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Working Papers from the Board of Directors Banco de la República

Monetary Policy Report

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Board of Directors

Banco de la República

Monetary Policy Report

Economic Studies Division

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I. External Context and Balance of Payments

1. The most recent data suggest that growth of the country's trading partners would have remained very modest, even more than what was forecast in the July Inflation Report.
2. Growth of the United States in the second quarter was 1.1% a.q., clearly lower than expected by market analysts (2.5% a.q.). However, monthly indicators to July suggest a better performance of GDP during the third quarter of the year. Household consumption has driven growth during this year, and it is expected to continue leading the expansion in the third quarter. The labor market has been dynamic in the past two months, and the unemployment rate remained close to 5.0%.
3. The annual increase of prices in the US has not shown significant changes. Core inflation is still fluctuating around 2.0%, while total inflation remains close to 1.0%, below the Fed's long-term target (2.0%).
4. In this context, the FOMC has opened the door to an increase of the benchmark interest rates at its September meeting. However, to date the market estimates a 36.0% probability for this event. To December 2017, the accumulated probability is close to 83.0%.
5. In the euro zone, GDP grew 0.3% quarterly during the second quarter, a lower rate than the one observed three months before, but in line with expectations. The surveys of the manufacturing sector remain with a positive balance.
6. In July, the indicator for total yearly inflation exhibited a slight increase and stood at 0.2%, while core inflation remained at 0.9%. With this, the European Central Bank (ECB) maintained a highly expansive monetary policy.
7. In China, a continuous decline in the growth of fixed-asset investment has been observed again since April. Although moderation in investment is expected within the context of transition to the new model of economic growth based on household consumption, a very rapid deceleration of this component can generate risks for growth in that country.
8. In Latin America, GDP figures available for the second quarter for Chile, Mexico and Peru show an annual growth below the level of the previous quarter.

In Brazil, the index of economic activity suggests that deterioration of real activity might be at its lowest. Although there are no recent figures, Ecuador and Venezuela are expected to continue with negative output growth rates.

9. So far this year, inflation in some Latin American countries has fallen. In Peru, Mexico and Chile it is already within their target ranges.

10. In the meantime, the exchange rates of the region remained relatively stable in July and August. In this period, the Colombian peso depreciated after the news of the downgrade in the country's credit rating outlook, but some days later it returned to its previous levels.

11. In August, volatility of the financial markets remained low, as did the interest rates of bonds from developed economies and the CDS from Latin America. Meanwhile, stock indexes exhibited an upward trend during this period.

12. In July, the indicator for Colombia's terms of trade continued to recover, reaching levels higher than those observed at the beginning of the year, although lower than the ones for the same period last year.

13. So far in August, the price of oil has exhibited an upward trend. Recent increases would be associated with the expectation of a supply reduction by the OPEC. However, recent news about Libya could suggest that some production cuts would be coming to an end. Additionally, inventory levels remain high; therefore, an increasing trend (if there were one) would not be expected to be very clear.

14. On the other hand, the prices of other products exported by the country such as coal, coffee, and nickel remained stable so far in August after the rises in June and July. As for raw materials imported by the country, the prices of soy and wheat recovered in August following the falls of July, while corn remains at low levels.

Exports and Imports

15. In June, exports registered a yearly fall of 15.4% due to setbacks in external sales of mining goods (-20.5%) and the group of other exports (-19.2%). To date, exports have registered a 25.8% decrease, mainly as a result of sales of mining goods (**Table 1**).

16. So far this year, the price index for total exports registered a significant yearly fall (-23.3%), while the volume index fell moderately (-3.5%). This would signal that the value of exports continues falling, primarily as a result of the reductions in the prices of exported products, from which the most significant are mining products (whose price index has fallen 30.0% on a yearly basis in the accumulated value p to June).

17. According to the foreign trade preview by DIAN, exports excluding oil fell 32.4% on a yearly basis in July.

18. In June, CIF imports recorded an annual 12.7% fall due to setbacks in external purchases in all groups, with that of capital goods as the most important (-21.8%). So far this year, imports have fallen 20.9% (**Table 2**).

19. In the period from January to June, the price index for total imports recorded a significant fall (14.5%), while the volume index fell 7.4%. This would suggest that imports fall due to a combined effect of the reduction in prices and quantities, although the former continues to be more important.

