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 Friday, September 25, 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 from the Central Bank will be presented in the Inflation Report for the third quarter of 2015 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. Figures for global economic activity continue to reflect a weak dynamics of external demand, below that recorded for 2014. In the United States, the economy would have continued to grow at favorable rates, while the euro zone is recovering slowly. In China, the slowdown continues and its central bank implemented new measures to stimulate the economy. The major economies of Latin America recorded low increases and, in some cases, setbacks.
2. In its meeting of September, the Federal Reserve of the United States decided not to increase its benchmark interest rate. According to its statement, this decision was reached due to the increased uncertainty in the international outlook and lower-than-expected inflationary pressures. In spite of this, projections from the members of the Federal Open Market Committee (FOMC) suggest that the Fed would increase its policy rate in the last part of the year, and that it would continue increasing gradually in the future.
3. So far this month, volatility indicators of financial markets fell from the high levels reached at the end of August. Risk premia in the largest economies in the region have remained at levels higher than those in 2014, and the prices of the currencies vis-à-vis the US dollar remain highly volatile.
4. In the last few weeks, the international price of oil recovered slightly, but is still low (less than USD 50 for the Brent reference) and highly volatile. The international prices of other commodities remain much lower than the levels recorded in recent years. This has caused a drop in the terms of trade of exporting countries and has deteriorated their national income. In the present year, this trend has been particularly marked in Colombia.
5. The figures for the second quarter of 2015 show that the adjustment of the external deficit of the country would be taking place more slowly than expected, a fact explained mainly by the behavior of the trade balance. Low prices of commodities and the weakness of external demand for the country have been reflected in a deterioration of external sales (-32.6% accumulated to July) a figure higher than had been forecast. Imports have fallen at a slower pace than had been foreseen (-12.1% accumulated to July).
6. As for the domestic context, GDP results for the second quarter revealed by DANE exhibited growth of the economy (3.0% on a yearly basis), somewhat better than had been projected. Domestic demand has slowed down significantly, as expected. The adjustment took place mainly by investment in machinery and transportation equipment, while private consumption decelerated at a slower pace. Both exports and imports fell in real terms, but their net contribution to GDP growth was positive.
7. On the supply side, the sectors that grew most were construction and mining (8.7% and 4.2%, respectively), and the only branch that reported a reduction in its production was industry (-1.3%). The information available for the third quarter exhibits no changes in these trends. For all of 2015, the technical staff maintained its estimation for economic growth at 2.8% as the most likely figure, within a range between 1.8% and 3.4%.
8. As for the labor market, the unemployment rate fell in July, which is explained by a lower level of labor force participation and not by an increase in hiring. Additionally, salaried and formal employment have slowed down in recent months.
9. Real interest rates continue at a level below their historical averages calculated since 2000 (except for credit cards). Credit to businesses and households continues to grow above nominal GDP.
10. In August, annual consumer inflation increased, reaching 4.74%. So far this year, accumulated inflation registers 4.02%. Most of the increase is explained by the tradable component of the CPI excluding food and regulated goods and by food. The four core inflation indicators also exceeded the ceiling of the target range. Their average reached the highest level since June 2009. In monthly terms and with seasonally adjusted series, more than 80% of the items in the CPI basket exhibited increases in their prices.
11. Inflation expectations of financial analysts and those embedded in public debt bonds increased significantly in September. The latter, calculated to 2, 3, 5 and 10 years, were, on average, above the ceiling of the target range to September 22.

In all, the new information available exhibits a continuous and higher-than-expected increase in inflation and core inflation indicators, as well as the appearance of signals of a potential “unanchoring” of inflation expectations. The sharp increases in the prices of goods that are mostly affected by the depreciation of the peso have continued pressing inflation upwards. Prices of other goods and services also show increasing variations, which may reflect indexation, expectations of higher inflation in the future, or pressures in costs in these sectors. El Niño has intensified, increasing the risk of further increases in food and energy prices. Recent data on

growth and economic activity confirm a slowdown in production and expenditure in line with the projections of the Central Bank's technical staff, compatible with the correction of the country's external deficit. Thus, the risk of a lasting increase in inflation and unanchoring of inflation expectations has augmented, while the risk of an excessive slowdown in economic activity has not exhibited a noticeable change.

2. DISCUSSION AND POLICY OPTIONS

In September 2015, the Board decided to increase the benchmark interest rate by 25 basis points, after keeping it stable for 13 months, sensing a shift in the risk balance faced by the economy.

All members of the Board agree that the Colombian economy is adjusting to the strong impact on income derived from the fall in the international price of oil that has generated a substantial depreciation of the peso, which is necessary to achieve a sectoral re-orientation of spending and production, leading to the adjustment of the country's external accounts.

Due to its magnitude, this devaluation has raised inflation of consumer prices, and this increase has been reinforced by other supply pressures, especially on food. However, the Board considers that this shock is temporary, given that an additional, strong and continuous depreciation is not expected; also, they expect the phenomena affecting food prices to disappear in the policy horizon.

Although there have been different perceptions concerning the risks of a fall in the rate of growth that could lead to the possibility that a larger-than-necessary adjustment may take place (particularly in a context of weak external demand), such perceptions have diminished.

On the contrary, the risks of inflation expectations becoming "unanchored" in the presence of a continuous and higher-than-expected increase of inflation and core inflation indicators have augmented. Inflation expectation indicators increased, and those embedded in short and long term public debt bonds are above 4.0%.

Considering this change in the risk balance faced by the economy, with greater risks of a lasting increase of inflation and unanchoring of inflation expectations, the Board decided to raise the Central Bank's benchmark interest rate by 25 bp. With the current information, the Board believes that this increase is consistent with the convergence of inflation to the 3.0% target.

3. POLICY DECISION

The Board of Directors of Banco de la República unanimously decided to increase the benchmark interest rate by 25 bp to 4.75%.

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