BANCO DE LA REPÚBLICA
DIVISION OF ECONOMIC STUDIES

Monetary Policy Report of February 2015

I. External Context and Balance of Payments

1. International prices of oil fell again in the last few weeks, after the slight recovery that had been observed in February. This is a consequence of the high levels recorded by global inventories, especially in the United States, and the prospect of reaching a deal with Iran regarding its nuclear program, allowing again the access of Iranian oil to the international markets.

2. Meanwhile, during the first weeks of March, the international prices of some commodities have been lower than their average in February. This behavior was observed in the prices of coffee, nickel, and some food products imported by Colombia. In contrast, the international prices of coal and copper have shown a slight recovery in the last few weeks.

3. The figures for real activity in the United States to February display a positive trend, although less pronounced than at the beginning of the year, indicating that the economy maintained an acceptable behavior during the first quarter. Additionally, household and business confidence indicators continue at high levels, suggesting that dynamism would continue in the next months.

4. The registers for February show that the American labor market continued recovering. This is corroborated by: the creation of employment, which was greater than expected; the unemployment rate that fell to 5.5%; and the fact that other indicators monitored by the Federal Reserve such as the underemployment rate and the long-term unemployment rate, continue improving.

5. Annual inflation to January in the United States reduced 90 basis points (bp), and exhibited a negative register (-0.1%). This fall is explained mainly by the strong fall in fuel prices. Inflation, excluding energy and food, remained at 1.6%. The changes in the press release of the FOMC (Federal Open Market Committee) keep suggesting that the first increment of its benchmark interest rate would occur at the beginning of the second semester of 2015 and would be implemented gradually.

6. On the other hand, the real activity indicators of the euro zone in the first months of 2015 show a heterogeneous behavior. The retail sales figures to January and business and consumer confidence indexes to February showed a positive trend. In contrast, the figures to January for exports and industrial production stalled.

7. The euro zone was still in deflation in February, with an annual change of -0.3%, mainly as a consequence of the lower prices of fuels. In turn, the annual variation of the consumer price index (CPI), excluding food and fuels, remained stable at 0.6%. In this context, at the beginning of March, the European Central Bank (ECB) initiated the purchase of sovereign bonds that it had announced in its meeting in January.

8. Regarding China, the figures for January and February indicate that the slowdown of this economy would have continued. The figures for annual growth of industrial production and retail trade registered the lowest levels since 2008, while fixed asset investment continued showing a clearly decreasing trend.

9. In Latin America, GDP figures for the fourth quarter of 2014 show that the economies of Chile, Peru and Mexico grew very little in comparison with the average of recent years. Meanwhile, the figures of the economic activity index to January show some recovery in Chile and Peru, while in Brazil the contraction that began in the second semester of 2014 was accentuated.

10. The central banks of various Asian countries have decreased their interest rates. The case of China stands out, given that its central bank reduced its benchmark interest rate in the meeting of March by 25 bp, setting it at 5.35%. In turn, Latin America has presented reductions of the benchmark rates in Chile, Peru and Mexico in recent months. In contrast, in Brazil the policy rate increased in 50 bp to 12.75%.

11. As for the international financial markets, long-term bond rates of the main countries of the euro zone continued reducing in the last few weeks, thanks to the start in early March of the program by the ECB to purchase sovereign bonds. In contrast, the rates of the United States' long-term bonds showed some correction from the low levels that had been observed in recent months; the US dollar appreciated versus the main currencies of the world.

