



# PUBLIC VERSION

Working Papers from the  
Board of Directors  
Banco de la República

## **Monetary Policy Report**



# PUBLIC VERSION

Working Papers from the  
Board of Directors  
Banco de la República

## **Monetary Policy Report**

Economic Studies Division

July, 2015

## **I. External Context and Balance of Payments**

1. In August, Colombia's terms of trade experienced an additional shock due to a new reduction in international oil prices. So far in August, the price of Brent oil dropped 14.1% on average, as compared to the one observed for the previous month. Concerns for greater weakness in global demand (mainly from China), high levels of oil inventories, prospects indicating that the supply of oil would remain high, and the strength of the US dollar explain this fall to a great extent. The current price levels of Brent oil (USD 46.8 per barrel) are below the expectations of *Banco de la República's* technical staff for the average of the second semester of the year (USD 60 per barrel).
2. The prices of nickel and other metals exported by some countries in the region have also decreased significantly in the last few weeks, mainly as a consequence of China's more pronounced slowdown. For its part, the international price of coffee, while showing some increases *vis-à-vis* the previous month, remains at relatively low levels compared to those observed last year.
3. More recent records of global economic activity confirmed that growth for Colombia's major trading partners for 2015 would be lower than that of the previous year. The data available for the third quarter suggest that the euro zone would have continued expanding at modest rates, while China is still slowing down. Meanwhile, Latin American economies grew at rates lower than those observed on average over the past few years. In contrast, real activity in the US exhibited improvement, although not enough to offset the low dynamism of other trading partners of the country.
4. In the United States, data to July on retail sales, consumer confidence and housing market showed some improvement, suggesting that household spending would consolidate as the main engine for growth in this economy. Meanwhile, industrial production continued expanding at modest rates. As for the labor market, job creation continues at a favorable pace, with which the unemployment rate in July remained at 5.3%. Regarding the annual variation of prices, a modest increase in total inflation (0.2%) was observed in July, while core inflation indicators (1.8%) remained stable.
5. In this context, the minutes of the meeting of the Federal Open Market Committee (FOMC) of the Federal Reserve (Fed) in July suggest that the benchmark interest rate would be raised towards the end of the year, and that it would continue increasing gradually in the future. However, the strength of the US dollar and the complicated international outlook pose significant risks for the normalization of the monetary policy in the United States.
6. In the euro zone, GDP registered a quarterly growth rate of 0.3% from April to June, which represents a slight slowdown compared to the data from the previous quarter (0.4%). Confidence indicators and industrial surveys for July indicate that the economy would have continued to expand at a modest rate. Regarding the variation of prices, the yearly

indicators of total inflation (0.2%) and core inflation (1.0%) remained relatively stable at low levels in July.

7. In China, the data for July on industrial production, fixed-asset investment, and exports suggest a deepening of the slowdown of real activity. Additionally, annual inflation in July remained at low levels (1.6%). In this context, the Chinese central bank decided to modify the mechanism that determines the exchange rate of the yuan versus the US dollar, which led to a devaluation of the currency.
8. In Latin America, growth records for Chile's GDP in the second quarter show some moderation *vis-à-vis* those observed three months ago, with which this economy continues to expand at a slow pace. For its part, the figures for real activity in June suggest some recovery in Peru, although it would have continued exhibiting low dynamism. As for Brazil, the records show that a deepening of the contraction that began last year would be taking place.
9. Inflation data for Latin American economies to July continued showing an uneven performance among countries, but with a predominance of rising trends. Inflation in Chile and Peru increased mainly as a consequence of the depreciation of their currencies. For its part, annual variation of prices in Brazil remains high and with a marked upward trend. In contrast, inflation in Mexico reduced and remained within the target range of its central bank.
10. In terms of international financial markets, an increase in financial volatility indicators was observed mainly as a result of the devaluation of the yuan and the fears of a greater economic slowdown in China. In this context, the US dollar continued to strengthen against the world's major currencies, while long-term bond rates of United States and of the major countries of the euro zone exhibited some reductions.
11. As for Latin America, an increase in risk premia was observed in the first half of August, while the currencies in the region have continued depreciating *vis-à-vis* the US dollar. This behavior has been particularly marked in the Colombian case, where the credit default swaps to 5 years reached the highest levels since 2009. For its part, the Colombian peso depreciated 7.6%, from an average value of COP 2,749 per dollar in July to COP 2,959 per dollar a month later.

