PUBLIC VERSION

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Board of Directors

Banco de la República

Monetary Policy Report

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Monetary Policy Report

Economic Studies Division

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I. External Context and Balance of Payments

1. The new data suggest that the external growth scenario presented in the previous report continues, with global economy continuing its recovery mainly driven by advanced economies.
2. Regarding the price of oil, the news about greater compliance with the OPEC agreements in recent weeks, as well as a more dynamic demand, would have contributed to increase the prices in this market. The average price for the year to date (28 September) for Brent oil is USD 52.5/b, higher than the average forecast for 2017 (51 USD/b).
3. The Fed announced that the program for the reduction of its balance sheet will begin in October and would last three years. In the view of many analysts, this decision should not imply major consequences on financial markets, given that it was announced in advance, therefore part of its effects would have already been discounted.
4. Although the Fed maintained the policy rate unaltered at its September meeting, the market's reading of its press releases led to a significant upward revision of the likelihood of future increases.
5. Inflation in developed economies is still below their goals; however, the latest data available show some recovery, particularly in core inflation.
6. Despite the fact that growth figure of the United States for the second quarter was revised upwards, the recent climatic phenomena are likely to have a negative effect on the third quarter. To August, the labor market continues to record good growth rates in employment, while the unemployment rate remains relatively stable at very low levels.
7. The information available for the euro zone for the third quarter shows that economic activity was more intense than expected. Consumer and entrepreneur confidence to August continues at high levels.
8. In Latin America, the figures available on economic activity to the second quarter exhibit slight recovery in Brazil, Chile, Mexico, and Peru.
9. In general terms, inflation exhibited a downward trend in emerging economies to August. Mexico continues to be the exception in Latin America, where it is still accelerating.
10. Thus, the prices of Latin American currencies remained relatively stable in recent weeks.
11. Colombia's terms of trade to July continue to show recovery *vis-à-vis* the low levels in 2016. So far in 2017, this indicator has been stable, close to the levels forecast.
12. In August, significant capital inflows to emerging economies continued. In Latin America, these inflows increased versus the previous month, and were observed both in fixed and variable income.

Balance of Payments

13. During the first half of 2017, the country's current account of the balance of payments registered a USD $6,119 m deficit (4.1% of GDP) (**Table 1**), greater in US dollars than a year ago, when it reached USD $5,992 m (4.6% of GDP). It must be noted that the value of the current account deficit for the second quarter (USD $2,708 m, 3.5% of GDP) was in line with the estimated value.
14. The larger deficit in the first half of the year is explained by increase of the outflows (USD $3,185 m), originated by the increase in imports of goods and of outflows by revenues of companies from the mining and energy sector with foreign direct investment (FDI), as well as by the higher payment of interest on the foreign debt. This more than offset the increase in revenues (USD $3,058 m), particularly of exports of goods.
15. By components, the increase in the current account deficit (USD $127 m) was explained by higher net outflows of factor income (USD $1,248 m) and, to a lesser extent, by non-factor services (USD $125 m). On the contrary, the lower deficit in trade of goods (USD $996 m) and the larger current transfers (USD $249 m) contributed to the decline in the external deficit.
16. For the first half of 2017 to June, foreign capital inflows totaled USD $7,531 m, while the capital outflows to purchase assets abroad were USD $1,389 m (**Table 1**). From the total inflow, FDI was the main source of financing (69%), followed by the purchase of government bonds by foreign investors (27%). Placement of securities in international markets and the purchase of shares in the local market accounted for 16%, while there were net repayments of loans and other flows.
17. Compared to a year ago, the financial account of the balance of payments during the first half of 2017 registered lower net capital flows (USD $653 m, due mainly to the USD $3,040 m fall of FDI as a result of a low basis for comparison by the sale of Isagen in the early months of 2016.

