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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
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Monetary Policy Report

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I. External Context and Balance of Payments

1. In recent weeks, international oil prices declined significantly after the news of higher inventories and production increases in non-member countries of the OPEC countries, such as the United States and Libya, despite the extension of the agreement to cut production announced by the OPEC and other countries at the end of May.
2. Should these levels and trend continue, Colombia's terms of trade would be negatively affected.
3. On 14 June, the FED increased its policy rate to a range between 100 and 125 bp. Additionally, it announced a program for the gradual contraction of nearly a trillion US dollars on its balance sheet, which would be implemented over the next few years. However, a starting date has not yet been established.
4. In the United States, growth continues to be based on domestic demand, particularly consumption. The unemployment rate continues to decline, and would be close to its non-inflationary level. On the other hand, annual headline inflation fell from 2.2% in April to 1.9% in May, and core inflation did so from 1.9% to 1.7%. It should be noted that this decline is attributed to transitory factors. The market continues anticipating inflation to post above the Fed's 2.0% target for the remainder of 2017 and during 2018.
5. In the euro zone, data to May and June exhibit an upward trend in the levels of consumer and business confidence. Regarding price variation, there was an annual reduction from 1.9% in April to 1.4% in May, significantly below the European Central Bank's target (slightly below 2.0%). However, this decrease is also considered to be transitory.
6. In some Latin American countries, the figures available on economic activity to April exhibit low growth, close to zero in some cases. Thus, the growth of the country's trading partners would continue to be driven by advanced economies.
7. In April, capital inflows to Latin America continued, concentrated in variable income (outflows were observed for fixed income).
8. In the last few weeks, country risk premia have increased (measured by CDS) for Brazil and Colombia. In the first case, due to the recent corruption scandal, and in the second, partly on account of the fall in the price of oil, mainly.
9. The currencies of the region continue to exhibit a trend towards appreciation. However, Colombia and Brazil have exhibited some depreciation in recent weeks.

Exports (Table 1).

10. In April, the value of exports in US dollars registered a yearly 6.8% increase, mainly explained by the behavior of mining goods, which increased 32.5% on a yearly basis. On the other hand, the fall in external sales of main agricultural products (32.0% annually) and others associated with manufactured goods (5.7%), stand out.
11. So far this year, the value of exports in US dollars grew 25.4%, mainly responding to the 52.1% increase in the external sales of mining goods. In this period, the price index for total exports registered a significant increase (31.7%), while the volume index fell (-4.6%). This suggests that the value of exports increases as a result of improvements in prices, from which the most significant is that of mining products (51.9% YOY in the accumulated value to April).

Table 1: Behavior of Exports in US dollars

	April 2017			
	Annual Variation [Contribution]	**Main contributing items to annual variation, in the same direction:**		
		Item	**Annual variation of the item**	**Contribution to annual variation**
Total Exports	6.8%			
Agricultural goods	-32.0%	Coffee	-24.6%	-2.8
	[-6.6]	Banana	-50.4%	-2.1
Mining goods	32.5%	Oil	43.4%	10.5
	[15.2]	Coal	21.3%	2.8
Other exports*	-5.7%	Chemical Products	-9.3%	-0.8
	[-1.8]	Vehicles and other means of transportation	-43.0%	-0.8
	Accumulated value for January-April 2017			
Total Exports	25.4%			
Agricultural goods	6.7%	Coffee	18.3%	1.6
	[1.2]	Banana	-4.7%	-0.2
Mining goods	52.1%	Oil	46.1%	11.6
	[25.1]	Coal	65.9%	8.5
Other exports	-2.5%	Foods, beverages, and tobacco, excluding coffee	-4.6%	-0.3
	[-0.8]	Vehicles and other means of transportation	-12.0%	-0.2

* Within this group, the destinations which contributed most to the fall were Venezuela, USA, Mexico, and Asia, with annual reductions of 54.3%, 13.4%, 20.8%, and 16.8% in April, respectively.
Source: DANE

12. According to the preview for foreign trade by DIAN, exports excluding oil and its derivatives increased 33.6% on a yearly basis in May mainly due to external coal sales (according to this source, this group of exports had declined 4.8% in April; however, the fall reported later by DANE was 6.4%).

Imports (Table 2).

