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Working Papers from the

Board of Directors

Banco de la República

Monetary Policy Report

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Economic Studies Division

JANUARY

2016

I. External Context and Balance of Payments

1. According to the data available to February 17, the turbulence in international financial markets that started in January continued this month, which has led the indicators of financial volatility to remain high, as well as to further declines in global stock indexes. On this occasion, the bonds from banks were hit most strongly by the prospect that their profits could be affected by low interest rates (even negative) in advanced economies and by their exposure to the energy sector. Additionally, regulatory changes in the euro zone raised some fears about the financial stability of the region.

2. The rates of long-term sovereign bonds in the United States fell significantly, which suggests that the agents would be expecting that the normalization of the monetary policy by the Federal Reserve (Fed) will be much slower than projected by the members of the Federal Open Market Committee (FOMC) in its meeting of December, in addition to an increased risk aversion in the market. Additionally, there were falls in bond yields from Germany and France, while countries in the periphery of the euro zone showed increases.

3. In this environment, risk premia for Latin America have continued to increase during February, and for the majority of countries they have reached the highest levels since 2009. The region's currencies weakened further *vis-à-vis* the US dollar. The Colombian peso depreciated 2.7%, moving from an average value of COP $3,288 per dollar in January to COP $3,376 per dollar to February 17.

4. The information available on the international prices of commodities suggests that Colombia's terms of trade would have remained at their lowest since 2003.

5. The price of Brent oil rose slightly, moving from an average of USD $32 per barrel in January to USD $33.30 per barrel to February 17, although it has exhibited much volatility during the month. These low prices are explained because there are still prospects of a lasting excess supply, despite the announcements made by some countries about not expanding their production in the future. Additionally, global demand continues to show signs of weakness and there is still a high amount of global oil inventories.

6. The prices of nickel and other metals of industrial use exported by some countries of the region remained low compared to observations from previous years, as a result of the prospects of moderation in global demand. By contrast, the prices of precious metals, particularly gold, exhibited strong increases associated with a greater risk aversion in international financial markets. The

international price of coffee did not show significant changes and remained at levels lower than those observed in the same period of 2015.

7. The most recent records of economic activity confirm the low growth of Colombia's main trading partners in 2015 compared to previous years, also suggesting that this rate would continue so far in 2016.

8. In the United States, GDP figures for the fourth quarter of 2015 show a slowdown of economic growth (from 2.0% annualized quarter in the third quarter to 0.8% in the fourth). This responds to moderation in the majority of the components of demand, especially in non-residential investment and exports. Thus, expansion for all 2015 was 2.4%, which is slightly below the level expected by the technical staff from *Banco de la República* (2.5%) in its December report.

9. The figures of real activity available for January show a mixed picture for the US economy. On the one hand, expansion of retail sales and consumer confidence remained favorable, suggesting that private consumption continues to consolidate as the main growth engine. By contrast, industrial surveys suggest that manufacturing would continue contracting, and that the rate of expansion for services would have moderated. As for the labor market, employment creation records in January were favorable, despite the fact that they moderated versus observations from previous months. Thanks to this, the unemployment rate fell to 4.9%, reaching a level close to that which analysts and members of the Fed consider to be long term.

10. Although there are no records for January, inflation is expected to remain low thanks to lower fuel prices.

11. In the euro zone, GDP growth for the fourth quarter was the same as that observed three months ago (0.3% quarterly), indicating that the economy of the region continues recovering slowly. Thus, expansion for all 2015 was 1.5%, as expected. On the other hand, the indicators of real activity and confidence available for January suggest that this trend would continue in the first part of the year. Regarding variation in prices, the indicators of yearly total inflation and core inflation did not exhibit significant changes in January, continuing at low levels (0.4% and 1.0%, respectively).

12. In China, the figures available for January suggest that industrial production would have continued slowing down, while expansion of the service sector would have stabilized at favorable rates. Yearly inflation remained low (1.8%).

13. In Latin America, the figures of real activity available to December exhibit a mixed behavior. In the case of Peru, an important recovery was observed compared to observations from previous months, driven mainly by the high expansion of the mining and fishing sectors. In contrast, the Chilean economy would have maintained a very low dynamism compared to the observations from previous years.

14. Inflation records in Latin American economies to January show prevalence of increasing trends. In Chile and Peru, inflation continued above the target range of their monetary authorities and further increases were observed, which, in the case of Peru, led to a new increase of its benchmark rate. In Brazil, inflation remains high and with a marked upward trend. Contrastingly, although Mexico exhibited a slight increase in its yearly variation in prices, inflation remains below the target of its Central Bank (3.0%). Despite this, the Bank increased its benchmark interest rate by 50 bp in February, anticipating future inflationary outbreaks.

