



**BANCO DE LA REPÚBLICA  
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. External Context, Exports and Imports**

1. The pace of growth in the global economy during the second quarter of 2014 was moderate, but probably more than the rate observed in the first quarter.
2. In the United States, the first-quarter GDP figure showed a sizeable drop as a result of all investment components being weaker, together with fewer exports and a reduced amount of government spending. The increase in consumption also was less than in the final quarter of 2013.
3. Even so, the second-quarter figures suggest an important surge in growth during this period. Industrial production and retail sales posted quarterly and annual increases in this sense.
4. In fact, according to the first estimate for the second quarter of 2014, annualized quarterly growth (a.q.) in the United States was 4.0% during this period, largely because of positive investment performance (residential and non-residential). Household consumption also performed well, with an a.q. increase of 2.5%. Although net foreign trade took away from growth, it does show a strong increase in both exports and imports.
5. As for the job market in the United States, the downward trend in the unemployment rate persists, thanks to more jobs being created in the economy. At the same time, other indicators such as the underemployment rate or the average duration of unemployment, continue to show improvement, but are still a long way from their pre-crisis levels.
6. In the euro area, economic activity during the first quarter continued to recover at a slow pace. With the June figures, indicators of sentiment in the manufacturing and service sectors remained in expansionary terrain, while business and consumer confidence rates again showed a positive trend. Even so, retail sales and industrial production still exhibit extremely moderate growth rates. The contrast between the good performance figures for Germany and the poor data from France is noteworthy.
7. In the case of China, GDP growth accelerated slightly during the second quarter, posting an annual increase of 7.5%, partly due to expansionary fiscal and monetary policies aimed at specific sectors of the economy. On the other hand, the figures for industrial production and sales stabilized.

8. In contrast, the first-quarter figures for real activity in Latin America suggest the economies in the region, with the exception of Colombia, continue to grow at annual rates below those recorded in previous quarters. Part of this slowdown would be associated with weak external demand and lower terms of trade. Mediocre performance in several of these countries during the second quarter is also anticipated.
9. As for international prices of the commodities exported by Colombia, oil prices have been increasingly volatile in recent weeks due to the unstable geopolitical situation in Russia and Ukraine, as well as new outbreaks of violent conflict in the Middle East. Meanwhile, coal, nickel and coffee prices have been stable, and one sees a sharp downward trend in prices for certain imported foods.
10. With respect to inflation in the major developed economies, the variation in prices remained low in Europe and increased slightly in the United States. In this context, the major central banks maintained their expansionary monetary stance. The European Central Bank took additional measures to mitigate the risk of deflation (i.e. lowering the benchmark rate, long-term refinancing operations (LTRO), and a negative interest rate for reserves). As for the Federal Reserve Bank of the United States, the cutbacks in its monthly purchases of assets continued in line with the market's expectations.
11. In the emerging economies, the outlook for inflation remains mixed. While inflation in Colombia is within the target range, it has reached or exceeded the upper limit of that range in Chile, Brazil and Peru. Even so, the central banks in Mexico, Chile and Peru lowered their benchmark rates in recent weeks.
12. The geopolitical issues in Ukraine and the Middle East have added to financial market volatility, especially in Europe. However, the perception of risk in Latin America saw no major changes in recent weeks.

#### **a. Exports and Imports**

13. Annual growth in total exports in dollars came to 2.9% in May, thanks to the combined rise in mining exports (5.7%) and foreign sales of major agricultural products (32.7%). However, industrial exports were down by 13.5%, while the others declined by 36.7%. The increases in mining exports were in coal (40.4%) and oil (8%). As for agriculture, growth was observed in exports of bananas (64.8%), coffee (26.4%) and flowers (22.8%).

