



**Banco de la Republica
Division of Economic Studies**

Description of the foreign context that the Colombian economy faces, the change in foreign trade, performance of domestic demand, output, and credit as well as the performance of inflation and inflation expectations.

I. Foreign Context, Exports, and Imports

1. GDP in the United States rebounded during the second quarter and posted 4.2% annualized quarterly growth (a.q.), according to the second estimate published on August 28. This positive performance is explained largely by a favorable increase in domestic demand, especially household consumption and private investment. The revision was mainly in the figure for this last item.
2. With the data at July, retail sales, industrial production, and consumer and business confidence all suggest the momentum in the country's economy would continue during the third quarter of the year.
3. As for the labor market, job creation remained extensive in July; however, the participation rate increased. So, the unemployment rate rose slightly to 6.2%.
4. Measurements of inflation in the United States have stabilized near the 2% target set by the Federal Reserve (Fed). As a result and thanks to improvements in the job market, the Fed has already begun to discuss the strategies it might adopt when it starts to raise its benchmark interest rates, which still is expected to happen in mid-2015.
5. The economy in the euro area was at a standstill during the second quarter as a result of structural productivity problems in some countries, the decline in confidence (owing to geopolitical tensions in Ukraine and Russia), and a higher basis for comparison in Germany (which was favored, in the first quarter, by weather factors).
6. An analysis, by country, shows a loss of momentum due to the performance of the major economies in the region. For example, the German economy contracted (-0.6% a.q.), Italy entered a new recession (-0.8% a.q.) and France's economy languished. In contrast, peripheral economies such as those of Spain (1.6% a.q.) and Portugal (2.5% a.q.) saw positive growth in the second quarter.
7. With the figures at August, consumer and business confidence in the euro area continued to deteriorate owing to fears of an escalation in the conflict between Russia and Ukraine. This suggests that growth during the remainder of the year could be less than expected.
8. Given this situation, the risk of deflation in the euro area may be building. In fact, there have been further reductions in annual inflation, which was 0.4% in July.

9. In the case of China, the annual variations in retail sales and industrial production had stabilized by July. This is consistent with the technical team's forecast for growth in that country's economy (7.3%) However, it is important to point out that investment in fixed assets continued to lose momentum and there was a sizeable drop in new loans that month, all of which increase the risk of a slowdown in the second half of the year.
10. In Latin America, the second-quarter results for GDP in Mexico, Peru and Chile, as well as the indicator of economic activity in Brazil, show these economies continue to weaken, suggesting that growth in 2014 would be mediocre. These poor results are due largely to deterioration in investment performance and would be associated, in part, with falling terms of trade.
11. With respect to international prices for the commodities Colombia exports, oil prices have fallen in recent weeks, thanks to restoration of the supply in Libya and despite the geopolitical tensions in the Middle East. Meanwhile, nickel and coffee prices remain high.
12. For now, there is a sharp downward trend in the prices of some imported foods, owing to a larger supply resulting from good harvests in the United States and Europe.
13. As for financial markets, poor economic performance in Japan and the euro area, as well as the geopolitical conflicts in Ukraine and the Middle East have affected world stock indexes, especially the European ones. Even so, financing costs for the European countries continued to decline.
14. With respect to the Latin American financial markets, there was an increase in the risk premiums associated with the selective suspension of payments by Argentina; however, it proved to be temporary. The currencies of Peru, Chile and Colombia have depreciated in recent weeks.
15. Total exports in dollars registered an annual reduction of 4.1% in June. This is explained by a decline of 12.8% in "other exports" (95% of the value in this category pertains to industrial products), and 3.5% in major mining exports. The performance of "other exports" is due to a drop in exports of "other" industrial goods (-26.4%, with the most significant reductions being in basic metallurgical products and furniture), vehicles (-38.9%), meat (-87.8%), and machinery and equipment (-36.9%). The most important sales reductions in the second category involved petroleum by-products (-39.1%) and gold (-30.8%). The main exports of

agricultural origin rose 18.2%, given the increase in exports of coffee (16%), bananas (27.9%) and flowers (15%).