15. On February 16, Standard & Poor's (S&P) revised the prospects of Colombia's long-term sovereign debt from “stable” to “negative.” This decision was reached considering the decline in the forecasts for oil prices, which generates risks of further deterioration of the country’s foreign position, public finances, and growth, particularly if the government does not take the required fiscal measures on time.

a. Exports and Imports

16. In December, exports registered an annual fall of 32.5%, due to setbacks in the external sales of all groups of goods. In 2015, total exports declined 35.1%, with an important decrease in those of mining goods (**Table 1**).

Table 1: Behavior of exports in US dollars

December 2015			
	Annual Variation	**Main items that contributed**	
		Item	**Annual variation of the item**
Total	-32.5%.		
Agricultural goods	-8.8%.	Coffee Bananas	-11.1%. -13.8%.
Mining goods	-46.5%.	Oil	-54.6%.

		Coal	-57.7%.
Other exports*	-9.2%.	Leather manufacturing Others	-43.5%. -26.3%.
Accumulated Value for January-December 2015			
Total	-35.1%.		
Agricultural goods	-1.20%.	Flowers Bananas	-5.7%. -3.9%.
Mining goods	-46.80%.	Oil Coal	-50.7%. -33.0%.
Other exports*	-11.6%.	Food and Beverages Chemical products	-14.5%. -7.7%.

* By destinations, the falls toward Venezuela (58.2%) and to Ecuador (37.3%) stand out. Contrastingly, external sales of this item towards the United States (12.4%) and the European Union (38.3%) increased.
Source: DANE

17. On the other hand, according to the preliminary report on foreign trade by DIAN, regarding imports, in December 2015 the total recorded an annual 25.4% fall, while in January of 2016 it would have contracted 34.3% annually.

II. Growth, Domestic and Credit

18. The most recent information available for the fourth quarter of 2015 allows to maintain the mid-point and the forecast range for GDP growth presented in the previous Inflation Report (i.e., 3.1%, between 2.6% and 3.6%, respectively).

19. With information to November, the Real Activity Index (ISE) increased 3.2%, a figure similar to that of October (3.3%), and somewhat above the aggregate for the third quarter (3.0%). Should this dynamics continue in December, the Colombian economy would have expanded in the fourth quarter at a pace similar to that recorded in the third quarter.

20. On the other hand, according to figures from the monthly retail survey (EMCM) published by DANE, in December retail sales excepting fuel expanded 0.1% annually. With this, the aggregate of the fourth quarter fell 0.4% compared to the same period of 2014, which is significantly lower than the 4.7% expansion observed for the third quarter.

21. Excluding vehicle sales, the yearly growth rates of retail were 4.2% and 4.9% for December and the fourth quarter of 2015, respectively. The trend component of this indicator suggests stagnation compared to the observations from recent months.

22. According to the same survey, sales of vehicles and motorcycles fell 21.8% yearly in December (-24.2% for the aggregate of the fourth quarter). It should be noted that there is a high base of comparison for the same period of 2014, since the 14th edition of the *Salón del Automóvil* took place in Bogotá that month. In addition to the base effect, the trend component of this series suggests a weak momentum for this item of retail sales.

23. With information to December, labor market indicators suggest a future slowdown in the pace of private consumption growth. The seasonally adjusted unemployment rate has stopped falling and would be starting to rise slowly. Although the figures for employment showed some recovery led by the behavior of the group of salaried employees, this was not enough to reduce the unemployment rate in the last three months.

24. On the supply side, the indicators available suggest an uneven performance. Among the favorable news, those related with the industry stand out, while trade, as already mentioned, has decelerated significantly.

25. The Index of Industrial Production (IIP) grew 3.9% annually in December. During the period of October-December 2015, yearly growth rate was 3.6%, which meant an acceleration compared to the third quarter (1.8%). This is largely explained by the reopening of Reficar, which generated an 8.1% increase in the subgroup of oil-refining during the fourth quarter (13.1% in December).

26. Thus, for 2015, the industry reached an annual growth of 0.9%. Excluding oil refining, the remaining manufacturing sector grew 2.1%, 2.5% and 1.5% in December, in the fourth quarter and in 2015, respectively. Although there has been a slowdown in the past four months, the trend component continues to show a positive slope.

27. Regarding construction, cement production grew 7.2% in December, with which the fourth quarter showed acceleration versus the third (rising from 5.3% to 7.8%). Something similar happened with cement shipments, which expanded 12.5% in December and 7.2% in the fourth quarter of 2015. Construction

licenses also increased significantly in December (53.5%). However, given the volatility of the indicator, the accumulated value to twelve months was also examined, which grew 5.1%.