Table 1

BALANCE OF PAYMENTS - (Millons of USD)	January - June	
	2016	2017
CURRENT ACCOUNT (A+B+C+D)	**-5,992**	**-6,119**
Percentage of GDP	**-4.6%**	**-4.1%**
A. Goods	**-4,984**	**-3,988**
Exports	15,730	17,924
Imports	20,714	21,912
B. Non-factor Services	**-1,570**	**-1,694**
Exports	3,688	3,900
Imports	5,257	5,595
C. Factor Income	**-2,218**	**-3,466**
D. Transfers	**2,780**	**3,029**
FINANCIAL ACCOUNT (A+B+C+D)	**-6,413**	**-5,760**
A. Direct Investment (ii-i)	**-6,315**	**-3,208**
i. Foreign Investment in Colombia	8,239	5,199
ii. Colombian Investment abroad	1,924	1,991
B. Portfolio Investment	**-1,545**	**-1,741**
C. Other investment (loans, credits, and other derivatives)	**1,505**	**-1,058**
D. Reserve Assets	**-57**	**247**
ERRORS AND OMISSIONS	**-421**	**359**

Exports of Goods

18. In July, total exports in US dollars registered an annual 37.6% growth rate explained by increases in the three main groups of goods. Part of this growth was due to a low basis for comparison in July 2016, when the trucking strike took place. However, the trend of the series, which partly corrects this statistical effect, maintains important positive variations.
19. Mining goods and the group of other exports contributed the most to overall growth of the month, with annual increases of 26.4% and 56.4%, respectively (**Table 2**).

Table 2 Behavior of Exports in US dollars

	July 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	37.6%			
Agricultural goods	52.3%	Coffee	77.6%	4.4
	[6.0]	Banana	113.9%	1.6
Mining goods	26.4%	Coal	104.9%	15.0
	[16.2]	Oil	5.3%	1.8
Other exports*	56.4%	Foods, beverages, and tobacco, excluding coffee	64.8%	3.4
	[15.4]	Chemical products	37.5%	3.3
Accumulated value for January - July 2017				
Total Exports	22.7%			
Agricultural goods	12.6%	Coffee	19.5%	1.4
	[2.0]	Flowers	7.1%	0.4
Mining goods	34.8%	Coal	62.4%	8.6
	[18.2]	Oil	21.5%	6.0
Other exports	7.8%	Foods, beverages, and tobacco, excluding coffee	12.5%	0.8
	[2.5]	Non-metal minerals and basic metals	28.3%	0.6

* Within this group, the destinations that contributed the most to growth were: rest of ALADI[1], Peru, and Ecuador, with 87.6%, 95.9%, and 65.9%, respectively.

Source: DANE

20. On the other hand, so far this year, total exports have grown 22.7% annually, as a response to the increase in external sales of the three groups of goods, particularly in mining goods (34.8%). The annual variation of the group of other exports so far this year (7.8%) remained positive for the second month in a row, after standing for over three years in negative figures (from January 2014 until May 2017, except for January this year).
21. As for the accumulated value for this year, the value of exports increased as a result of improvements in prices (with a significant 21.3% annual increase), while the figure for quantities increased 1.3%. This improvement in prices took place in the three groups of goods, highlighting agricultural goods (32.9% annual variation).
22. According to the foreign trade preview by DIAN, in August, exports excluding oil and its derivates fell 3.3% on a yearly basis. However, this figure is affected by a high basis for comparison, due to the rebound recorded by exports in August 2016 after the trucking strike last year. By levels, the data reflects a good performance.

Imports of Goods

[1] Latin American Integration Association (ALADI), excluding Venezuela, Ecuador, Peru, and Mexico.

23. In July, CIF imports in US dollars registered an annual 11.8% growth, to which the increase in external purchases of the three groups of goods contributed, particularly raw materials and capital goods (Table 3). These growth figures are also influenced by a low basis for comparison. However, the trend of the series, which partly corrects this statistical effect, maintains slight positive variations.
24. Regarding consumer goods, July recorded a 9.6% annual variation explained by the greater imports of non-durable goods (10.1%) and durable goods (8.9%).