13. In April, CIF imports in US dollars registered an annual 9.0% increase, mainly explained by the increase in external purchases of capital equipment (24%) and raw materials (9.3%). Excluding purchases of aircraft, which exhibited the main increase, total imports and imports of capital goods maintain positive growth rates (2.8% and 2.6%, respectively).
14. In April, imports of consumer goods registered an annual 9.6% decline explained by both durable and non-durable goods (-7.4% and -11.6%, respectively).
15. So far this year, the value in US dollars for total imports increased 7.4%. The indexes of quantities and prices showed annual increases (5.9% and 1.4%, respectively).

Table 2: Behavior of Imports in US dollars

	April 2017			
	Annual Variation [Contribution]	Main contributing items to annual variation, in the same direction:		
		Item	Annual variation of the item	Contribution to annual variation
Total Imports	9.0%			
Capital Goods	24.0% [7.0]	Transport equipment	243.7%	7.0
		Industrial	3.5%	0.2
Raw materials	9.3% [4.4]	Fuel	89.7%	4.7
		Mining products	13.1%	1.0
Consumer Goods	-9.6% [-2.3]	**Non-durable consumption goods**	**-11.6%**	**-1.5**
		Food products	-20.4%	-1.0
		Pharmaceutical products and toiletries	-5.1%	-0.2
		Durable consumption goods	**-7.4%**	**-0.8**
		Private transportation vehicles	-14.6%	-0.9
Accumulated Value for January-March 2017				
Total Imports	7.4%			
Capital Goods	10.9% [3.2]	Transport equipment	74.2%	2.2
		Parts and accessories for transport equipment	13.8%	0.5
Raw materials	7.5% [3.5]	Food products for industry	15.2%	1.0
		Chemical and pharmaceutical products	5.5%	0.8
Consumer Goods	3.0% [0.7]	**Non-durable consumption goods**	**-1.9%**	**-0.2**
		Food products	-2.6%	-0.1
		Tobacco	-53.4%	-0.1
		Durable consumption goods	**9.1%**	**1.0**
		Private transportation vehicles	12.6%	0.7

Source: DANE

16. According to the preview for foreign trade by DIAN, CIF imports recorded an annual 2.2% increase in May. (According to this source, they had grown 1.6% in April; however, the figure reported later by DANE was 9.0%).

17. Regarding the balance of payments, during the first quarter of 2017, the current account deficit was USD3,182 m (4.4% of GDP), lower than a year ago when it reached USD3.546 m (5.9% of GDP). It must be highlighted that the value for the first quarter of 2017 was similar to the one estimated by the Central Bank´s staff in the last quarterly report (US$ 3,233 m, 4.5% of GDP).
18. Unlike what was observed in 2016, the lower external imbalance is explained by a significant increase in revenue (USD2,274 m), which more than offset the increase in expenditure (USD1,910 m).
19. By components, the reduction of the deficit in the current account (USD364 m) was mainly explained by the lower trade deficit (USD1,025 m), which in turn resulted from an increase in revenues from exports greater than outflows due to imports. The improvement in the trade balance offset the increase in net factor income outflows (USD 773 m), due to the higher profits of companies in the mining-energy sector, and to the payment of interests on the foreign debt. Services and current transfers also contributed, although to a lesser extent, to the decline in the current account deficit.
20. Particularly, regarding non-factor services, exports rose 6.8% annually in the first quarter of 2017 driven especially by higher income from travels and from insurance, financial, business, and construction services. It is worth noting that current revenue from services is concentrated mainly in travel (USD 1,212 m) and transport (USD 406 m), representing close to 80% of these exports. On the other hand, imports of services recorded an annual 1.6% increase, mainly due to higher expenses associated with the cost of insurance and financial services, travel expenses, and payment of transportation services. During the first quarter of 2017, the main outflows were those of foreign travel expenses (USD 987 m) and transport services (USD 623 m), contributing altogether to 61% of this item.
21. As for capital flows, the first quarter recorded net inflows for USD2,858 m (foreign capital income for USD 4,587 m and outflows of Colombian capital for USD 1,730 m). From the total income, foreign direct investment (FDI) was the main source of funding (55%), followed by portfolio investment in the local market (38%, mostly for purchases of TES by foreign investors). Placement of bonds in international markets accounted for 5.0%, while the remaining 2.0% was due to external loans and other flows, mainly credits with multilateral banks.
22. Compared to the situation a year ago, the financial account of the balance of payments registered lower net capital flows (USD 841 m). This was due mainly to the fall of FDI by USD 2,188 m, on account of the base effect of the sale of Isagen in the early months of 2016.