16. During the first half of the year, the value of exports in dollar fell 4.5 % compared to the same period last year. This was because of fewer exports of mining products (-4.5%) and “other” exports (-10.6%). As for mining exports, the largest reductions were in petroleum by-products (-26.6%) and gold (-43.5%); in the case of other goods, the major declines were in vehicles (-53%), other agricultural goods (-46.5%) and other industrial goods (-17.7%). However, exports of major agricultural goods rose 14.9% in annual terms, thanks to increased foreign sales of coffee (17.6%), bananas (28.8%) and flowers (4.3%).
17. If gold exports from free-trade zones are included, the reduction in total exports during the first half of the year comes to 3.7% annually.
18. Total imports were up by 14.9% in June with respect to the same month last year, given the increase in intermediate goods (24.5%), capital goods (7.3%) and consumer goods (8.2 %). In the first case, most of the growth was in the “fuels and lubricants” category (90.4%), while the major rise in capital goods involved transport equipment (21.7%) and capital goods for industry (5.1%). The biggest boost in the case of consumer goods came from imports of consumer durables (13.8%).
19. During the year to June, the total value of CIF imports in dollars rose 6.1% annually, thanks to intermediate goods (13.1%) and consumer goods (4.7%). This expansion was offset, in part, by fewer imports of capital goods (-1.8%). As for intermediate goods, the largest increases were in fuels and lubricants (32.9%) and raw materials for industry (7%). Most of the growth in consumer goods was in durables (7.4%). The drop in capital goods was due to fewer imports of transport equipment (-12.7%). Indeed, it is worth noting that the reduction in aircraft during the first quarter accounts for about half of the decline in dollars.

II. Domestic demand, growth, and credit

20. According to new information, the Colombian economy would have continued to expand at a healthy pace during the second quarter of 2014, although below the rate observed earlier in the year (6.4%). This was anticipated in the previous report and is due, in part, to the statistical effect associated with the Easter holiday being in April and not in March, as it was last year.

- 21.Regarding household consumption, the indicators at hand suggest second-quarter growth would have been relatively high, but less than during the first quarter. By June, the annual rise in the retail sales index of the Monthly Retail Trade Survey (GMCS) conducted by DANE was 3.3%. This increase boosted the aggregate for the second quarter to 6.2%, which was less than the figure on record for the first three months of the year (7.9%). When discounting the effect of vehicle sales, the increases were 4.8% and 8.5% for June and the second quarter, respectively. These results are consistent with the way private consumption, excluding durables, is expected to perform.
- 22.In the case of automotive vehicles and motorcycles, the annual decline in sales was 4.0% by June. There was an annual increase of 4.2% during the second quarter as a whole, which is lower than the rate posted in the first quarter (15.4%). This figure suggests a slowdown in the consumption of durable goods during that period.
- 23.The results of Banco de la República's Monthly Survey of Economic Expectations, particularly the sales balance, also indicate private consumption would have grown at a good pace.
- 24.In addition, the June unemployment rate (UR) continued to decline in all the geographic domains, thanks to the growth in employment, particularly salaried jobs. This increase in salaried employment was mainly in commerce and services.
- 25.As for gross capital formation, the figures in the balance of investment expectations from the EMEE at June suggest this variable would have continued to perform well during the second quarter. The estimates by the Bank's technical team concerning imports of capital goods measured in constant pesos corroborate this perception.
26. On the supply side, the industrial production index, without coffee processing, was down 0.6% annually in June, which was less than expected (1.2%). With this figure, it posted an annual decline of 0.3% during the quarter and rose 2.0% for the year to date. Performance in the different sectors remains mixed. Some registered significant growth (sugar refining, 59.8%; chemicals, 11.0%; beverages, 7.5%; other food products, 10.6% and non-metallic minerals, 5.3%). Others experienced major declines; oil refining (-26.1%), precious and nonferrous metals (-21.1%) and processed metallic goods (-8.7%) are the most important ones. The poor result for oil refining was due to temporary closure of the Cartagena refinery. If refinery production is discounted, the annual rate of industrial growth during the

year to June is 3.2%. The Cartagena plant is scheduled to resume operations early next year.