12. In the financial markets of Latin America, risk premia have increased in the last few weeks, especially in Brazil. In turn, the currencies of the region resumed their tendency to depreciate against the US dollar, being particularly marked for the Brazilian real and the Colombian peso. In the case of the latter, the average value so far in March is COP 2,607 per US dollar, which represents a depreciation of 7.6% versus the average in February.

a. Exports and imports

13. During 2014, total exports fell 6.8% due to a fall in prices that was not offset by the greater quantities exported. This reduction resulted from lower exports of mining origin (-9.8%) and of the category of other exports (-4.8%). In turn, exports of agricultural goods grew 17.6% in the accumulated value for the year. As for mining goods, it is worth highlighting the lower values registered for oil (-6.8) and refined products (-34.6%), and within the category of other exports those registered for vehicles (-36.8%), the remainder of agricultural products (-35.8%) and meat (-66.2%). The main agricultural goods exhibited an increase of 31.3% in coffee, 9.4% in banana, and 3% in flowers. Per destination, the goods under the category of other exports that recorded the greatest falls were destined to Argentina (-68.9%), Venezuela (-7.0%) and Brazil (-11.7%).

14. Total exports recorded an annual fall of 40.2% in January, explained by the reduction of mining exports (-53.5%) and of other exports (-17.4%). In the case of mining goods, the falls in foreign sales of oil (-59.8%) and products from oil refining (-66.3%) stand out. On the other hand, agricultural exports had an increase of 44.1%, with the increase in coffee exports (102.7%) as the most prominent within this group.

15. The most significant falls within the category of other exports were those of meat (-83.3%), food and beverages (-9.2%), and machinery and equipment (-33.0%). The destination that exhibited the greatest falls in these items was Venezuela, which registered no meat exports in January, while at the same time exports of food and beverages and of machinery and equipment fell -94.7% and -77.5%, respectively.

16. On the other hand, in December, imports grew 11.2% in annual terms as a product of the increase in the main group of imported goods: intermediate goods (18.2%), capital goods (6.1%) and consumer goods (9.5%). The greatest purchases of intermediate goods concentrated mainly on fuels and lubricants (43.5%) and raw materials for the industry (9.9%). In turn, the greatest contribution to the increase in capital goods came from the surge in transportation equipment (14.4%). Finally, regarding consumer goods, both non-durable (11.2%) and durable goods (7.8%) increased.

17. During 2014, imports grew 7.8%. This growth is associated with the generalized expansion in the main categories: 8.9% in the imports of

intermediate goods, 6.0% in those of capital goods, and 8.6% in those of consumption goods. In the first case, the most important increases were those in fuels and lubricants (18.3%) and raw materials for the industry (6.0%). In the case of capital goods, the increases which contributed the most were those of capital goods for the industry (6.1%) and transportation equipment (6.8%). Finally, the growth of consumer goods was prompted by the increase in durable goods (11.3%) and in non-durable consumer goods (5.8%).

II. Growth, Domestic Demand, and Credit

18. According to the information provided by DANE, annual growth of the Colombian economy for 2014 was 4.6%, a slightly lower rate than that of 2013 (4.9%). This last figure was revised upwards from 4.7% to 4.9% (**Chart 1**).

19. During the fourth quarter of 2014, economic activity expanded 3.5% in annual terms. This result is at the lower end of the forecast interval presented in the previous Inflation Report (between 3.3% and 4.7%, with midpoint at 4.6%). The increase between quarters was 0.7%.

20. The most recent information of the *Índice de Seguimiento a la Economía, ISE,* (Economic Activity Index) published by DANE shows that the aggregate value for the fourth quarter of the seasonally adjusted index expanded 3.1% annually, which is lower than the figure for the third quarter (3.9%). Particularly, the seasonally adjusted data for December suggest that economic activity showed a better behavior than in October and November (4.1% versus 2.7% and 2.8%, respectively).

21. Results show that the Colombian economy has been slowing down so far this year. In the first semester, the GDP increased on average 5.3%, which contrasts what was observed in the second semester (3.8%).

22. On the supply side, the sectors that showed higher growth than the whole economy during 2014 were construction (9.9%), social, communal, and personal services (5.5%), and financial products (4.9%). In the first case, the subcomponents that recorded a strong dynamism were the construction of buildings (7.4% annually) and civil works (12.0%). In the second one, public administration and defense services led this behavior with a growth rate of

6.2%. Finally, the expansion of financial products was mainly explained by the significant boost of financial intermediation, which grew 8.1%.