14. The drop in exports of industrial goods is explained largely by the decline in foreign sales of vehicles (-70.3%), chemical products (-9%), meat (-79.5%) and clothing (-22.6%); the destinations with the largest cutbacks were Argentina (-86.6%), Venezuela (-30.4%) and Mexico (-20%).
15. In the January-May aggregate, the dollar value of exports was down by 4.6% with respect to the same period last year. This decline was associated with a 4.8% reduction in mining exports and 9.4% in industrial exports. The largest slowdowns among the major exports in the mining sector were in gold (-45.3%) and petroleum derivatives (-24.3%); in the group of industrial goods, the reductions in exports of vehicles (-55.2%), rubber and plastic products (-18%) and chemical products (-3.6%) were the most predominant. On the other hand, agricultural exports rose 14.3% in annual terms, given the combined increase in foreign sales of coffee (17.9%), bananas (29%) and flowers (2.2%).
16. Total imports in April were up by 5.6% compared to same month last year. The growth in imports of consumer goods (13.2%), intermediate goods (3.5%) and capital goods (1.2%) contributed to this performance. In the first case, imports rose with respect to non-durable goods (13.5%) and durables (12.9%), with the most significant expansion being in food products (14.3%) and vehicles (16%). As for intermediate goods, the major increase was in purchases of fuel and lubricants (25.2%). The only growth in capital goods was in transport equipment (11.4%).
17. Between January and April 2014, the total value of CIF imports in dollars rose 4.5%, due to added purchases of intermediate and consumer goods (11.1% and 3.4%, respectively). These increases were partially offset by the decline in imports of capital goods (-3.7%). Within the group of intermediate goods, the largest rise was in fuels and lubricants (34.3%); in the consumer goods category, it was in durable goods (5.5%). Capital assets declined largely because of the drop in imports of transport equipment (-18.4%).

## **II. Domestic Demand, Growth and Lending**

18. The information at hand suggests the annual increase in economy activity during the second quarter of 2014 would have been less than in the first three months of the year. Several components of demand would have maintained the momentum exhibited in the first quarter, while growth in others would have returned to normal. Private consumption would have benefited from the recovery in household confidence, the good growth in consumer lending and the constant improvement in

the job market. However, some moderation in civil works is expected. It is important to bear in mind that fewer business days in the second quarter compared to 2013, due to Easter Week in April (not in March, as was the case last year), tends to reduce annual growth.

19. All the consumption indicators pointed to good performance for this aggregate. The results of the Monthly Retail Trade Survey (EMCM in Spanish) conducted by DANE show retail sales were up by 8.2% in April-May compared to the same period in 2013. Respective annual growth in May was 8.5%. Discounting vehicle sales, the increase came to 8.8% and 8.6%, in that order. On the other hand, the performance of vehicle and motorcycle sales suggests the momentum in spending on durable goods is strong, although less than in the first quarter. In line with what was observed by DANE, the sales balance from Banco de la República's Monthly Survey of Economic Expectations (EMEE in Spanish) suggests household consumption would have increased at a good pace during April and May.
20. The second-quarter average for the consumer confidence index published by Fedesarrollo was higher than in the first quarter and exceeded the average on record since 2001. This recovery was due mainly to a better perception among consumers with regard to the future. For that reason, the consumption pattern is not expected to change significantly during the remainder of the year.
21. Other indicators also point to good performance in household spending during that period; those associated with the job market are a case in point. The May figures indicate the unemployment rate continued to decline across the board. This reduction is explained by the increase in employment observed in recent months, particularly salaried employment.
22. The household loan portfolio showed a real annual increase of 8.7% in consumer financing by June, which is somewhat less than the 9.8% rise observed in December 2013. Real interest rates for households also were less during the first quarter, given the behavior of inflation.
23. The investment indicators denote less momentum compared to the first quarter of the year. In fact, the tally for the EMEE question on businessmen's investment expectations shows gross capital formation in the second quarter, excluding civil works and construction, would increase slightly less than during the first quarter of the year. The variations in the figures for imports of capital goods in the form of transport equipment and for industry point in the same direction.