20. According to the foreign trade preview by DIAN, CIF imports in July recorded a 33.9% yearly fall.

Table 1 Behavior of Exports in US dollars

June 2016			
	Annual Variation	**Main contributing items:**	
		Item	**Annual variation of the item**
Total	-15.4%		
Agricultural goods	26.5%	Banana	70.3%
		Flowers	21.2%
Mining goods	-20.5%	Oil	-33.9%
		Gold	-35.0%
Other exports*	-19.2%	Vehicles and other means of transportation	-69.3%
		Chemical products	-15.3%
Accumulated value for January-June 2016			
Total	-25.8%		
Agricultural goods	-2.3%	Coffee	-11.9%
Mining goods	-37.3%	Oil	-50.6%
		Coal	-18.7%
Other exports*	-11.8%	Chemical products	-16.3%
		Others	-17.5%

* By destinations, the falls toward Venezuela (59.6%) and to Ecuador (43.3%) stand out. Contrastingly, external sales of this item towards the United States (13.3%) and the European Union (6.5%) increased. Source: DANE

Table 2 Behavior of Imports in US dollars

June 2016			
	Annual Variation	Main contributing items:	
		Item	Annual variation of the item
Total	-12.7%		
Capital Goods	-21.8%	Transportation equipment	-54.4%
		Other fixed equipment (for industry)	-24.2%
Raw materials	-10.3%	Fuels	-15.4%
		Mining Products (for industry)	-14.4%
Consumer Goods	-3.2%	Vehicles for private use	-15.4%
		Clothing and other textiles	-28.8%
Accumulated Value for January-June 2016			
Total	-20.9%		
Capital Goods	-31.5%	Transport equipment	-65.6%
		Industrial machinery	-24.6%
Raw materials	-14.9%	Fuels	-23.7%
		Mining Products (for industry)	-21.3%
Consumer Goods	-16.0%	Vehicles for private use	-26.8%
		Clothing and other textiles	-27.1%

Source: DANE

II. Growth, Domestic Demand and Credit

21. According to the most recent publication of quarterly national accounts by DANE, economic activity grew 2.0% during the second quarter, compared to the same period of 2015. This figure stood below the central forecast presented in the previous Inflation Report (2.6%), and was ranked in the lower limit of the forecast range (between 2.0% and 3.2%). The increase between quarters was 0.2%, which corresponds to an annualized rate of 0.8%. In line with this, Real Activity Index (ISE) recorded a 1.0% growth for the aggregate of the April-June quarter.

22. Per branch of activity, the sectors that grew most were those of industry and financial services. Three of the largest branches recorded a yearly contraction:

mining, utilities (electricity, gas and water), and agriculture (**Table 3**). Annual variations for the non-tradable and tradable sectors were 2.8% and 0.7%, respectively. The tradable GDP excluding mining grew 2.7% on a yearly basis.

Real annual GDP growth per economic activity

Branch of activity	2015 1st Q	2015 2nd Q	2015 3rd Q	2015 4th Q	2015 Whole Year	2016 1st Q	2016 2nd Q
Farming, forestry, hunting and fishing	2.2	2.4	3.0	5.8	3.3	0.7	**(0.1)**
Mining and quarrying	0.4	4.2	(0.5)	(1.5)	0.6	(4.6)	**(7.1)**
Manufacturing	(2.0)	(0.1)	3.2	3.9	1.2	5.3	**6.0**
Electricity, gas and water	2.5	1.6	3.8	3.8	2.9	2.9	**(0.8)**
Construction	3.1	8.1	0.2	4.6	3.9	5.2	**1.0**
Buildings	1.4	9.0	(7.9)	7.1	2.1	10.9	**2.8**
Civil works	4.7	6.5	7.1	3.2	5.4	0.4	**(0.4)**
Retail, repairs, restaurants and hotels	4.6	3.5	4.7	3.8	4.1	2.7	**1.4**
Transportation, warehousing and communications	2.6	0.4	2.2	0.7	1.4	1.8	**0.1**
Financial, real estate and corporate services	4.8	3.8	4.2	4.3	4.3	3.8	**4.6**
Social, community and personal services	2.4	2.5	3.4	3.5	2.9	1.7	**2.3**
Subtotal value added	2.5	2.9	3.0	3.4	3.0	2.5	**1.9**
Taxes minus subsidies	4.1	4.0	4.6	3.4	4.0	2.3	**2.8**
GROSS DOMESTIC PRODUCT	**2.7**	**3.1**	**3.1**	**3.4**	**3.1**	**2.5**	**2.0**

Source: DANE, calculations by *Banco de la República*

Table 3 GDP on the supply side

23. In this context, the short-term indicators for retail and the survey of expectations by the Central Bank also accounted for the slowdown in some components of expenditure during the second quarter of the year, in spite of having had a greater number of working days (two) versus the same period of 2015.

