Monetary Policy Report
Must reads
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 Wednesday, June 22, 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 May and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. In its meeting of June, the Federal Open Market Committee of the FED decided not to increase its benchmark interest rate. Some indicators available for the second quarter suggest that the US economy would exhibit a lower-than-expected dynamism despite the good performance of household consumption. With this, the market anticipates that the normalization of the monetary policy will be slower than expected.
2. A few days before the meeting of the FED, risk aversion in international financial markets had increased, and the US dollar had strengthened. Latin American economies exhibited a small increase in risk premia and a slight weakening of their currencies.
3. The figures for economic activity available from other countries suggest that global growth in general, and specifically that of Colombia’s main trading partners, would be low.
4. In the euro zone, retail sales slowed down in April, and industrial production continued with a low growth level. In China, retail sales and fixed asset investment also reduced its pace of expansion in May.
5. In Latin America, GDP data for the first quarter and activity indicators to April show a weak growth, lower than in recent years in Mexico, Chile and Peru. Brazil, Venezuela and Ecuador would continue in recession (for the last two there are no recent figures available).
6. To June 20, the price of Brent oil has remained around USD $50 per barrel. This, with the increases in the prices of other goods exported by Colombia, suggests that the terms of trade would be at levels higher than at the beginning of the year, despite the recent increases in some of the international prices of some foodstuffs imported by the country.
7. According to the figures of the balance of payments, in the first quarter of 2016 the current account deficit was US$ 3,381 million (m), equivalent to 5.6% of GDP. Compared to a year ago, the deficit lowered both in levels as well as relative to GDP. The main corrections took place in a lower primary income deficit and a lower services deficit. The lower trade balance deficit and the greater net income from transfers also contributed to this reduction.
8. Foreign trade information available for the second quarter indicates that both exports and imports continue falling at significant rates (-24.8% and -17.0% in April, respectively).
9. In the first quarter, GDP exhibited a yearly increase of 2.5%, in line with the forecasts of the Central Bank. The growth of domestic demand was 1.3%, somewhat higher than expected. On the supply side, the sectors that grew the most were industry and financial services, while mining was the only one that is contracted.
10. The figures available for retail and industry to April show a better performance of the economy. The results of different surveys point at the same direction. However, the estimates of the technical staff suggest that a good part of this better behavior is explained by the effect of Easter and the holidays. In contrast, with information to May, energy demand (total and by the industry), oil and coffee production exhibited decreases.
11. The technical staff maintains its growth forecast for the whole year at 2.5%, within a range of 1.5% and 3.2%.
12. In May, yearly consumer inflation reached 8.20%. The increase is mainly explained by the behavior of food, particularly perishable goods. The average of core inflation indicators monitored by the Central Bank moved from 6.38 in April to 6.33% in May.
13. Inflation expectations to December 2016 obtained from the monthly survey to financial analysts increased significantly from 6.02% in May to 6.23% in June. On the contrary, expectations to twelve and twenty-four months obtained from the same survey, and those embedded in public debt bonds to 2, 3, and 5 years lowered. However, all expectations except those of analysts to twenty-four months (3.67%) are above 4.0%.
14. 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 continues adjusting in an orderly manner to the strong shocks recorded since 2014. The current account deficit is correcting gradually, and the risk of an excessive deceleration of domestic demand remains moderate. Inflation has accelerated because of the depreciation of the peso, El Niño, and by the activation of some indexation mechanisms.

2. DISCUSSION AND POLICY OPTIONS

For the members of the Board of Directors, the data available for the first quarter suggest that domestic demand and output growth continue to slow down, in line with the forecast by the technical staff of the Central Bank. On the other hand, the current account deficit showed a reduction greater than anticipated. This represents a better-than-expected behavior of national income during this period, and means that there was a decline in the external vulnerability of the economy. This corresponds to an orderly adjustment to external shocks that the Colombian economy has been facing since mid 2014.

The majority of the Board Members deemed appropriate to increase the policy interest rate by 25 bp. They consider that this increase, added to the already significant adjustment in the policy interest rate in the past, is needed to underpin the process of convergence of inflation and inflation expectations to their 3.0% +/-1 pp goal in 2017. Despite the strong shocks that have led to recent increases in inflation, previous increases in the Central Bank’s interest rate have impacted inflation expectations in the desired direction.

Among the members of the Board who proposed a 25 bp increase of the policy interest rate, some stated that the high volatility of external conditions, the signals of persistence of inflation and of the activation of indexation mechanisms could pose serious threats to achieving the inflation target in 2017, which must be confronted with adjustments in the policy interest rate. In their opinion, the credibility costs of failing to achieve the inflation target in 2017 would make future disinflation much more costly in terms of output growth and employment creation.

One member of the Board considered that the previous increases in the policy rate have led to enough contraction, and that there are signs that domestic demand is adjusting at a convenient pace. Additionally, this member noted that inflation expectations for 2017 have not increased. Therefore, this Board member did not consider an additional increase to the benchmark interest rate necessary.

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 7.5%.

Bogotá, D. C.