24. With respect to foreign trade, exports in the second quarter would have been affected by the attacks on infrastructure in the petroleum sector. This situation would not have been offset by the good performance in coal production. As for imports, lower increases are expected compared to those posted in the first quarter of the year.
25. On the supply side, the indicators at hand suggest the second quarter would see no annual growth in industrial GDP. In May, the industrial production index (IPI), excluding coffee processing, rose 2.0%; even so, the two-month period (April-May) witnessed a drop of 0.2%. This performance is influenced, in part, by the Easter calendar. When the series is seasonally adjusted, one sees flat growth in the level, accompanied by a slight steepening of the trend component, suggesting a moderate recovery in industry.
26. The aforementioned is ratified by other industry indicators for June. According to the Fedesarrollo survey, the indicator of orders placed that month declined slightly, although its trend component has an upward slope. The inventory indicator also worsened with respect to May, but its trend component remained stable. On the other hand, although the expectations of industrialists three months out improved slightly, the trend was not affected. As a result, the industrial confidence index fell slightly in June, but the slope of its trend component is positive.
27. With the June data, the industrial demand for energy - an indicator with some contemporary relationship to the IPI - fell by 2.2%. This would suggest a slowdown in the IPI for that month.
28. The transport and commerce sectors are expected to maintain the momentum witnessed during the first quarter. In the case of commerce, the Fedesarrollo and Fenalco figures show the current perception remains unchanged, while expectations six months forward are at more favorable levels than those reported in previous months.
29. Mining might see less growth in the second quarter, mainly because of the decline in oil production. In fact, oil production during the quarter came to less than one million barrels (964 mbd) and posted an annual reduction of 3.6%.
30. In the construction sector, the indicators at hand suggest the good performance witnessed during the first quarter would have continued in the three months thereafter. Specifically, the annual increase in cement production came to 15.3% in May and was 15.6%, on average, between April and May, having averaged 10.1%

growth between January and March. Building permits were up by 11.1% in April-May, and the twelve-month aggregate continued to grow at a rate of 7.14% in May.

31. In the agricultural sector, the Colombian Federation of Coffee Growers reported an annual increase of 12.3% in coffee production during the second quarter, after having done so by 35% in the early months of the year. Additionally, the slaughter of cattle dropped by 9.2% in annual terms as a result of the retention phase that is currently part of the production cycle.

### **III. Developments in Inflation**

32. Annual inflation declined to 2.79% in June; this is 14 basis points (bp) below the figure for the previous month. After a recent low in November 2013 (1.76%), annual inflation rose steadily until May (Table 1). The June figure was lower than anticipated by the technical team and by market analysts. In monthly terms, the variation was 0.09%. The decline in annual inflation during June was concentrated in food and non-tradables excluding food and regulated items.
33. Core inflation also declined in June, following steady increases over a period of several months. According to the average of the four indicators monitored by the technical team, core inflation was 2.76% compared to 2.87% in May (**Table 1**). The four indicators declined on this occasion, with Nucleo 20 maintaining the highest estimate (3.0%); the lowest was the CPI excluding food, utilities and fuel (2.5%). Non-food inflation was around 2.7%; this is 10 basis points less than a month ago.