23. The less dynamic sectors were industry and mining. In 2014, industry presented a low growth (0.2%) and completed three consecutive years of stagnation. On this matter, it is important to point out that the revisions to the national accounts for 2012 and 2013 implied important changes for industry. In the first year it passed from -1.1% to 0.1%, while in 2013 the initial data was -1.0% and was revised to 0.6%.

24. In turn, the mining industry was the only activity that recorded an annual contraction (-0.2%), contrasting with the dynamism of previous years (9.4% on average between 2008 and 2013) (**Chart 1**).

Chart 1
Real Annual GDP Growth per Branch of Economic Activity

Branch of Activity	**2012**	**2013**	**2014**				**2014**
	Whole Year	**Whole Year**	**1st quarter**	**2nd quarter**	**3rd quarter**	**4th quarter**	**Whole Year**
Farming, forestry, hunting and fishing	2.5	6.7	6.2	0.3	1.7	0.9	2.3
Mining and quarrying	5.3	5.5	6.1	(2.2)	(1.2)	(3.3)	(0.2)
Manufacturing	0.1	0.6	4.1	(2.0)	(0.6)	(0.3)	0.2
Electricity, gas and water	2.3	3.2	4.4	3.7	4.0	3.1	3.8
Construction	5.9	11.6	14.2	8.4	11.1	5.9	9.9
Buildings	5.9	11.2	6.8	1.0	14.1	7.5	7.4
Civil works	6.0	12.1	24.8	14.3	7.1	3.8	12.0
Retail, repairs, restaurants and hotels	3.9	4.5	5.5	4.1	4.2	4.5	4.6
Transportation, warehousing and communications	3.9	3.6	4.9	4.3	4.2	3.2	4.2
Financial, real estate and corporate services	5.1	4.6	5.4	5.5	4.5	4.1	4.9
Social, community and personal services	4.6	6.0	7.6	5.5	4.7	4.2	5.5
Subtotal value added	**3.9**	**5.0**	**6.3**	**4.0**	**4.1**	**3.2**	**4.4**
Taxes minus subsidies	**5.4**	**3.9**	**7.5**	**8.2**	**7.4**	**8.3**	**7.8**
GDP	**4.0**	**4.9**	**6.4**	**4.3**	**4.2**	**3.5**	**4.6**

Source: DANE, calculations by Banco de la República

25. The few available indicators for the first quarter of 2015 suggest that the pace of expansion of output would slow down from the figures registered at the end of last year. In any case, it must be considered that the effect of a high base of comparison during the same period of 2014 would lead to lower growth rates in the quarter.

26. As per the results of the *Encuesta Mensual de Comercio al por menor, EMCM* (Monthly Retail Trade Survey), in January, retail sales excluding fuel increased at an annual rate of 7.3%. Although it is a significant expansion, it is lower than the one registered in the fourth quarter of 2014 (11.0%). Excluding vehicle sales, the annual expansion of the indicator was 10.0% during the same month (9.4% in the fourth quarter). Vehicle sales had a negative contribution, contracting 6.6% annually.

27. The information from the *Comité Automotor Colombiano* (Colombian Automotive Committee comprised by ANDI, Fenalco and Econometría), confirms the poor performance of the vehicle market. In February, sales fell 7.6% annually, which is greater than the contraction observed in January (-6.4%). The trend component of this series exhibits a strong negative slope, suggesting a similar behavior for the consumption of durable goods.

28. According to the *Encuesta Mensual de Expectativas Económicas, EMME* (Monthly Economic Expectations Survey) by the Central Bank to January, the outlook for sales and investment expectations to six months recorded falls when compared to the figure in December. The correlation of these series with private consumption and with investment different from construction, respectively, would indicate a lower growth of these GDP components during the first quarter of the year.