Table 3 Behavior of Imports in US dollars

	July 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	11.8%			
Capital Goods	13.0%	Fixed equipment for industry (others)	33.2%	1.9
	[3.9]	Industrial machinery	15.2%	1.0
Raw materials	12.2%	Fuel	50.2%	3.4
	[5.6]	Mining products	25.0%	2.1
Consumer Goods	9.6% [2.3]	**Non durable consumption goods**	**10.1%**	**1.3**
		Clothing and other textiles	41.6%	0.5
		Durable consumption goods	**8.9%**	**1.0**
		Domestic machines and appliances	13.3%	0.3
	Accumulated Value for January - July 2017			
Total Imports	6.8%			
Capital Goods	9.6%	Transport Equipment	37.1%	1.1
	[2.9]	Fixed equipment for industry (others)	13.6%	0.8
Raw materials	6.9%	Mining Products	12.6%	1.0
	[3.2]	Chemical and Pharmaceutical Products	5.9%	0.9
Consumer Goods	3.1% [0.7]	**Non durable consumption goods**	**1.1%**	**0.1**
		Clothing and other textiles	14.3%	0.2
		Food products	-3.3%	-0.2
		Durable consumption goods	**5.5%**	**0.6**
		Private transportation vehicles	3.4%	0.2
		Domestic Machines and appliances	8.5%	0.2

Source: DANE

25. So far this year, total imports have increased 6.8% on a yearly basis, with increases in the three groups of goods. In this period, the indexes for quantities and prices exhibited 5.7% and 1.1% annual increases, respectively.
26. According to the foreign trade preview by DIAN, CIF imports in August registered an annual 1.1% fall; however, they are affected by the high basis for comparison, characteristic of the rebound after the trucking strike in 2016.

Balance of Trade for Goods

27. The accumulated value of the trade balance to July registers a deficit of USD $4,869 m FOB. This indicates a 30.8% reduction in the deficit *vis-à-vis* the same period last year, due to higher increase of exports (22.7%) versus imports (6.9%).

II. Growth, Domestic Demand, and Credit

28. The information available for the third quarter of 2017 suggests that the pace of expansion of the GDP would have accelerated compared to the records from the first half of the year. This would have been favored by a low basis for comparison in the same period of 2016 (as a result of supply shocks in transport that took place in July last year), as well as by the Easter holiday in the second quarter of 2017. However, when controlling for these effects, growth would have accelerated. Besides the above, the indicators have exhibited a slightly higher dynamism than had been expected by the technical staff at *Banco de la República*.
29. Indeed, the dynamics observed for the seasonally adjusted series in the Economic Activity Indicator (ISE) by DANE confirms this. These dynamics recorded a 3.0% annual increase in July, higher than in June (1.4%) and than the aggregate for the second quarter (1.7%). Again, this performance was due largely to a low basis for comparison in the same month of 2016.
30. Thus, this report forecasts an improvement of domestic demand for the third quarter in a context in which recovery of the terms of trade continued, increases in consumer prices moderated, and transmission of the reductions to the benchmark interest rate to the market continues to take place. Both consumption and investment would have recorded a slightly higher level than in previous quarters. On the other hand, the contribution of the foreign trade accounts to GDP growth would have been negative.
31. The information from the short-term indicators supports this. According to the Monthly Survey of Retail trade (EMCM by its acronym in Spanish) from DANE, in July, total retail sales (excluding fuels) increased 2.9% annually, a figure higher than the one in June (0.9%) and that the fall registered for the aggregate of the second quarter (-0.5%). Excluding vehicle sales, the remaining aggregate expanded 2.2% on a yearly basis in the same month. This also accelerated compared to the records in June (1.2%) and in the second quarter of 2017 (0.2%). It should be noted that in both cases the results were influenced by a low basis for comparison in the same month of 2016, when the trucking strike took place.
32. The motor vehicle sales index increased 7.7% annually in July. This increase contrasts with the fall registered in the aggregate for the second quarter of 2017 (-4.0%). Similarly, these results were strongly influenced by a low basis for comparison in the same month of 2016.
33. On the other hand, in August, the Consumer Confidence Index (ICC) fell back *vis-à-vis* the records in June and July. Its level continues being negative, below the average calculated since November 2001 and the one for the second quarter of 2017. This behavior was determined both by the component of the Index of

Economic Conditions (ICE) for households and the one for medium and long-term consumer expectations (IEC).