### **Exports and Imports**

12. Total exports in US dollars fell 31.5% in June due to the decline in the value of exported goods from mining (-43%) and agriculture (-17.2%). In the first case, the fall is associated to lower exports of oil (-48%) and carbon (-29.2%), to a greater extent. Exports of agricultural goods fell jointly for flowers (-29.6% ), bananas (-26.5%) and coffee (-0.9%).
13. Other exports registered a 4.3% growth rate. Within this group, increases in vehicles (141.5%), rubber and plastics (22.2%), machinery and equipment (35.5%) and chemicals

(3.3%) stand out. By destinations, the increases toward Mexico (106.8%), United States (14.2%) and Chile (40.1%) stand out.

14. During the first semester of the year, total exports recorded a 31.2% fall. Exports of mining goods (-42.3%) and other products (-7.2%) contributed to this drop. Exports of agricultural goods increased by 3.5% in that period. The decrease in exports of mining goods was due to the general decline in goods from this group, with major falls being registered in oil (-45.9%) and refined products (-57.8%). Within the rest of exports, the falls in foods and beverages (-13.9%), paper (-13.9%), beef (-52.8%), and non-metallic minerals (-16.2%) stand out. Exports of agricultural goods grew 3.5% thanks to the 17.3% increase in coffee.

## II. Growth, Domestic Demand and Credit

15. The new data available on the dynamics of economic activity for the second quarter of 2015 allow to maintain the forecast range of GDP growth for this period presented in the previous Inflation Report (between 2.0% and 3.5%, with 2.7% as the most likely figure).
16. According to the data from the monthly retail trade survey (EMCM) by DANE, retail sales excluding fuel expanded 5.2% annually in June, below the expectations by the SGEE (8.6%, without correction for working days). In the April-June quarter, annual growth was 2.5%. This figure reveals a slowdown *vis-à-vis* the records of the first three months of the year, when sales increased at an annual rate of 5.4%. It should be noted that the apparently good performance of retail sales in June was due largely to a low base of comparison for the same month in 2014.
17. Upon discounting vehicle sales, annual growth rates for the remaining aggregate were 5.4% and 4.9% for June and the second quarter, respectively. This segment of retail trade also slowed down versus the register of the first quarter of 2015 (8.1% on a yearly basis). The trend component of the series shows a stagnation that has lasted for several months.
18. For its part, according to the results of the EMCM, vehicle sales recorded an expansion of 4.3% on a yearly basis in June. With this, the aggregate for the second quarter fell 9.1%, as compared to the same period in 2014. This meant a deepening of the fall compared with the registers for the first quarter (-6.7%). It is important to emphasize that the expansion of these sales also took place within the context of a low base of comparison in June last year.
19. An estimate by the technical staff at *Banco de la República* based on the figures provided by the EMCM, suggests that sales of non-durable, semi-durable and durable goods expanded, in this order, 5.6%, 2.5%, and 4.3% on a yearly basis in June. The aggregates of the second quarter for the three cases recorded growth of around 5.9%, 2.3% and -9.1% on a yearly basis, which meant a slowdown compared to the calculation of the first three months of the year, when annual growth rates of 8.1%, 7.3%, and -6.7% were registered, respectively.