29. In turn, the *Indice de Confianza del Consumidor, ICC* (Consumer Confidence Index) published by Fedesarrollo showed a fall in its level in February, and registered its third consecutive fall. This time, the CCI is below its average since 2001. By components, the willingness to purchase durable goods and cars fell. Given this, a lower household consumption dynamics is foreseen, particularly in the expenditure on durable goods.

30. Additionally, consumer credit in nominal terms slowed down again in February (12.75%) with respect to the figures in January and to the average for the fourth quarter of 2014 (13.0% in both cases).

31. On the supply side, the indicators available for the first quarter of the year convey mixed signals. Oil production grew 2.5% in February, with a level that remained above one million barrels (1,027 mdb) for second consecutive month. In the first two months of the year, oil production has remained above one million barrels (1,030 mdb) and over the production assumed in the baseline scenario (1,020 mdb).

32. In turn, energy demand grew 3.0% annually, and its trend component, although still growing, has slowed down. By components, the regulated component expanded (4.9%) and the non-regulated component decreased (-0.5%).

33. Retail sales, despite the slowdown, continue expanding above their average rates, as mentioned above.

34. In contrast, according to DANE, the manufacturing index contracted 2.5% in January. It is worth mentioning that the behavior within sectors is quite uneven: while sectors such as the beverages industry (7.4%), production of substances and basic chemical products (13.3%), and basic industries of iron and steel (12.6%) showed high growth, other sectors recorded important falls, as is the case of coking, oil refining and fuel mixing (-11.6%), elaboration of sugar and *panela* (unrefined, whole cane sugar blocks) (-13.1%), and printing activities (-16.1%).

35. Additionally, it should be mentioned that DANE made changes to the methodology of the *Muestra Mensual Manufacturera* (Monthly Manufacturing Sample).[1] This implied that the activity related to the industrial production of oil refining received greater participation within the indicator (passing from 5.6% to 20.0%), in times in which this sector is falling importantly due to the programmed closing of Reficar.

36. If the weights of the prior methodology had been kept in use, the results would have been thus: total industry: -0.9%; industry excluding coffee threshing: -1.1%; and production excluding coffee threshing and oil refining: -0.5%. Under the new methodology, growth indicators were: -2.5%, -2.5% and -0.2%, respectively.

[1] Among the main changes, the following stand out: An update of the classification standards (from ISIC 3 to ISIC 4), a change in the base year (from 2001 to 2014), reduction of the number of activities from 48 sectors to 39, increase in the number of establishments passing from 1.383 (EAM 1997) to 2,666 (EAM 2011), and update of weights according to the aggregate value in the Encuesta Anual Manufacturera, EAM 2011 (Annual Manufacturing Sample).

37. In this context, the unemployment rate continued descending monthly in January, but at a lower pace than in previous months. The creation of employment has slowed down, although salaried employment continues growing at high rates. It is worth mentioning that the majority of the employment generated during recent months corresponds to workers with higher education.

38. The scarce information available does not allow for a complete GDP growth forecast exercise for 2015. For the time being, the indicators published so far this year suggest an expansion in the first quarter lower to the one recorded for the last quarter of 2014. This is due, among other things, to a high base of comparison (as is the case with the GDP for civil works). Under these conditions, the forecast range for all of 2015 is still between 2.0% and 4.0%, with 3.6% as the most likely outcome.

39. The slowing trend of the GDP is confirmed by the inverse additive of the Risk Index constructed by the Operations and Market Development Department of the Central Bank. Something similar can be inferred from other forecast exercises.

III. Behavior of Inflation and Prices

40. In February, annual consumer inflation accelerated for fifth consecutive month, registering 4.36% and surpassing the figure of January by 54 basis points (bp) (**Chart 2**). In monthly terms, variation amounted to 1.15%, which is higher than expected by the market (0.64%) and by the technical staff. As in previous months, acceleration of inflation is explained mainly by increases in the prices of foodstuffs, and secondly by higher prices of tradable goods.