27. In the construction sector, the information for the second quarter suggests expansion remained high. Cement production was up by 14.2% annually, while shipments rose 8.4%. Although building permits declined in June compared to May, their annual increase came to 7.1%. The twelve-month accumulated increase was 8.9%.
28. The DANE indicator for monitoring the economy (ISE) shows it would have grown 3.8% in April and May compared to 6.3% in the first quarter, according to the same indicator.
29. As such, no major revisions in the forecasts for second-quarter growth are considered necessary. The Bank's models point to an annual increase of 4.3% (with a range of 3.6% to 5.0%).
30. Figures for the third quarter of 2014 are scarce and available only for July. They suggest the economy would grow at a good pace, although less than at the beginning of the year.
31. In July, the consumer confidence index (CCI) published by Fedesarrollo was similar to the level observed in June, but above average for the second quarter. This indicator is closely correlated with the expansion in private consumption. The component relative to economic conditions continues to exhibit an upward trend, while expectations remain at levels that suggest good future performance for household spending.
32. On the other hand, the July figures published by Econometrics show 12.5% annual growth in automobile retail sales. This represents a build-up compared to the figure for the second quarter (1.4%).
33. Moreover, the performance of consumer loans and interest rates continues to favor the momentum in private spending. The former maintained a growth rate of 11.8% in July, similar to that observed in May and June (11.7%), while the latter, in real terms, is still below its average since 2000.
34. On the supply side, several industry-related indicators in July suggest the sector performed better. This is the case with the leading indicators in the Fedesarrollo business opinion survey (EOE), such as orders, inventories and expectations for

industrial production in the next three months. Thanks to them, the index of business confidence in manufacturing increased.

35. As expected, oil production dropped below one million barrels per day (mbd 968) in July, compared to 1,008,000 in June. This implied a monthly decline of 4.1% and an annual reduction of 5.1%. Production has fallen 2.7% during the course of this year. According to the Colombian Petroleum Association, there have been approximately 97 attacks against hydrocarbon facilities in Colombia during 2014, mainly pipelines. This situation prevented nearly five million barrels from being exported or marketed during the year to July.
36. Coffee production totaled 1,236 million sacks in July, 19.9% more than during the same month last year. So far in 2014, accumulated production comes to 6.7 million sacks, with 13% annual growth. According to the National Federation of Coffee Growers, (FNC), the harvest during the first seven months of the year was valued at \$ 2.7 billion; this reflects 36% growth compared to the coffee income recorded for the same period the year before. These calculations include the value of subsidies delivered through the PIC (Coffee Income Protection Program).
37. In July, the annual increase in the total demand for energy was 5.9%. The regulated component rose by 6.7% and the unregulated, 1.6%. The total demand for energy continued to expand significantly with respect to levels and the trend.
38. Given the foregoing, the forecast for 4.2% to 5.8% growth during the year as a whole was maintained, as was 5.0% as the most likely figure.

III. Trend of inflation

39. Annual consumer inflation accelerated in July, reaching 2.89%. This is 10 basis (bp) points above the outcome for the previous month (**Table 1**). The increase was similar to the one anticipated by the SGEE, but higher than the market expected. In monthly terms, the variation amounted to 15 bp, compared to 17 bp forecast by the SGEE and only 9 bp expected by market analysts. The accumulated change in the CPI during the first seven months of the year comes to 2.7%, which is higher than the figure on record for the same period in 2013 (1.8%).
40. The acceleration in consumer inflation last month was the result of upward pressure from food and regulated items. The other two baskets (tradables and non-tradables excluding food and regulated items) exerted downward pressure.

41. Contrary to what occurred with total inflation, core inflation fell in July. The average of the four indicators monitored by Banco de la República was 2.58%, as opposed to 2.76% the month before. This is the second reduction during the year, following the one registered between May and June. Apart from the non-food CPI, which increased, the other three indicators declined. The CPI excluding staple foods, fuel and public utilities was the lowest (2.33%); the non-food CPI was the highest (2.75%). Inflation excluding food and regulated items came to 2.51% (Table 1)