20. Other indicators holding a historically high correlation with growth in household consumption also allow to foresee a moderate performance of this component of GDP. According to the balance of sales of the Monthly Survey of Economic Expectations (EMEE) from *Banco de la República*, this series did not register significant variations in June compared with data from May, with which the average for the second quarter registered levels similar to those of the first.
21. Also, the recent labor market indicators suggest that the unemployment rate would have ceased to fall due to a reduction in the number of persons employed. Although salaried employment continues to explain the greater part of the employment generated, it has slowed down.
22. Regarding gross fixed-capital formation, the balance of investment expectations of EMEE to June once more suggests that investment in items other than construction of buildings and civil works could register new slowdowns in the second quarter.
23. On the supply side, the index of industrial production grew by 1.5% in yearly terms in June, a result that was lower than expected (3.5%). However, with this data, during the second quarter and so far this year, manufacturing contracted 1.9% and 2.0%, respectively. Excluding oil refining, the remaining industry grew by 2.8% in June (-0.5% in the quarter and +0.2% so far this year).
24. The sectors continue exhibiting a heterogeneous behavior. While some sectors showed significant growth (beverage manufacturing (6.0%), clothing (8.6%), manufacture of plastic products (8.0%), and manufacturing of other chemical products (8.6%)), others, on the contrary, exhibited significant setbacks. This is the case for coking, oil refining, and fuel mixing (-4.9%), and basic industries of iron and steel (-9.5%). Regarding oil refining, it is estimated that the factory in Cartagena should resume operations by the end of this year, and according to announcements made by *Ecopetrol*, it is expected to be operating fully by March 2016.
25. Other industry indicators for June exhibited improvements. According to a survey by *Fedesarrollo*, the indicator for orders picked up slightly compared to the previous month, while the one for supply reduced. Trend components suggest a slight improvement. On the other hand, expectations of the industrial sector regarding production to three months increased slightly compared to the previous month. Its trend, on the contrary, is descending. As a result of this, the confidence index of manufacturers improved, but its trend component remained flat.
26. As for the construction sector, information for the second quarter suggests a slowdown of the activity and the possibility of its weakening towards the second semester of 2015 and the following year. Although cement production exhibited an annual growth of 4.9% in June, which is above its average since 1993 (3.1%), it registered 4.3% for the second quarter, which implies a slowdown compared to the 7.8% observed between January and March. Something similar happened with cement dispatches, which in June and in the second quarter grew 10.2% and 5.8%, respectively (8.1% in the first three months of the

year). Additionally, although construction licenses reported a 19.5% increase in June, so far this year, the fall is around 9.0% (twelve-month accumulated value: -5.5%).

27. The information for the third quarter of 2015 is still scarce, and does not allow to define a clear trend for economic growth. However, it is important to note that in July 2015 the consumer confidence indicator from *Fedesarrollo* fell significantly as compared to the data from June. With this, the CCI registered below the average for the second quarter and the one calculated since 2001.
28. By disaggregating into its components, falls in the indexes of economic conditions (IEC) and consumer expectations (CEI) are noted. Additionally, purchase intentions of durable goods and vehicles were adjusted downwards, in line with the high levels observed in the nominal exchange rate.
29. In spite of this, the figures for the loan consumption portfolio cast a positive signal on the performance of private consumption. In July, this aggregate expanded 13.7% on a yearly basis, which meant an acceleration with respect to the 12.8% register for the aggregate of the second quarter. Additionally, real interest rates for consumption and credit cards on the margin have fallen.
30. On the supply side, as expected, oil production registered below one million barrels per day (945 mbd) in July due to the impact of attacks on infrastructure. This has led to a monthly contraction of 6.2%, and a yearly contraction of 2.4%. So far this year, production reached 1,012,000 barrels in average, resulting in a 3.4% expansion.
31. Coffee production registered 1,463,000 bags in July, i.e., 18.4% more than in the same month last year. So far this year, the production accumulates 7.7 million bags and an annual growth of 13.8%. This results from the consolidation of the coffee renovation program.
32. Finally, in July, total energy demand increased 2.8% on a yearly basis. The regulated component did so by 3.9%, and the non-regulated one by 2.3%. Total energy demand continued to expand both in level as in trend.
33. Given the above, the growth forecast for all of 2015 remains between 1.8% and 3.4%, with 2.8% as its most likely outcome.

### **III. Behavior of Inflation and Prices**

34. After a pause during May and June, annual consumer inflation picked up slightly in July reaching 4.46% from 4.42% a month ago (**Table 1**). Acceleration of inflation in the last month focused on tradable items excluding food and regulated items, and on regulated items. The monthly variation, for its part, was 0.19%, which is higher than expected by the market (0.12%), but relatively close to that estimated by the Economic Studies Division at *Banco de la República*.
35. Inflation for the year to date reached 3.52% in July, which exceeded the 2.73% record for the same period last year. Seventy-seven point three percent (77.3%) of the increase in

annual inflation since December last year (3.66%) to July is explained by the increase in prices of the tradable component excluding food and regulated items, followed by food prices, whose contribution was of 36.7%, (especially by processed foods), and the CPI for non-tradables excluding food and regulated items, which contributed 22.5%. On the contrary, the CPI for regulated items had a negative contribution (-36,5%) (**Table 1**).