24. The figures to June of the monthly survey of retail (EMCM) by DANE revealed an annual contraction of 0.7%. This figure was below the expectations of the technical staff at the Central Bank. With this, the aggregate for the second quarter expanded 1.2% compared to the same period of 2015, slowing down as compared to that in the first quarter (1.5%).

25. Excluding vehicle sales from the figures of retail, the remaining aggregate expanded 0.4% compared to the same month in 2015. The one for the second quarter grew 1.9% on a yearly basis, which also meant a slowdown compared to 3.5% in the first quarter of 2016.

26. On the other hand, the index for motor vehicle sales from the same survey posted again an annual drop. In June, the contraction was 6.8% compared to the same month last year, and for the aggregate of the quarter it was -2.6% (vs. -9.3% registered in the first).

27. Other auxiliary indicators confirm these results. The results of the Monthly Survey of Economic Expectations (EMEE) by the Central Bank show that in June 2016 the balance of sales fell slightly compared to the records of previous months. This suggests a slowdown in private consumption during the second quarter.

28. Regarding investment excluding construction of buildings and civil works, data of imports of capital goods (in real terms) as well as the balance of investment expectations of the survey to June suggest a contraction of this item in the second quarter of 2016, although lesser than the one recorded in the first.

29. The unemployment rate to June shows few increments, even discounting the seasonal effect, and reversed the increases shown at the beginning of the year (particularly in the 13 major cities). This change in trend is explained by a drop of labor supply in recent months. Although employment is stagnant, salaried employees continue to grow annually at rates close to 3.0%.

30. Although information for the third quarter is still preliminary, some indicators suggest that the low dynamism of GDP could continue. The Consumer Confidence Index in July recorded a deterioration compared to the records of June and the second quarter, mainly due to a decline in the Index of Economic Conditions (ICE) for households, while medium and long-term consumer expectations (IEC) showed no significant changes.

31. Similarly, as reported by the Colombian Automotive Committee (ANDI, *Fenalco*, and *Econometría*), a yearly 34.1% contraction was observed in July, a figure much higher than the annual fall of 9.7% registered in the second quarter. By segments, the declines took place both in vehicles for private use (-33.6%), as well as in those for commercial use (-34.7%).

32. On the supply side, the indicators available point at a low dynamism of real activity. According to *Fedesarrollo's* survey to consumers, in July, retailers were less optimistic facing the current situation and prospects.

33. In July, oil production fell below 1 million daily barrels for the tenth consecutive month (843 mdb), which implied a 10.8% contraction on a yearly basis (-5.1% monthly).

34. Total energy demand fell 3.2% annually in July, both for regulated (-0.7%) as for non-regulated (-4.9%). The trend was also reduced.

35. According to the figures of the Federation of Coffee Growers, coffee production stood at 1,102,000 sixty-kg bags in July, which represents a yearly 24.7% contraction. So far this year, this sector has fallen 0.9%.

36. On the contrary, in July, the indicators of *Fedesarrollo's* survey to consumers for orders and stock levels for the industry remained at favorable levels, and production expectations for the next three months increased slightly. This last indicator maintains a positive trend, (although the high volatility during this last year should be noted). With this, the confidence of the industry improved slightly, and its trend shows a positive slope.

III. Behavior of Inflation and Prices

37. Yearly headline inflation in July stood at 8.97%, a level 37 bp higher than the previous month (**Table 4**). Accumulated inflation so far this year closed at 5.65%, above the figure of 3.52% registered in the same period of 2015. Monthly variation stood at 0.52%, a figure that exceeded the forecasts of the market (0.32%) as well as those of the technical staff at the Central Bank.

Headline and Core Inflation - July 2016

Description	Weight	Dec 2015	Mar 2016	Jun 2016	Jul 2016	Participation percentage in monthly acceleration	Participation percentage in acceleration of the year to-date
Headline inflation	**100.00**	**6.77**	**7.98**	**8.60**	**8.97**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.17**	**6.20**	**6.31**	**6.26**	**(9.28)**	**34.62**
Tradables	26.00	7.09	7.38	7.90	7.87	**(0.90)**	8.46
Non-tradables	30.52	4.21	4.83	4.97	5.01	**3.52**	11.34
Regulated items	15.26	4.28	7.24	6.71	6.40	**(11.90)**	14.82
Food inflation	**28.21**	**10.85**	**12.35**	**14.28**	**15.71**	**109.28**	**65.38**
Perishables	3.88	26.03	27.09	34.94	39.27	48.86	28.04
Processed food	16.26	9.62	10.83	12.09	13.33	51.14	27.09
Eating out	8.07	5.95	7.53	8.11	8.50	9.29	10.24
Core inflation indicators							
Non-food inflation		5.17	6.20	6.31	6.26		
Core 20		5.22	6.48	6.82	7.03		
CPI excluding perishable foods, fuel and utilities		5.93	6.57	6.77	6.92		
CPI excluding food and regulated items		5.42	5.91	6.20	6.22		
Average of core inflation indicators		**5.43**	**6.29**	**6.52**	**6.61**		

Source: DANE. Calculations by *Banco de la República*.

