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, June 29, 2018. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; Juan José Echavarría, Governor of the Central Bank; and Board Members Gerardo Hernández Correa, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, José Antonio Ocampo Gaviria, and Juan Pablo Zárate Perdomo.

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

Greater detail of the macroeconomic situation prepared by the technical staff at *Banco de la República* will be presented in the Monetary Policy Report for June 2018 and in the statistical annex (Only Available in Spanish).

1. MACROECONOMIC CONTEXT

1. In this report, the projection of the 2018 average growth of some of the country's main trading partners was maintained, which implies an acceleration compared to 2017. For 2019, growth of trading partners is expected to be similar to the forecast for 2018. Thus, the Colombian economy would receive an additional boost from a stronger external demand.
2. The prices of oil and other raw materials are estimated to reach higher levels than those observed in 2017. In particular, this report revised upwards the forecast of the average price of oil, to USD 69 per barrel for 2018. This would continue driving the recovery in the country's terms of trade and the positive effects on national income.
3. Compared to the previous report, the increase in the risk perception for emerging economies has been an important change in the external context. However, this has not yet affected capital flows towards most of these economies.
4. Forecasts suggest that the country's external deficit as a share of GDP should continue correcting in 2018 as a result of a better dynamics of exports of goods and the good performance of current transfers. Thus, the current account deficit in 2018 is estimated close to 3.1% of GDP.
5. The technical staff considers that the Colombian economy would grow 2.7% in 2018 in the baseline scenario. International financing conditions, prices of commodities, and demand from trading partners are expected to be favorable to the expansion of Colombia's GDP in 2018. Additionally, internal factors such as the decline in inflation, an expansive interest rate, and a labor market without many variations would strengthen the process of convergence towards the growth potential.
6. In terms of inflation, results in the last three months of the year show that the variation in prices has remained stable, after a significant decline the first two months of the year. Particularly, in May, annual inflation stood at 3.16%, a figure significantly lower than the one observed in December 2017 (4.09%). The declines were concentrated in the sub-groups of tradables (excluding food and regulated items) and, to a lesser extent, in non-tradable inflation (excluding food and regulated items) and meals outside the home.
7. In May, the average of the four core inflation indicators exhibited a slight increase to 3.43%, after four months of continuous declines. Inflation expectations to December 2018 obtained from the monthly survey to financial analysts posted at 3.36%. Analysts’ expectations and those embedded in public debt bonds to horizons greater than or equal to a year stand between 3.0% and 3.4%.

In all, for 2018, inflation is expected to continue its process of convergence to the target, and economic growth is expected to exhibit a greater dynamism in 2018 and 2019. The monetary policy actions carried out so far should consolidate the convergence of inflation to the target and maintain a favorable path for the expansion of the GDP. However, uncertainty about the external and internal conditions and on the volatility of oil prices remains high, all of which could affect the dynamics of prices and economic activity.

2. DISCUSSION AND POLICY OPTIONS

The members of the Board noted the reduction in the inflation rate that has been taking place throughout 2018 as positive, although it has slowed down its downward trend in recent months. However, they highlighted that there are risks for the rest of the year associated with potential increases in food prices, high oil prices and their effects on the price of gasoline, and the new depreciation trend of the peso.

Regarding economic activity, they noted that the reactivation is still in progress, although it is still weak and the output gap continues to widen. This reactivation is reflected, particularly, on economic growth in the first quarter and, according to some data (still incomplete), in the second. However, they expressed doubts about the sustainability of some components of demand, particularly government consumption. Nevertheless, they agreed that the data for the second quarter suggests that economic activity has been better than the forecast for the baseline scenario by the Central Bank’s technical staff.

For some members of the Board, this would indicate that growth could come closer to 3.0% during the current year. The greatest weakness continues to take place in the construction sector.

As for the external sector, the Board Members highlighted the persistent dynamics of exports other than oil and mining, particularly manufacturing. At the same time, they showed concern about the uncertainty in international financial markets, albeit noting that, until now, its effect on the country's capital flows and risk premia has been quite moderate. However, they agreed that these uncertainties should be taken into account in the design of monetary policy. They also discussed the extent to which the trends in international markets, together with the Colombian economy, could result in increases of the long-term real interest rate, although with differences of opinion on the magnitude of this increase.

Several Board Members also emphasized that the reversal of the revaluation trend from previous months has been good, since it could have endangered the buoyancy of exports other than oil and mining.

In this context, in the opinion of the Board Members, the balance of risks arising from the somewhat less favorable trends in inflation, the ongoing recovery of economic activity, and the uncertainties in the international markets indicates the need to maintain the monetary policy stance on this occasion.

3. POLICY DECISION

The Board of Directors of *Banco de la República*, at today’s meeting, unanimously decided to maintain the benchmark interest rate at 4.25%.

Bogotá, D. C.