36. It should be noted that inflation of tradables (including food and regulated items) went from 2.27% in December to 4.94% in June, and to 5.27 % in July. For its part, the total price variation of non-tradables that had reached 4.53% in December fell to 4.1%, and to 3.96% in July.

37. In July, the average of the four core inflation indicators increased for the tenth consecutive month, reaching 4.3% and exceeding the records of June and December last year by 13 bp and 121 bp, respectively. This average is the highest since October 2009. All the indicators increased in July compared to June, except for the Core 20 (4.27%). CPI excluding food continues to register the lowest level (3.98%), and it is the only indicator that is still below the ceiling of the inflation target. For its part, CPI without primary food, fuels and utilities rose to 4.64%, presenting the largest register; CPI excluding food and regulated items closed at 4.26% (**Table1**).

**Table 1**

**Inflation to July 2015**

Description	Weighting	DEC	MAR	JUNE	SEPT	DEC	MAR	JUNE	JULY	Participation in monthly acceleration (%)	Participation in acceleration so far this year (%)
		2013	2014	2014	2014	2014	2015	2015	2015		
<b>Total</b>	<b>100.00</b>	<b>1.94</b>	<b>2.51</b>	<b>2.79</b>	<b>2.86</b>	<b>3.66</b>	<b>4.56</b>	<b>4.42</b>	<b>4.46</b>	<b>100.00</b>	<b>100.00</b>
<b>Non-food Inflation</b>	<b>71.79</b>	<b>2.36</b>	<b>2.62</b>	<b>2.66</b>	<b>2.70</b>	<b>3.26</b>	<b>3.46</b>	<b>3.72</b>	<b>3.98</b>	<b>510.12</b>	<b>63.27</b>
Tradables	26.00	1.40	1.65	1.94	1.59	2.03	3.46	4.17	4.69	<b>339.08</b>	77.26
Non-tradables	30.52	3.76	3.55	3.45	3.26	3.38	3.56	3.98	3.95	<b>(31.50)</b>	22.50
Regulated items	15.26	1.05	2.21	2.14	3.25	4.84	3.25	2.55	2.99	<b>202.54</b>	(36.48)
<b>Food Inflation</b>	<b>28.21</b>	<b>0.86</b>	<b>2.23</b>	<b>3.11</b>	<b>3.25</b>	<b>4.69</b>	<b>7.37</b>	<b>6.20</b>	<b>5.67</b>	<b>(410.12)</b>	<b>36.73</b>
Perishables	3.88	(0.16)	3.17	8.92	7.61	16.74	21.57	10.73	7.99	(295.89)	(34.72)
Processed food	16.26	(0.24)	0.92	1.44	2.14	2.54	5.99	6.00	5.71	(127.95)	60.39
Eating out	8.07	3.26	4.13	3.52	3.23	3.51	3.59	4.45	4.51	13.72	11.06
<b>Core Inflation Indicators</b>											
Non-food Inflation		2.36	2.62	2.66	2.70	3.26	3.46	3.72	3.98		
Core 20		2.72	2.86	3.04	2.89	3.42	3.70	4.24	4.20		
CPI excluding perishable foods, fuels and		2.19	2.53	2.53	2.39	2.76	3.95	4.54	4.64		
Inflation excluding foods and regulated items		2.74	2.74	2.81	2.55	2.81	3.52	4.06	4.26		
<b>Average of Core Inflation Indicators</b>		<b>2.51</b>	<b>2.69</b>	<b>2.76</b>	<b>2.63</b>	<b>3.06</b>	<b>3.65</b>	<b>4.14</b>	<b>4.27</b>		