41. So far this year, the accumulated price increase amounted to 1.80%. Eighty-four percent of this acceleration is explained by increases in the prices of foodstuffs, 41% by the prices of tradable goods excluding food and regulated goods, and 5.9% by non-tradable goods. In this period, the basket of regulated goods contributed negatively in 31%.

42. In February, core inflation also increased for fourth consecutive month. The average of the four indicators estimated by the Central Bank registered 3.53% in February, 31 bp more than the registers of January and the highest level since October 2009. The four indicators increased this time, being the CPI excluding primary food, fuels and public utilities the one presenting the

highest acceleration and reaching the highest level (3.7%). Inflation excluding food, in turn, increased from 3.2% to 3.4% (**Chart 2**).

Chart 2

Behavior of Inflation
(To February, 2015)

Description		**Dec 2013**	**Mar 2014**	**Jun 2014**	**Sept 2014**	**Dec 2014**	**Jan 2015**	**Feb 2015**	**Percentage of participation in monthly acceleration**	**Percentage of participation in acceleration so far this year**
Total		**1.94**	**2.51**	**2.79**	**2.86**	**3.66**	**3.82**	**4.36**	**100.00**	**100.00**
Non-food Inflation		**2.36**	**2.62**	**2.66**	**2.70**	**3.26**	**3.20**	**3.42**	**29.11**	**16.03**
	Tradables	1.40	1.65	1.94	1.59	2.03	2.28	3.26	42.58	41.11
	Non-tradables	3.76	3.55	3.45	3.26	3.38	3.47	3.50	2.78	5.91
	Regulated items	1.05	2.21	2.14	3.25	4.84	4.01	3.46	-16.25	-31.00
Food Inflation		**0.86**	**2.23**	**3.11**	**3.25**	**4.69**	**5.41**	**6.78**	**70.89**	**83.97**
	Perishables	(0.16)	3.17	8.92	7.61	16.74	16.78	19.68	20.57	18.62
	Processed food	(0.24)	0.92	1.44	2.14	2.54	3.70	5.62	54.54	67.19
	Eating out	3.26	4.13	3.52	3.23	3.51	3.60	3.34	-4.22	-1.85
Core Inflation Indicators										
	Non-food Inflation	2.36	2.62	2.66	2.70	3.26	3.20	3.42		
	Core 20	2.72	2.86	3.04	2.89	3.42	3.58	3.62		
	CPI excluding perishable foods, fuels and utilities	2.19	2.53	2.53	2.39	2.76	3.12	3.69		
	Inflation excluding foods and regulated items	2.74	2.74	2.81	2.55	2.81	2.97	3.40		

	Average of all Indicators	**2.51**	**2.69**	**2.76**	**2.63**	**3.06**	**3.22**	**3.53**		

Source: DANE. Calculations by BANCO DE LA REPÚBLICA.

43. Within the CPI excluding food, the annual variation of tradable goods in February was 3.3%, a figure not seen since January of 2005 and approximately 100 bp higher than a month before. With these results, the pass-through of the accumulated depreciation of the peso to inflation, which until January had been relatively low compared to previous episodes and lower than had been forecast, has tended to normalize. It is worth remembering that the estimations over the magnitude of this pass-through indicate that it is about 5% (that is, a 10% depreciation causes core consumer inflation to rise by 0.5%).

44. In February, there were increases in a wide group of tradable goods and services (excluding food and regulated goods). The increase in the CPI for vehicles stands out, with a monthly variation of 2.9% this month, accumulating a rise that is slightly greater than 6.0% since October last year. The weight of this item in the basket is 4.4%, the third more important after rents (effective and attributed) and eating outside of the household. Other tradable items that also increased importantly this month were newspapers (3.2%), telephone services (2.7%), school texts (2.7%), cell phones (2.4%) and, in general, a wide range of electrical appliances and electronic devices that had presented reductions in their prices in the past for a long time.