34. The seasonally adjusted balance of sales of the EMEE by *Banco de la República* in July recovered slightly. However, the trend of the series continues to suggest a weak dynamics of private consumption during that month.
35. Labor market indicators continue to show resilience at the national level, but some deterioration for the thirteen areas. The seasonally adjusted series for the unemployment rate to July exhibited few changes in the first case, but the increasing trend has continued for over a year in the second case. This is consistent with an almost null growth of annual employment in these areas. For this same geographical domain, with information to the moving quarter ending in July, the seasonally adjusted series exhibit a slight yearly increase in salaried and formal employment; few changes are observed in non-salaried employment, and informal employment reduced.
36. In August, the growth of household indebtedness in nominal terms continued to decelerate in the margin. Additionally, the transmission of the reductions of the benchmark intervention rate to the household market rates is still slow, although it has become more evident in recent months. With this, the households' real consumption interest rate is below its average since 2005, but the one for credit cards and usury continue above.
37. Regarding gross capital formation other than construction of buildings and civil works, the seasonally adjusted series of the balance of investment expectations of the EMEE in July suggest a slight recovery *vis-à-vis* the previous month. Additionally, according to the information of the foreign trade bulletin of DIAN to August, the recent dynamics of imports of capital goods (in constant pesos) suggests that this line of investment would continue to grow, although at rates lower than those observed in the second quarter of the year.
38. Finally, according to the figures of foreign trade in US dollars produced by DANE and the bulletin by DIAN, the trade deficit would have continued correcting so far in the third quarter. This is equally true for the series in constant pesos, although the contribution to growth would continue being negative. Real exports would have been driven by the recovery of mining and agricultural goods, while imports would have recorded dynamism given the performance of purchases of capital and intermediate goods, mainly.
39. On the supply side, the few indicators available for the third quarter of 2017 also exhibit recovery of economic activity compared to the first half of the year.
40. As for industry, according to the Monthly Survey of Manufacturing by DANE, the yearly growth of production in July stood at 6.2%, somewhat higher than anticipated by the technical staff at the Central Bank. Excluding oil refining, the rest of the industry grew at a yearly 5.1% rate. It is important to note that this

expansion is due partly to a low basis for comparison last year, when the trucking strike that contracted production significantly took place.

41. Despite this, so far this year, total industrial production fell 0.4%, while industry excluding oil refining did so by 1.9%. Similarly, the trend component of this series continues exhibiting significant deterioration. Finally, heterogeneity among the sub-branches of the industry is high. While branches such as production of oils (13.9%), paper (6.6%), and oil refining (5.9%) exhibit expansions above the total of the industry and the economy as a whole so far this year, others such as the manufacture of car bodies (-21.7%), precious metals (-22.5%), and travel goods, handbags and leather (-22.3%) show significant contractions.
42. Other variables related to the sector obtained from the survey of business opinion by *Fedesarrollo* showed mixed signals. With information to August, while the indicator of orders and expectations to three months suggest a slight improvement, the indicator of stock was unfavorable. With all of this, although the confidence of the industry improved compared to the previous month, the trend component continues to suggest a weakening in the sector.
43. In the case of retailers, there was further deterioration in August for the current situation of retail sales. In contrast, the six-month prospects for sales showed a slight improvement. In both cases, the trend components continue to show an unfavorable behavior of the sector.
44. In July, cement production registered a significant increase (18%), while the accumulated value to six months expanded slightly (0.2%). The trend component shows a rising slope. It should be noted that this indicator could also be affected by the trucking strike (in July 2016, it fell 17.6% annually).
45. On the other hand, total energy demand increased 0.2% annually in August. While the regulated component grew 1.4%, the non-regulated one fell 1.1%. Energy demand by the industry also exhibited a contraction in August (-4.2%).
46. In August, coffee production stood at 1,294,000 sacks, which represented an 8.8% yearly expansion. For the two-month period of July-August, the expansion was 16.7%.
47. In August, oil production stood at 858 thousand barrels per day, increasing 3.8% compared to the same month last year. A 2.7% growth was also observed for the July-August period.
48. With this, the technical staff at the Central Bank maintains its growth forecast for 2017 at 1.6%, within a range between 1.0% and 2.0%. These forecasts imply that growth in the second half of the year would be higher than in the first.

