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[Banco de la República increases the benchmark interest rate by 25 basis points](#)

A regular meeting of the Board of Directors of Banco de la República took place in the city of Bogotá D.C. on Friday, May 27, 2016. 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 Zárate Perdomo.

These minutes contain a summary of the outlook by the technical staff of the Central Bank on the macroeconomic situation (section 1), followed by a review of the main discussion regarding monetary policy by the Board of Directors (section 2).

Further detail on the macroeconomic situation prepared by the technical staff from Banco de la República will be presented in the Monetary Policy Report of April and in the statistical annex.

1. MACROECONOMIC CONTEXT

a. In May, the international price of oil continued rising and risk premia remained stable at last month's levels. However, like other currencies in the region, the peso depreciated, probably associated with possible increases in the Fed's benchmark interest rate sooner than had been expected by the market.

b. So far in May, indicators of volatility in international financial markets and long-term bond rates in developed economies remained low.

c. The most recent information of global economic activity suggests that the second quarter would be somewhat better than the first. In the United States, household consumption would have boosted, Europe would continue recovering slowly, and China would continue to slow down, although less than expected thanks to the stimulus policies.

d. As for Latin America, the data for GDP in the first quarter of 2016 from Chile and Mexico were better than at the end of 2015, but still low compared to those of recent years. In the same period, the activity rate in Peru points at an annual growth of 4.4%, while for Brazil, this indicator suggests that the economy would continue in a deep recession.

e. For Colombia, so far this year to March, the US dollar value for exports fell 31.8% annually, and that for imports 25.1%. In both cases, significant declines in the major groups were observed.

f. Regarding growth in the first quarter, the available information suggests that domestic demand would have continued slowing down, as had been expected. As for private consumption, in addition to the deterioration in confidence indicators, retail sales (excluding vehicles) in the first quarter of 2016 grew less than in the previous quarter. This last result is maintained after adjusting the series by its seasonal component. Regarding investment, the data on imports of capital goods different from construction (in constant pesos) anticipate a fall.

g. Including the new results of economic activity, the technical staff maintained its growth forecast at 2.5% on a yearly basis for the first quarter, within a range between 1.8% and 3.2%. Part of the lower growth in the first quarter of 2016 compared to the fourth quarter of 2015 would be associated with the effect of the Easter holiday, and should be partially reversed in April. For all 2016, the growth forecast would be between 1.5% and 3.2%, with 2.5% as the most likely outcome.

h. In April, annual consumer inflation stood at 7.93%, with a slight decrease compared to last month (7.98%). The slowdown is explained by the behavior of regulated items, particularly public utilities. Food prices continue to rise, although at a somewhat slower pace than in the past few months. Those of tradables and non-tradables (excluding food and regulated items) also continue to increase. The average of core inflation indicators continued increasing, reaching 6.38%.

i. The different measures of inflation expectations monitored by the Central Bank remained relatively stable vis-à-vis the previous month. In all cases they are above 4.3%, except those obtained from the survey applied to economic analysts to two years (3.69%).

j. The effects of El Niño, pass-through of the accumulated depreciation of the peso to prices, and the activation of indexation mechanisms on prices and salaries would keep inflation high during the first semester of the year. Shocks in food prices and depreciation are expected to begin fading in the second semester, which, together with monetary policy decisions, should lead inflation towards its target during 2017.

In summary, the Colombian economy is adjusting in an orderly manner to the strong external shocks recorded since 2014. The risk of an excessive deceleration of domestic demand is moderate, and there is still an excess of expenditure with respect to national income, which is reflected in a high current account deficit. Inflation has accelerated so far this year on account of the depreciation of the peso, El Niño, and by the activation of some indexation mechanisms.

2. DISCUSSION AND POLICY OPTIONS

The members of the Board agree that it is still necessary to continue increasing the benchmark interest rate in order to lead inflation to its 3.0% target ± 1.0% by the end of 2017.

The majority of the Board Members proposed a 25 bp increase in the benchmark interest rate. This proposal was based on the following considerations: (i) Policy interest rates, expressed in real terms, have increased sharply since March as a result of the Board's actions and the stabilization of inflation expectations. As a result of this behavior, the level of the real interest rate is higher than the average for the last decade and consistent with a neutral rate, according to some recent studies. (ii) This effect is reinforced by a full and quick transmission of the policy rates to the rates of the financial system. (iii) Several real sector indicators show that, although with sectoral and regional differences, domestic demand is slowing down, achieving the purposes of the monetary policy. (iv) The effects of the slowdown of demand on inflation will take time to be seen, considering that the shocks derived from El Niño and depreciation are still present. Once the effects of these shocks have passed, the slowdown in demand will be reflected on inflation and inflation expectations, increasing the risk of an over-adjustment in the benchmark interest rate. (v) In the near future, there will be relevant information available on the international monetary conditions and their impact on emerging economies. In this framework, the majority of the members of the Board considered that an increase lower than the one from the previous session is the appropriate one to start contracting the thrust of the policy. Also, it allows to track the evolution of the adjustment in domestic demand (given the lags of the monetary policy on this variable), and it enables a proper reaction to the information on the monetary policy stance of the Fed and its effect on the Colombian economy.

Other Board Members proposed a 50 bp increase in the benchmark interest rate. In April, the average of core inflation continued to increase for nineteenth consecutive month, and expectations remain above the upper limit of the target range. Likewise, there are signs of persistence of inflation and the activation of indexation mechanisms, and the risk of an additional pass-through of depreciation to domestic prices cannot be disregarded, particularly considering the Fed's monetary policy stance. All this puts the effective convergence of inflation to the target range before the end of 2017 at risk. The current dynamics of domestic demand indicates that deceleration is not excessive and gives room for a 50 bp increase in the benchmark reference rate, encouraging the anchoring of inflation expectations more clearly and facilitating convergence of inflation to the target range in 2017.

3. POLICY DECISION

The Board of Directors of Banco de la República, by majority, decided to increase the benchmark interest rate by 25 bp to 7.25%.