Table 4

38. The increase in annual inflation in July was largely explained by the rise in food prices, both perishable and processed. Within the CPI excluding food, only the non-tradable sector contributed marginally to the increase. Contrastingly, the prices of regulated and tradable items generated downward pressure on inflation (very mild in the latter case).

39. Core inflation, measured by the average of the four indicators monitored by the Central Bank, increased from 6.52% in June to 6.61% in July. Both Core 20 (with the highest level, 7.03%) and the CPI excluding perishable food items, fuels, and public utilities (6.92%) increased. The CPI excluding food and regulated items, with the lowest level, remained stable at 6.22%, while the CPI excluding food was reduced (6.26%).

40. Within the CPI excluding food and regulated items, the non-tradable component rose slightly (4.97% in June to 5.01% in July). In this case, the main upward pressure took place in the CPI for entertainment, culture and recreation. The CPI for leases, on the contrary, decreased somewhat, standing at 4.12% in August. Something similar happened with items that are usually highly indexed and with those most affected by the exchange rate.

41. In August, the CPI for regulated items fell 31 bp to 6.40%. This was possible thanks to a lower adjustment in the subgroup of public utilities (which rose from 12.5% annually in June to 11.9% in July). The fees for electric energy could be favored by the end of *El Niño* and its implications in terms of the recovery of the levels of the reservoirs, the fall in energy prices on the stock exchange, and the lower generation of thermal energy (especially with gas), which is more expensive than hydroelectric energy. The CPI for water and sewage was the only one that increased strongly (from 7.76% in June to 9.32% in July). The new fees framework for this utility involves, for the majority of cities, a surcharge for the greater investment by the sector in the coming months. The annual adjustment of the CPI for fuels dropped from -3.63% to -5.16%, while transport increased from 4.56% to 4.97%.

42. In the past three months, annual variation in the CPI for the group of tradables excluding food and regulated items has remained relatively stable around 7.9%. Apparently, in recent months the pass-through of the depreciation of the peso seems to have receded somewhat, which could be explained because a good part of it has already taken place and/or by the appreciation and greater stability of the currency since February.

43. Regarding the CPI for food, its yearly variation rose from 14.28% in June to 15.71% in July, a figure higher than expected by the technical staff at the Central Bank and by the market. The inflationary pressures for this group were divided similarly between processed and perishable goods.

44. Processed items, whose variation increased to 13.33% in July, were driven by the price of beef (from 18.7% to 24.4%). The increasing dynamics in the price of this item are associated with the past event of *El Niño*, which impacted livestock productivity negatively, and with the continuation of the cattle retention phase (less slaughter). According to the guild of the sector, this retention phase would continue for a few more months.

45. On the other hand, the annual CPI for perishable items went from 34.9% in June to 39.3% in July, driven by increases in potato, carrot, and banana, among others. Apparently, the trucking strike, which ran from June 6 to July 22, reduced the supply more than in similar episodes in the past, particularly that of perishable items.

46. It is important to note that on previous occasions, once the flow of cargo has normalized, food prices tend to lower quickly, returning to the levels prior to the strike. The most recent information by Sipsa confirms this downward behavior.

47. The upward pressures of non-labor costs moderated in August. Yearly variation of the PPI for domestic supply (domestically produced and consumed items plus imported goods) lowered from 9.64% in June to 8.38% in July. This fall is explained by the PPI for imported items (whose annual adjustment was of 5.81% in July compared to 9.99% in June), while the PPI variation of goods produced and consumed locally remained relatively stable (around 9.5%).

48. Regarding labor costs, with information to June, wage adjustments for industry and retail trended downwards, reaching somewhat below the increases in the minimum wage and inflation to December last year (6.3% and 5.8%, respectively). In heavy construction (4.1%) and housing (4.3%), wage adjustments to July showed no significant changes.

49. Inflation expectations to December 2016, from the monthly survey to financial analysts at the beginning of August rose from 6.53% in July to 6.77% in August. Those to 12 months (4.55%) and 24 months (3.72%) remained relatively stable. On the other hand, inflation expectations embedded in TES in pesos and UVR (Breakeven Inflation) on average to 26 August decreased relative to July, 9, 13

and 17 bp for 2, 3 and 5 year terms, respectively, posting at 4.37%, 4.10%, and 3.83%.