#### **Table 1**

## Developments in Inflation at June 2014

Description	Dec-13	Mar-14	Apr-14	May-14	Jun-14	Share	
						of pct. in the slowdown for the month	of pct. in the build-up year to date
<b>Total</b>	<b>1.94</b>	<b>2.51</b>	<b>2.72</b>	<b>2.93</b>	<b>2.79</b>	<b>100.00</b>	<b>100.00</b>
<b>Excluding food</b>	<b>2.36</b>	<b>2.62</b>	<b>2.85</b>	<b>2.76</b>	<b>2.66</b>	<b>50.55</b>	<b>25.33</b>
Tradables	1.40	1.65	1.83	1.95	1.94	2.32	14.83
Non-tradables	3.76	3.55	3.51	3.68	3.45	49.06	-10.34
Regulated	1.05	2.21	3.05	2.14	2.14	-0.82	20.85
<b>Food</b>	<b>0.86</b>	<b>2.23</b>	<b>2.39</b>	<b>3.35</b>	<b>3.11</b>	<b>49.45</b>	<b>74.67</b>
Perishables	-0.16	3.17	6.89	10.97	8.92	58.58	41.01
Processed	-0.24	0.92	0.51	1.23	1.44	-22.54	30.84
Dinning out	3.26	4.13	3.73	3.75	3.52	13.40	2.82
<b>Core inflation indicators</b>							
Excluding food	2.36	2.62	2.85	2.76	2.66		
Nucleo 20	2.72	2.86	2.80	3.14	3.04		
CPI excl. perishables, fuel & pub.util..	2.19	2.53	2.54	2.63	2.53		
Inflation excl. food and regulated items	2.74	2.74	2.80	2.95	2.81		
<b>Average first four indicators</b>	<b>2.51</b>	<b>2.69</b>	<b>2.75</b>	<b>2.87</b>	<b>2.76</b>		

Source: DANE. Banco de la República calculations

34. As for the non-food CPI, the most prominent aspect in June was the decline in the annual change in non-tradables excluding food and regulated items (**Table 1**). To a large extent, this was due to reductions in the entertainment, culture and recreation categories (because of soccer tickets), which offset the increases observed in May. The behavior of the rental CPI is another noteworthy aspect of the sub-basket of non-tradables excluding food and regulated items; its annual variation declined again this month and stood at 3.2%. The reduction so far this year has been primarily in Bogotá, in the middle and lower echelons. Rentals account for 61% of the sub-basket and 18.6% of the total CPI.
35. The annual variation in regulated prices and tradables excluding food and regulated prices remained stable, at the levels observed the previous month (**Table 1**). The changes in regulated prices were significant in the case of electricity rates; however, they were offset by reductions in residential gas and water rates. With respect to energy, it is important to point out that prices on the stock market, a key factor in establishing rates for the consumer, dropped sharply in recent weeks, reversing the boom observed three months earlier. Moreover, reservoir levels tended to normalize as of the second quarter of this year, after falling below normal levels during the second half of 2013.
36. In tradables excluding food and regulated items, the increases seen again in automobiles and products related to their use were offset by reductions in prices for air fares, mobile phones and accessories, and television sets. Although these declines could be one-time events and seasonal in certain cases, it is likely that appreciation of the peso since April is beginning to pass through to a number of prices in this sub-basket.



37. As for food, most of the slowdown in the annual change by June came from prices for perishables (**Table 1**). There were reductions in the price of potatoes, other tubers and certain fruits. These products had accumulated sizeable price hikes in previous months. However, prices for other perishables and processed foods continued to increase, particularly in the case of beef. In connection with this last product, a livestock retention phase appears to be initiating and can lead to further price hikes during the second half of the year. The annual change in the price of dining out declined in June (Table 1).
38. In June, wage-cost pressures were contained judging by the salary adjustments, which continued to fluctuate between 3.0% and 4.0%. However, if the current trends in growth and employment were to continue, both these factors could bring upward pressure to bear in the coming quarters.
39. In the case of non-wage costs, peso appreciation since April also would be halting the upward pressure observed in previous months. Accordingly, the annual change in the PII went from 3.1% in May to 2.5% in June. This was possible thanks largely to the decline in the imported PPI (from 1.8% to 0.0%).
40. Inflation expectations for the end of the year and at twelve months declined slightly in June, according to Banco de la República's monthly survey of financial market analysts. They were 3.27% and 3.16%, respectively. Its quarterly survey of entrepreneurs shows they expect 2.94% inflation twelve months out. In this case, 100% of those who were surveyed felt the target will be met this year. Finally, expectations derived from the TES yield curve at horizons of two, three and five years remained at around 3.0% (based on the figures up to July 23).