Table 3: Balance of Payments

BALANCE OF PAYMENTS - (Millons of USD)	January-March	
	2016	**2017**
CURRENT ACCOUNT (A+B+C+D)	**-3,546**	**-3,182**
Percentage of GDP	**-5.9%**	**-4.4%**
A. Goods	**-3,050**	**-2,025**
Exports	7,117	8,862
Imports	10,167	10,887
B. Non-factor Services	**-708**	**-623**
Exports	1,887	2,016
Imports	2,596	2,638
C. Factor Income	**-1,154**	**-1,927**
D. Transfers	**1,367**	**1,393**
FINANCIAL ACCOUNT (A+B+C+D+E)	**-3,698**	**-2,858**
A. Direct Investment (ii-i)	**-3,734**	**-1,799**
i. Foreign Investment in Colombia	4,703	2,515
ii. Colombian Investment abroad	969	716
B. Portfolio Investment	**-815**	**77**
C. Other investment (loans, credits, and other derivatives)	**752**	**-1,228**
D. Reserve Assets	**98**	**93**
ERRORS AND OMISSIONS	**-153**	**324**

Source: *Banco de la República*

II. Growth, Domestic Demand, and Credit

23. The information available for the second quarter suggests that the Colombian economy would have exhibited a low expansion, similar to that of the first three months of the year. Private consumption would have continued performing weakly, while investment would show a low growth rate, but it would have accelerated *vis-à-vis* the results from the first quarter. Foreign trade would have contributed negatively to GDP growth.
24. According to the Monthly Survey of Retail Sales (EMCM) by DANE to April, retail sales (excluding fuel) fell 2.1% compared to the same month in 2016. This meant a slowdown compared to what has been observed for the first quarter of the year (-1.7%).
25. Excluding vehicle sales, the remaining aggregate grew 0.3% on a yearly basis. This represents a recovery from the first quarter (-1.4%). The levels of the series are higher than in previous months, although the trend component suggests deterioration *vis-à-vis* the figures towards the end of 2016.
26. In April, car sales fell 15.4% annually, partly because of a relatively high basis of comparison for the same period last year.
27. Also in April, the balance of sales of the Monthly Survey of Economic Expectations (EMEE) of the Central Bank exhibited a sharp decline, which

suggests that private consumption in that month would have registered a weak dynamics.

28. Consequently, no important dynamism of private consumption is forecast for the second quarter of the year, although preliminary projections suggest that the growth of this item of GDP could be somewhat better than in the first quarter.
29. With information to May, the Consumer Confidence Index of Fedesarrollo fell slightly after three months of recovery. The level was greater than that of the aggregate for the first three months of the year, but is still low, and lower than the average calculated since November 2001.
30. Also with figures to May, vehicle registration records published by ANDI and Fenalco grew 2.2% annually, which meant a recovery of the levels of the series compared with the average for the first quarter of 2017. The increases took place both in vehicles for private use (3.2%) and for commercial use (1.2%). However, the negative trend continues.
31. Regarding the labor market, the seasonally adjusted series to April show stability in the unemployment rate across the nation, but a growing trend for that of the thirteen areas for nearly a year. As for employment, in April, the number of individuals employed increased significantly at the national level, but exhibited stagnation in the 13 areas. For this geographical domain, it must be highlighted that salaried employment continues to grow, while non-salaried employment decreases in both annual variations as in the margin.
32. On the other hand, banking credit to companies continues to decline, while the one granted to households has also reduced its growth rate in the last few weeks. This takes place within a context in which the transmission of the reduction in the benchmark rate has been higher to commercial credit rates than to household credit rates.
33. Regarding gross capital formation different from construction of buildings and civil works, imports of capital goods in April and May (in constant pesos) suggest a better dynamics of this item of GDP during the second quarter.
34. Finally, the figures for foreign trade (in US dollars) to April exhibited growth in both exports and imports. However, the production of mining commodities (coal and oil) and coffee exhibited mediocre dynamics (even recording contractions), which would be reflected on the performance of real exports on the GDP. In the case of imports, increases are observed when converting them to constant pesos.
35. On the supply side, the figures available for April and May suggest a higher-than-expected deterioration.
36. In April, total industrial production fell 6.8% on a yearly basis, a figure lower than expected by the staff. Excluding oil refining, the remaining industries

decreased 9.9% annually. The result for oil refining was an annual 7.5% variation. So far this year, total industrial production fell 1.5%, while industry excluding the oil refining did so by 3.5%.