Table 1

**Developments in Inflation
at July 2014**

Description	Jun-13	Sept-13	Dec-13	Jan-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14
Total	2.16	2.27	1.94	2.13	2.51	2.72	2.93	2.79	2.89
Non-food	2.48	2.36	2.36	2.49	2.62	2.85	2.76	2.66	2.75
Tradables	1.10	1.34	1.40	1.57	1.65	1.83	1.95	1.94	1.60
Non-tradables	3.78	3.70	3.76	3.61	3.55	3.51	3.68	3.45	3.17
Regulated	1.98	1.24	1.05	1.66	2.21	3.05	2.14	2.14	3.60
Food	1.34	2.05	0.86	1.20	2.23	2.39	3.35	3.11	3.26
Perishables	2.44	5.94	-0.16	2.13	3.17	6.89	10.97	8.92	9.18
Processed	-0.11	0.18	-0.24	-0.18	0.92	0.51	1.23	1.44	1.66
Meals outside the home	3.51	3.74	3.26	3.29	4.13	3.73	3.75	3.52	3.45
Core inflation indicators									
Excluding food	2.48	2.36	2.36	2.49	2.62	2.85	2.76	2.66	2.75
Core 20	2.83	2.79	2.72	2.69	2.86	2.80	3.14	3.04	2.73
CPI excl. perishables, fuel & publ útil.	2.14	2.19	2.19	2.27	2.53	2.54	2.63	2.53	2.33
Inflation excluding food & reg. items	2.63	2.69	2.74	2.74	2.74	2.80	2.95	2.81	2.51
Average of the first 4 indicators	2.52	2.51	2.51	2.55	2.69	2.75	2.87	2.76	2.58

Sources: DANE, Banco de la República calculations.

42. The annual change in the regulated sub-basket, as part of the non-food CPI, accelerated significantly, as anticipated in the Bank's forecasts, due largely to a low base of comparison in the case of the CPI for electrical energy. This led to an annual change of 7.9% in this item, which is the highest annual adjustment in recent years. However, the previous figure also can be explained by the high energy prices quoted on the commodity exchange in recent months. These eventually would pass through to consumer prices, with some lag. It is worth noting that the energy CPI has been extremely volatile in recent years, making it difficult to identify trends.

43. As for the other components of regulated goods and services, the price of fuel rose slightly in July, bringing its annual increase to 1.0%. On the other hand, the annual adjustment in residential gas stayed at around 7%, while the annual increase in water and sewage services remained at about 2.6%, as was the case with public transportation.
44. In July, the annual variations in tradables and non-tradables excluding food and regulated items declined more than expected. In the first instance, peso appreciation during the second quarter would be passing through to consumer prices, with the usual lag. The same month saw significant reductions in airline ticket prices, coupled with more modest declines in prices for electronics, home appliances, communication equipment and vehicles.
45. As for the non-tradable CPI, the annual variation in rental fees (3.2%) continued to decline slowly in July (3.2%). There also was a reduction in the item that includes entertainment, culture and recreation. This was associated with soccer tickets and is not likely to be repeated in the coming months. In fact, it might even be reversed later during the year. When the effect of soccer tickets is discounted, the annual change in the resulting index of non-tradables shows a downward trend as of several months, essentially due to the way rental fees behaved.
46. The annual change in the food CPI resumed an ascendant path in July (Table 1). This time, processed and perishable foods were again subject to upward pressure. In the first case, the increase in beef prices was particularly important and probably originated with the onset of a livestock retention phase in the sector. The past three months have seen increases in this variable. On the other hand, prices for imported products such as cereals and oils have exhibited stability or even reductions, thanks to limited pressure from international prices and the exchange rate. As for perishables, July saw continued increases in prices for fruits, vegetables, legumes and tubers, as expected. The annual variation in meals outside the home fell again slightly during that month.
47. There were no major changes in inflation expectations. Those based on Banco de la República's monthly survey of market analysts came to 3.33% for December of this year, which is only 6 bp higher than a month ago. In contrast, the expectation for inflation twelve months ahead is 3.14%, 2 bp less than in the previous survey. Expectations derived from the TES yield curve at two, three and five years averaged slightly over 3.0%.
48. Wage pressures remained low in recent months, judging by the wage adjustments. In the case of industry and commerce, they accelerated slightly in the two months

ended at June of this year, but not by more than 4.0% in annual terms. As for construction, stability was observed, with annual adjustments of 4.0% or less. It is important to consider that Banco de la República's estimates indicate the job market gap would have closed, thereby increasing the risk of some pressure emerging on this front next year, if the unemployment rate continues its current downward trend. In addition, there will be no labor cost reductions in 2015 such as those observed in 2013 and 2014 as a result of the tax reform.

49. Finally, the PPI fell again in July, and the annual variation was 2.3%, 23 basis points less than in June. Peso appreciation in the second quarter continued to pass through to domestic prices, which explains much of the reduction in the imported PPI. It should be noted that pass-through of movement in the exchange rate to prices occurs faster in the PPI than in the CPI. In the first case, it is usually immediate; in the second, there is a three-month lag.