28. With this, the technical staff reaffirms its forecast range for economic growth for 2015 between 2.8% and 3.2%, with 3.0% as the most likely figure.

29. The information available for the first quarter of 2016 is still scarce, but it allows to anticipate a slowdown in the pace of growth of the economy. This is inferred from the results observed for retail vehicle sales, the behavior of consumer confidence, the dynamics of household credit, and interest rates.

30. Indeed, the series of retail sales published by the Colombian Motor Vehicle Association (ANDEMOS) recorded a yearly fall of 21.1% in January. These falls took place both in vehicles for private use (durable consumption) as in those destined to commercial use (investment in transport equipment).

31. Regarding the Consumer Confidence Index (CCI) published by *Fedesarrollo*, in January, the level of the series plummeted *vis-à-vis* the records of previous months, reaching the minimum value since April 2002. This time, the setback in the CCI focused on two items, current economic conditions and expectations. This could be related to the perception of households on the widespread increase in prices, the depreciation of the peso, and the possible enforcement of a tax reform in 2016, among others.

32. This situation was reflected by the fall of purchase intentions for housing, vehicles and durable goods, series that reached historical lows. Similarly, it should also be noted that the future perception of the labor market and the cost of credit have deteriorated. The decline in confidence was widespread in the cities of the sample (Bogotá, Medellín, Cali, Barranquilla and Bucaramanga), as well as in all socio-economic levels.

33. Additionally, with figures to January, the expansion pace for household credit was 12.7% in nominal terms, a figure similar to that recorded in December, but which reveals a slowdown versus the observations throughout 2015. In real terms, the evidence of a slower pace of growth in this area is more compelling. Given the correlation of this aggregate with private consumption, should this trend continue in February and March, there would be a lesser dynamism of expenditure in consumption by households during the first quarter of 2016. Meanwhile, real interest rates on consumer credits (excluding credit cards) began to increase.

34. On the supply side, the few indicators available with information to January suggest a slower pace of growth. Although coffee production maintains levels above one-million bags (1,136,000 bags), its annual growth was 4.4%, a significant slowdown explained by a high base of comparison. On its part, oil production stood at 982 mdb, which meant a yearly contraction of 5.1% (-1.1% monthly). This was due to technical maintenance in the fields at Rubiales, Quifa and Piedemonte, as well as pumping limitations caused by maintenance on the pipeline *Caño Limón Coveñas*.

35. Lastly, total energy demand grew at an annual rate of 5.2% in January. The regulated component grew 7.0%, and the non-regulated one grew at a yearly rate of 3.3%. The Caribbean region (8.9%) and Tolima-Huila-Caquetá (12.7%) are the regions with greatest increase in energy demand by households, a phenomenon associated with weather.

36. Given that the information is still very scarce, this Report maintains the forecast range for GDP growth for 2016, which shows a downward bias. Growth would post between 1.5% and 3.2%, with 2.7% as the most likely figure.

III. Behavior of Inflation and Prices

37. In January, annual consumer inflation stood at 7.45%, increasing significantly *vis-à-vis* the figure of the previous month (6.77%), and significantly above the forecasts of both market analysts and the technical staff at *Banco de la República* (**Table 2**). In terms of monthly variations, the result was 1.29% versus 0.81% foreseen by the market. The figure for yearly inflation in January is the highest since December 2008.

Chart 2

Inflation to January 2016

Description	Weight	Dec 2014	Mar 2015	June 2015	Oct 2015	Nov 2015	Dec 2015	Jan 2016	Participation in monthly acceleration (%)
Total	**100.00**	**3.66**	**4.56**	**4.42**	**5.89**	**6.39**	**6.77**	**7.45**	**100.00**
Non-food Inflation	**71.79**	**3.26**	**3.46**	**3.72**	**4.75**	**5.05**	**5.17**	**5.54**	**37.24**
Tradables	26.00	2.03	3.46	4.17	6.42	6.92	7.09	7.39	**9.45**
Non-tradables	30.52	3.38	3.56	3.98	4.34	4.39	4.21	4.46	**10.87**
Regulated items	15.26	4.84	3.25	2.55	3.14	3.66	4.28	5.02	**16.92**
Food Inflation	**28.21**	**4.69**	**7.37**	**6.20**	**8.80**	**9.81**	**10.85**	**12.26**	**62.76**
Perishables	3.88	16.74	21.57	10.73	21.54	23.31	26.03	31.31	36.85
Processed food	16.26	2.54	5.99	6.00	7.39	8.56	9.62	10.22	15.04
Eating out	8.07	3.51	3.59	4.45	5.28	5.67	5.95	6.78	10.87
Core Inflation Indicators									
Non-food Inflation		3.26	3.46	3.72	4.75	5.05	5.17	5.54	
Core 20		3.42	3.70	4.24	4.94	5.23	5.22	5.56	
CPI excluding perishable foods, fuels and utilities		2.76	3.95	4.54	5.54	5.85	5.93	6.13	
Inflation excluding foods and regulated items		2.81	3.52	4.06	5.21	5.45	5.42	5.69	
Average of Core Inflation Indicators		**3.06**	**3.65**	**4.14**	**5.11**	**5.40**	**5.43**	**5.73**	