Source: DANE. Calculations by BANCO DE LA REPÚBLICA

38. Within the segment of the CPI excluding food and regulated items, the yearly variation of the tradable component (4.7%) has steadily increased since August last year. This trend was more pronounced in the last month, when an increase of 52 bp was observed in the indicator (**Table1**). Thus, the pass-through of the exchange rate to consumer prices, which had been slow at the end of last year and the beginning of this year, tends to resemble what



was observed in previous years. In this regard, it should be noted that, from July 2014 until July 2015, the exchange rate accumulated a 47.0% increase *vis-à-vis* the dollar, reflecting a 4.7 % adjustment for the same period in the CPI of tradables excluding food and regulated items. The depreciation of the peso *vis-à-vis* the currencies of other countries from which consumer goods are also imported has been lower, for which it should be having a lower inflationary impact.

39. In July, increases in the items of the tradable component of the CPI excluding food and regulated goods were once again widespread. Items such as vehicles, washing machines and air tickets recorded yearly adjustments to this month which exceeded 8.8%.
40. Regarding the CPI of non-tradable items excluding food and regulated items in July, its annual variation did not present significant changes, standing at 3.95%. This level exceeds the one observed last December (3.4%) (**Table1**). In the last month, declines were observed in the subgroup of entertainment, culture and recreation (in soccer tickets) which offset increases in items sensitive to the exchange rate and rentals (with an annual variation that increased 8 bp to 3.35%). Other indexed items maintained their annual variation stable.
41. So far this year, annual variation for the group of regulated goods increased for the second month. This time, it went from 2.6% in June to 3.0% in July (**Table1**). The indicator remains below the registration for December thanks to the reduction in the price of gasoline registered in the first quarter. The rise in the annual variation of regulated goods in the last month is attributable to the annual increase in the rates of public utilities (from 4.4% in June to 5.4% in July) mainly due to the increase in the CPI for gas (11.2% in June to 16.5% in July). Annual variations in fuels remained stable at -5.5%, so as those for transportation at 4.1%.
42. In July, annual food inflation (5.7%) declined as compared to June (6.2%), but remains higher than the record for last December (4.7%). In terms of components, it was observed that processed foods fell from 6.0% in June to 5.7% in July, a behavior explained mainly by the monthly 3.7% fall in the price of rice, thanks to higher supply. Also, perishable goods reduced from 10.7% to 8.0%, a behavior linked to the significant -15.5% decline in the price of potatoes. For its part, eating outside remained stable at 4.5%.
43. The pressures of non-labor costs have been increasing for the past two months, as suggested by the increase in the annual variation of producer prices (PPI) of domestic supply (produced and consumed plus imported items), from 5.0% in June to 6.4% in July. This new increase is associated, above all, with the depreciation of the peso *vis-à-vis* the US dollar in recent months, which propelled the PPI for imported goods from 12.1% in June to 16.9% in July. Also, the local component contributed to a higher inflation to the producer, moving from 3.2% in June to 3.5% in July. In turn, the local segment of the PPI was driven by all its major components: farming and agriculture (6.7% to 7.0%), industry (from 2.6% to 2.9%) and mining (from -3.6% to -3.0%).
44. With information to June and July, wages continued showing adjustments compatible with the inflation target range. Those of construction to July (both housing and heavy

construction) were adjusted to yearly rates of around 4.0%. For its part, those of trade to June did so by 4.2% on a yearly basis, a rate lower than in previous months, according to the sample of retail trade. Those for manufacturing increased at a rate of 7.0%, which represents an important change from the adjustment observed by the end of 2014 (approximately 3.0%). However, in this case, a major change of the manufacturing sample at the beginning of this year prevents splicing and comparing the new results with previous ones.

45. Inflation expectations to December this year obtained from the monthly survey to financial analysts increased significantly between July (3.89%) and August (4.21%), with information to the second week of August. The inflation expectations to twelve months, obtained from the same survey, also rose from 3.11% in July to 3.47% in August. At the same time, on average, inflation expectations embedded in public debt bonds for 2, 3, 5 and 10 years have increased so far in August 64 bp, 64 bp., 52 bp, and 16 bp, respectively, compared to the average data of July. In this way, break-even inflation to 2, 3, 5 and 10 years registered at 3.64%, 3.55%, 3.59% and 4.08%, respectively.