45. Regarding the non-tradable CPI excluding food and regulated goods, last month there was a slight acceleration in its annual variation (to 3.5%, from 3.47% in January) that had not been forecast by the technical staff. The main reason for this increase was the adjustments in the rates of education services (tuition and enrollment fees), as well as in health services, which was higher this time than in the same month last year. As for education, the increases in February usually concentrate more than 90% of the readjustments for the whole year, and they will tend to remain stable for the rest of the year. On the other hand, as for rents in February, a reduction in its annual variation was observed again, registering 2.86% (against 2.97% in January). In spite of the punctual and slight increase of inflation for non-tradable goods, it may be stated that inflationary pressures originating in demand are still low at the beginning of year.

46. The CPI for regulated goods reduced in February, as was expected. The reduction of the domestic price of the gasoline decreed by the national government by the end of January (by COP 138) and February 23 (by COP 300) impacted on this. Nevertheless, the 2.2% fall in the CPI for gasoline only includes one fourth of the reduction ordered at the end of February. The other three quarters should affect the result of March. CPI of household gas utilities rates increased, but not as much as last year, exercising downward pressures on the annual variation of the group. Increases in the rates of electric energy and water utilities were also recorded.

47. The annual variation of foodstuffs increased from 5.4% in January to 6.8% in February, a result which is higher than expected. Fifty-eight percent of this acceleration is explained by the increase in the CPI for rice (17.2% in the month), which adds to the increases of nearly 12% accumulated in the two previous months. The price of the rice would be affected mainly by lower planting in previous months, due to the low prices of 2013 and beginnings of 2014, as well as by the expectations over the appearance of El Niño climate phenomenon. Nevertheless, it is not ruled out that, due to the greater needs of imports to supply the domestic deficit, depreciation of the peso is being passed-through to some degree to domestic prices.

48. Other foodstuffs, whose prices also increased importantly in the last month, were those of potato, and of legumes and vegetables: as a group, these products contributed nearly 30% of the acceleration of food inflation this month. In both cases, supply would have been reduced also as a consequence of the low prices observed in the past, and of the greater risks generated by El Niño climate phenomenon. Regarding the prices of imported food such as cereals and oils, some increases took place in February that could be a result of the depreciation of the peso. Nevertheless, these adjustments have been of low magnitude, perhaps due to the fact that international prices have remained at levels lower than last year. Other products such as chicken did not present any important adjustments; eggs even showed considerable reductions (-2.7% in the month). Finally, the annual variation of eating outside the household reduced in February to 3.3% (from 3.6 in January), supporting the idea that demand-side pressures remain contained.

49. As for non-labor costs pressures, the variation of producer prices suggests that these have been increasing in recent months due to the impact of the depreciation and to the increases in the prices of agricultural goods. Nevertheless, in the month of February these pressures may have yielded slightly, since the annual variation of the PPI (measured as the sum of prices

of produced and consumed goods plus imported goods) reduced to 5.0% from 6.4% a month before. In part, this would have been possible by the reduction of the price of mining products, and, particularly, by the fall of the price of oil and its by-products.

50. At the beginning of year, salaries continued showing adjustments compatible with the inflation target. Those of industry were adjusted to an annual rate of 2.6% in January, while those of construction were adjusted by 4.0%. Both cases were very similar to what had been observed in previous months. Retail exhibited a significant slowdown at an annual rate of 5.0%. The acceleration that took place in this variable in the fourth quarter of last year would have been a punctual event that is now in the process of being reverted.

51. Inflation expectations to December this year, obtained from the monthly survey to financial analysts, with information to the second week of March, increased 30 bp as compared to the previous month, registering 3.65%. The inflation expected for twelve months, obtained from the same survey, remained stable at 3.2%. On the other hand, inflation expectations for 2, 3, 5 and 10 year horizons, inferred from public debt bonds, increased so far in March 10 bp, 13 bp, 17 bp and 19 bp as compared to the average data of February, registering 3.88%, 3.71%, 3.59%, and 3.88% respectively.