III. Behavior of Inflation and Prices

49. Annual headline inflation in August was 3.87%, a percentage higher by 47 basis points (bp) compared with the previous month. This rebound is the first since headline inflation reached its recent ceiling in July 2016 (8.97%). *Vis-à-vis* the data of December 2016, annual inflation fell 188 bp. (Table 4)
50. So far this year, the CPI accumulated a 3.44% increase, lower than the one observed in the same period last year (5.31%).
51. The monthly inflation rate was 0.14%, a figure higher than the one for August 2016 (-0.32%). The monthly inflation forecast by the market (0.10%) stood below the official data, while the technical staff's figure was slightly above.
52. The contribution of the main components of the family basket to the increase in headline inflation in August was mixed. The tradable sector, together with processed foods and meals outside the home, contributed to lower inflation. On the contrary, greater inflationary pressures concentrated in perishable foods and, to a lesser extent, in regulated and non-tradable goods.
53. Contrary to the rising dynamics of annual inflation, core inflation, measured as the average of the four indicators monitored by the central Bank, continued to fall (from 4.90% in July to 4.74% in August), maintaining the downward trend observed since August last year.
54. All core inflation indicators receded, except the CPI excluding food, which increased (from 4.79% in July to 4.81% in August). The CPI excluding primary food, fuel, and public utilities was the indicator that fell the most (from 4.88% to 4.56%). The core 20 CPI (with the highest level, from 5.22% to 5.00%) and the CPI excluding food and regulated items (from 4.72% to 4.59%) also fell (**Table 4**).

Chart 4

Headline and Core Inflation to August 2017

Description	Weight	Dec 2016	June 2017	July 2017	Aug 2017	Participation percentage in monthly deceleration	Participation percentage in deceleration of the year to-date
Headline inflation	**100**	**5.75**	**3.99**	**3.40**	**3.87**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.14**	**5.12**	**4.79**	**4.81**	**6.31**	**14.17**
Tradables	26.00	5.31	4.41	4.09	3.75	(15.53)	19.83
Non-tradables	30.52	4.85	5.21	5.20	5.23	3.35	(5.09)
Regulated items	15.26	5.44	6.01	5.03	5.57	18.48	(0.57)
Food inflation	**28.21**	**7.22**	**1.37**	**0.20**	**1.69**	**93.69**	**85.83**
Perishables	3.88	(6.63)	(14.72)	(16.92)	(6.81)	124.35	0.63
Processed food	16.26	10.74	3.29	2.24	1.71	(17.14)	75.11
Eating out	8.07	8.54	7.62	7.10	6.30	(13.52)	10.09
Core inflation indicators							
Non-food inflation		5.14	5.12	4.79	4.81		
Core 20		6.18	5.31	5.22	5.00		
CPI excluding perishable foods, fuel and utilities		6.03	5.07	4.88	4.56		
CPI excluding food and regulated items		5.05	4.87	4.72	4.59		
Average of core inflation indicators		**5.60**	**5.09**	**4.90**	**4.74**		

