3.0%).

5. The new foreign trade information continues to suggest that this year the current account deficit relative to GDP will be greater than the one registered in 2014. For the present year, the forecast interval remains between 4.8% and 6.4%, with 5.6% as the most likely outcome.

6. As for the domestic context, indicators of retail trade for the second quarter, confidence of consumers and commerce, as well as economic expectations from Banco de la República indicate that absorption continues slowing down. On the supply side, in the same period, the industry contracted and construction indicators suggest a slowdown in the sector. Data to July show a drop in consumer confidence and in oil production, while the production of coffee exhibited a significant increase.

7. Regarding the labor market, the unemployment rate (seasonally adjusted) stopped falling, and in yearly terms job creation slowed down. In June, excluding seasonal effects, the overall participation rate and the occupancy rate declined.

8. Real interest rates decreased, registering below their historical averages calculated since 2000 (except for credit cards). Commercial lending has slowed down, while that directed to households improved its dynamics. Both types of credit are growing at rates higher than nominal GDP growth.

9. With all of the above, the technical staff maintained its estimate for economic growth for the second quarter of 2015 between 2.0% and 3.5%, with 2.7% as the most likely figure. For 2015, the most likely outcome remains at 2.8%, within a range from 1.8% to 3.4%.

10. In July, annual inflation increased slightly and stood at 4.46%, somewhat higher than estimated by the technical staff and by the market average. On this occasion, acceleration of the CPI excluding food explained the largest rate of increase of inflation. Other indicators of core inflation also rose and their average stood at 4.29%, thus accumulating ten months of consecutive increases.

11. Inflation expectations by financial analysts to one and two years and those embedded in public debt bonds to more than two years increased. All these indicators are lower than the current inflation and are placed at the higher portion of the target range.

In all, inflation remains above the upper limit of the target range and domestic expenditure in the economy continues adjusting to a lower dynamics of national income. Projections indicate that in the monetary policy horizon temporary price shocks will be reversed and the probable excess capacity will contribute to inflation converging to the target, within an environment of anchored inflation expectations. However, partial pass-through of the devaluation of the peso to prices and an eventual intensification of El Niño could slow down said convergence.

2. DISCUSSION AND POLICY OPTIONS

The members of the Board highlighted that the Colombian economy has received a very strong shock associated with the fall in oil prices, which reduces growth and increases inflation in the short term, inasmuch as devaluation passes-through partially to prices. This increase in inflation is temporary as long as inflation expectations remain anchored close to the target set by the Central Bank. On the other hand, lower growth is the economy’s response to the adjustment needed in domestic demand facing lower national income, fruit of the negative impact in the terms of trade.

For some Board members, recent information could suggest that output growth could be lower than expected by the technical staff, and, given the current anchorage of inflation expectations, they deemed appropriate to wait until having more information on the evolution of variables that may significantly affect the future behavior of productive activity and inflation expectations. For them, this new information will contribute to better balance the risks of higher inflation and excessive adjustment of economic growth, which in the short term are opposed within the decision regarding the stance of policy.

Other members of the Board agree that recent data points at lower growth. This group opined that under these conditions, the most likely scenario is one in which excess productive capacity is generated within the policy horizon. This would bolster convergence of inflation to the target, and given the current anchorage of inflation expectations, it allows for the current policy stance to achieve its objectives. Similarly, they pointed out that, while inflation expectations are anchored to the target, the risks that they may no longer be so are mainly associated with the short-term dynamics of the exchange rate, which has a weak relationship with the intervention rate. Therefore, they considered essential to strengthen communication with the public regarding the nature of inflation and the mechanisms of convergence towards the medium-term target.

Another group expressed that the upward pressure on inflation originated by the pass-through of devaluation on prices, however temporary, manifests itself more quickly than the disinflationary pressures from the slowdown in domestic demand and the excess productive capacity. This can cause inflation expectations to become unanchored, generating an upward spiral of prices and a situation of instability which would make drastic policy measures in the future unavoidable. This risk of unanchored expectations has grown significantly in a scenario in which total inflation has been above the upper limit of the target range for over one semester, and which has continued to increase (even excluding food inflation), and in which the average of core inflation indicators has risen for the tenth consecutive month and is also above the upper limit of the range. They also consider that, given the above, and a real interest rate close to zero in the last few months, early adjustments of the benchmark rate could avoid later hikes of greater magnitude. In their view, a 25 bp increase would contribute to prevent expectations from becoming unanchored by strengthening the credibility of the Central Bank.

3. POLICY DECISION

The Board of Directors, by majority, considered maintaining the benchmark interest rate at 4.5%.