37. The decline of industry in April is explained largely by the calendar effect of the Easter holiday. The estimates of the technical staff correcting this phenomenon show that industry indicators excluding oil refining would have fallen 3.0%. The trend component of this series exhibits a significant decline from a year ago.
38. With information from the Business Opinion Survey (EOE) by Fedesarrollo to May, the trends of the stock indicators (countercyclical) and orders in industry, as well as production expectations to three months, continue to deteriorate.
39. As for retailers, the trend components of the indicators of current sales and prospects to six months reported in the EOE, exhibit a negative slope and suggest that the low dynamism of retail sales could continue in the coming months.
40. Regarding construction, in May, cement production fell 3.1%, while so far this year the reduction was 4.0%. Additionally, licensing both for housing and non-residential buildings has shown deterioration compared to the peak reached a year and a half ago.
41. Production data for the main export commodities to May reflect declines in annual terms. Oil fell to 851,000 barrels per day, which represents a 5.9% contraction (-9.4% so far this year), while coffee fell to 901,000 bags, which meant a 22.5% fall (-21.3% on average for the two-month period April-May, contrasting with its good performance in the first quarter (+12.8%).
42. Energy demand grew 2.5% in May, and its trend component shows a positive slope. By breaking down into regulated and non-regulated goods, they expanded 3.4% and 0.2%, respectively.
43. Finally, the monthly economy activity indicator (ISE) published by DANE, fell 0.6% in April, which contrasts with the +0.9% observed in the first quarter. Correcting for seasonality, the ISE expanded 1.4% in the same month, a figure greater than the one recorded in March (-0.7%) and that of the first quarter of 2017 (0.4%).
44. With this, downside risks, incorporated into the forecast range for GDP growth of the previous quarterly report (between 0.8% and 2.6%, with 1.8% as the most likely figure) seem to be materializing.

III. Behavior of Inflation and Prices

45. After a pause in April, annual headline inflation resumed a downward path in May, falling from 4.66% to 4.37% (**Table 4**). The monthly CPI variation was 0.23%, a figure lower than the forecasts by the market (0.33%) and the technical staff at the Central Bank. So far this year, accumulated inflation posted at 3.23%, lower than the figure recorded for the same period in 2016 (4.60%).
46. The fall of consumer inflation since December 2016 (5.75%) is mainly explained by the behavior of the food CPI (especially for processed items) and to a lesser extent by tradables. In contrast, the non-tradable component of the CPI (excluding food and regulated items) and the subgroup of regulated items pressured inflation upwards.
47. Core inflation, measured as the average of the four indicators monitored by the Central Bank, decreased from 5.52% in April to 5.33% in May, a significant drop compared with the slight fall between December 2016 (5.60%), and April 2017. All core inflation indicators declined in the month. The Core 20 CPI (from 5.84% in April to 5.59% in May) and the CPI excluding food (from 5.60% to 5.35%) fell the most. The CPI excluding food and regulated items, which was the lowest, moved from 5.28% to 5.09% (**Table 4**).
48. Within the CPI excluding food, in May, there was a significant reduction in the annual variation of the CPI for tradables (excluding food and regulated items), moving from 5.35% to 4.88%. After accelerating during the first two months of the year due to the increase in indirect taxes, this indicator resumed a downward path in line with the lower exchange rate pressures until May, and with the weakness exhibited by domestic demand. It must be remembered that the upward impact of the increase in indirect taxes concentrated on this component of the CPI.
49. On the other hand, the yearly variation of non-tradables (excluding food and regulated items) did not exhibit any significant changes from April (5.22%) to May (5.25%). By subgroups, the new increase for leases (from 4.28% to 4.34%) and of the indexed segment (education and health services, among others, from 6.86% to 6.91%), stand out.