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

55. Within the CPI excluding food, the subgroup of tradable goods (from 4.09% to 3.75%) was the only one that pressed the yearly inflation rate down in August. It is important to note that this segment has been falling uninterruptedly since last March, inasmuch as the upward effect of the depreciation of the peso *vis-à-vis* the US dollar finished diluting, and despite the increase in indirect taxes at the beginning of this year. Contraction in the annual tradable CPI adjustment is expected in the first months of 2018, due to a high statistical basis of comparison, which reflects the increase of such taxes and whose hikes hit this component especially.
56. The annual change in the non-tradable CPI has been showing a marked stability at around 5.2% over the past five months. In this sub-group, the increase in leases stands out (from 4.23% to 4.27%). Upward pressures also took place in entertainment and cultural services.
57. Annual variation in regulated items increased from 5.03% in July to 5.57% in August. All components of this sub-group increased, except for transport, which lowered from 5.83% to 5.30%. However, increases in this sector are expected starting October due to the new technological platform and update of taxi fares in Bogotá (an increase close to 7.0% is estimated). Among regulated items, public utilities increased the most (from 3.09% in July to 4.47% in August (due to gas, which increased by more than 4.0% in August). As for public utilities, increases are expected from January next year as a result of the increase in garbage collection rates announced by the Mayor of Bogotá. On the other hand, fuels stepped from 9.15% to 9.92% (in August, the price of gasoline increased COP $99).
58. After a year falling without interruption, the annual adjustment of foods picked up from 0.20% in July to 1.69% in August (due to perishable foods, which increased from -16.92% to -6.81%). So far this year, the food CPI has increased 2.32% versus 7.88% in the same period of 2016. It is important to clarify that the upturn in the annual adjustment of food is not explained by low performance of the agricultural supply. It is greatly due to a statistical effect by the low basis for comparison of last year. In fact, the variation in August 2017 was negative (-0.08%).
59. The effect of an unfavorable statistical base comparison in annual food inflation will last a few more months, as was anticipated last month. Thus, food will boost annual inflation upwards in the coming months.
60. Regarding non-labor costs, for the second month in a row, an increase in the total domestic supply annual PPI variation (domestically produced and consumed items plus imported items), moving from negative terrain in July (-0.30%) to positive in August (0.95%). This behavior is explained by the increase in the annual variation of the PPI for domestically produced and consumed goods (from

-0.95% in July to 1.29% in August). Contrastingly, the yearly variation of the imported segment of the PPI lowered (from 1.21% to 0.18%).

61. Regarding wages, those for the manufacturing industry continued to show increasing adjustments (from 7.2% in June to 8.6% in July), while those for trade, after a fall in June, picked up again (from 4.8% in June to 5.0% in July). On the other hand, annual adjustments of wages for housing construction (5.8%) and heavy construction (4.4%) have remained stable during the past four months. Despite the current slack in the labor market, wages continue adjusting to rates which are above the inflation target.
62. According to the latest monthly survey to financial analysts by the Central Bank (applied at the beginning of September), inflation expectations to December this year increased slightly from 4.16% in August to 4.18% in September, as well as expectations twelve months ahead (from 3.62% to 3.63%). In contrast, inflation expectations to 24 months fell from 3.42% to 3.39%.
63. Inflation embedded in public debt bonds (Breakeven inflation, BEI) extracted from the TES denominated in pesos and UVR to September 26 is at 3.28%, 3.36%, and 3.44% to 2, 3, and 5 years, respectively. Compared to the average in August, the average BEI increased 27 bp, 18 bp, and 6 bp for these same horizons, respectively.
64. Finally, using the Forward Break-Even Inflation (FBEI) curve, the estimation of annual inflation for 2017 is 4.58% (obtained by adding the accumulated inflation observed to the inflation expectations for the remainder of the year). For 2018, 2019 and 2020, it is 3.48%, 3.53% and 3.56%, respectively.