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

38. The increase in inflation last month resulted, above all, from a sharp rise in food prices, especially those of perishable goods, but also of processed goods and meals outside the household. Additionally, a significant acceleration of the yearly variation of the CPI excluding food was observed in its main subgroups (**Table 2**).

39. As has been happening for several months, consumer prices continued to be pressured upwards on account of the climate shock associated to *El Niño* as well as by the accumulated depreciation of the peso. Additionally, as expected, the triggering of automatic indexation mechanisms linked to the inflation observed at the end of last year began to translate into increasing readjustments for several consumer goods in the first month of 2016.

40. Core inflation, measured by the average of the four indicators monitored by the Central Bank, has also increased, reaching 5.73% compared to 5.43% in December. The four indicators exhibited significant increases, from which the highest record was that of CPI excluding primary food items, fuels and public utilities (6.15%), and the lowest that of the CPI excluding food (5.54%). The latter, however, increased considerably in January (37 bp).

41. Within the CPI excluding food, increases were widespread. As for regulated items, its annual variation rose from 4.3% in December to 5.0% in January. As in previous months, the upward pressures came mainly from the rates for household gas and electric power. These prices are still affected by factors such as the lack of rainfall, depreciation, the increase in producer inflation, and the

bottlenecks in production and transport (especially for gas). The price of gasoline, on the contrary, continues to exert downward pressures, given that the fall in international prices has more than offset the increase in the exchange rate.

42. Increases were also significant in the group of tradables of the CPI excluding food and regulated items. In January, the annual variation of this subgroup was 7.39%, which meant a 30 bp increase compared with the data from the previous month. The accumulated depreciation continues pressuring these prices upwards, although until now it cannot be stated that the degree of pass-through is higher than expected.

43. As for the CPI for non-tradables excluding food and regulated items, annual variation in January (4.46%) increased *vis-à-vis* the data from December (4.21%). As has been explained in previous reports, the accumulated depreciation continued exerting upward pressures through services such as car insurance or TV and video services, for example. Additionally, this month it became more evident that some prices for services (health, rent and others) might be adjusting to increasing rates, because they take the inflation record for December of the immediately preceding year and/or the increase in the minimum wage as reference. Anyway, to January, indexation is far from being complete and the annual variation in prices for most items in this subgroup was below the inflation for December (6.77%). However, in order to obtain a better picture, it will be necessary to wait for the results from the next two months, a period after which it is reasonable to expect that a significant percentage of companies will have adjusted their prices.

44. Non-labor costs continued pressuring consumer prices upwards, as suggested by the behavior of the PPI. In January, yearly inflation to producers of domestic supply (produced and consumed plus imported) reached 10.0% versus 9.6% in December. This increase is explained by the pressures exerted by locally produced and consumed items, whose yearly variation increased from 6.0% in December to 6.9% in January. On the contrary, the variation of the imported component fell compared to that of the previous month (moving from 18.0% to 17.3%), as a result of the decreasing trend of the annual depreciation rate, despite the fact that the level of the exchange rate increased.

45. Regarding labor costs, with information to January, the salary adjustments of construction increased *vis-à-vis* the previous month (from 3.7% to 4.6% for heavy construction, and from 4.2% to 4.7% for housing). By contrast, with

information to December, the salary adjustments in the retail sector lowered from 3.5% to 2.9%.

46. Inflation expectations for December 2016, obtained from the monthly survey to financial analysts collected at the beginning of February, stood at 5.49% (4.83% in the January survey); inflation expected to twelve and twenty-four months exhibited no significant changes (increasing from 4.50% to 4.54%, and from 3.68% to 3.70%, respectively). On average, so far to February 16, with average data from January, inflation expectations (Break-even Inflation, BEI) embedded in sovereign bonds in pesos and RVU remained stable for all terms (2, 3, 5, and 10 years). Thus, the average BEI so far in February to 2, 3, 5 and 10 years posted at 4.89%, 4.71%, 4.65%, and 4.93%, respectively.