Chart 4

Headline and Core Inflation to May 2017

Description	Weight	Dec 2015	Dec 2016	Mar 2017	Apr 2017	May 2017
Headline inflation	**100.00**	**6.77**	**5.75**	**4.69**	**4.66**	**4.37**
Non-food inflation	**71.79**	**5.17**	**5.14**	**5.13**	**5.60**	**5.35**
Tradables	26.00	7.09	5.31	5.59	5.35	4.88
Non-tradables	30.52	4.21	4.85	5.33	5.22	5.25
Regulated items	15.26	4.28	5.44	4.05	6.75	6.24
Food inflation	**28.21**	**10.85**	**7.22**	**3.65**	**2.49**	**2.09**
Perishables	3.88	26.03	(6.63)	(13.09)	(14.47)	(14.13)
Processed food	16.26	9.62	10.74	6.28	5.12	4.39
Eating out	8.07	5.95	8.54	8.94	8.08	7.79
Core inflation indicators						
Non-food inflation		5.17	5.14	5.13	5.60	5.35
Core 20		5.22	6.18	6.01	5.84	5.59
CPI excluding perishable foods, fuel, and utilities		5.93	6.03	5.61	5.37	5.29
CPI excluding food and regulated items		5.42	5.05	5.44	5.28	5.09
Average of core inflation indicators		**5.43**	**5.60**	**5.55**	**5.52**	**5.33**

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

50. Annual variation in regulated items fell from 6.75% in April to 6.24% in May. Unlike the data from April, all the components fell, including fuel (from 9.46% to 9.43%), despite the COP111 increase decreed for May.
51. As for food, the annual CPI variation maintained a strong decreasing trend in line with expectations, standing at 2.09%. By sub-groups, processed items (including beef and milk) and meals outside the house contributed to the decline in this month (**Table 4**). Regarding perishable goods, although the figure for annual variation continued in negative terms, it increased slightly compared to the previous month.
52. The declining trend in the annual variation of food should extend for two more months, considering the broad supply observed so far in June in supply centers around the country, the fall in the agricultural PPI recorded in May, and the high basis for comparison in the same period of 2016. On the other hand, the strike that took place in Buenaventura between mid-May and the first week of June does not seem to have affected the availability of imported food significantly.
53. As for cost pressures, in May, non-employment pressures continued to decline, as has been observed since mid 2016. The annual PPI adjustment for domestic supply (produced and consumed plus imported items) posted at negative terrain (-0.16 *vis-à-vis* 0.39% in April). So far this year, the PPI for domestic supply (-0.01) accumulated a variation lower than the one observed for the same period last year (1.78%).
54. As for the cost of labor, wage adjustments moderated, according to the latest information available. To April, wages in the manufacturing industry

increased 5.2% annually; those for trade did so by 5.4%; and those for housing and heavy construction in May did so by 5.8% and 4.3%, respectively. Despite this fact and the relative slack in the labor market, wage costs would continue to exert some upward pressures on prices, considering that they are still growing at rates well above the inflation target.

55. According to the latest monthly survey to financial analysts by the Central Bank (applied at the beginning of June), inflation expectations fell *vis-à-vis* those from the previous month. The inflation figure expected for December 2017 fell from 4.45% in May to 4.37% in June; to twelve months, it did so from 3.67% to 3.62%; and to twenty-four months, from 3.39% to 3.34%.
56. Comparing its behavior from May to June 28, inflation embedded in TES denominated in pesos and UVR (Breakeven Inflation, BEI), reduced 24, 18, and 7 bp, on average, for 2, 3, and 5-year terms, respectively. Thus, average BEI so far in June posts at 2.99%, 3.10%, and 3.21% for 2, 3, and 5 years, respectively.
57. Lastly, the estimation of annual inflation for 2018, 2019 and 2020, using the Forward Breakeven Inflation curve (FBEI), posted at 3.25%, 3.34%, and 3.39%, in that order. Thus, the FBEI calculated in June was slightly higher for 2020, and lower than estimated in May for 2018 and 2019. Additionally, since the accumulated inflation in May posted at 3.23% and BEI for the remainder of the year at 3.04%, the estimation of implicit inflation for 2017 is 5.05%, lower than the estimations performed in May (5.25%).