

Introduction

The figures for 2017 and early 2018 suggest that the Colombian economy is culminating the adjustment process required after the sequence of shocks that affected its macroeconomic performance in the last few years. The first shock, undoubtedly the most severe, was the fall in the price of oil starting in the second half of 2014, which led to a sharp deterioration in the country's terms of trade with significant consequences on economic growth as well as on the external and internal equilibria. Subsequently, since late 2015, *El Niño* led to a significant increase in food prices, which pushed consumer inflation upwards. Similarly, the collapse in the economic activity of our major trading partners in the region, also affected by the oil shock or by the fall in the prices of other commodities (e.g., copper), weakened the demand for our non-traditional exports. Finally, the 2016 tax reform, as a necessary measure for fiscal sustainability whose main component was the increase in the VAT, reduced the income available for households, temporarily slowing down consumption growth.

The numerous effects of this sequence of shocks on the Colombian economy have been analyzed in detail in previous versions of the *Report to Congress*. This *Report* intends to highlight different aspects. Firstly, the ability of the economy to adjust without further upheaval, avoiding situations of crisis. Secondly, the change in the trend of the shocks, some of which have already disappeared and others continue to lose strength.

Perhaps the figure that best reveals this macroeconomic adjustment is the current account deficit, which was USD 10,359 million (-3.3% of GDP) for 2017, even lower than the deficit recorded in 2013 (USD 12,722 million; -3.4% of GDP), on the last year of high oil prices. The magnitude of this adjustment is best appreciated by remembering that in 2015 the current account recorded a deficit of -6.4% of GDP, which fell to -4.4% of GDP in 2016. This resulted from a far superior fall in external outflows than income due to the stagnation of domestic demand and the depreciation of the exchange rate. This external imbalance continued to adjust in 2017; however, the difference this year was that the adjustment was no longer explained by the decrease of outflows, but to the recovery of the external income, which more than offset the growth of imports and factor income outflows.

A second variable that reveals the extent of the adjustment is the behavior of inflation. At the end of 2017, yearly consumer inflation stood at 4.09%, and at the beginning of 2018, it continued to fall, reaching 3.37% in February, getting closer to its 3.0% target. The decline in inflation has

been fast considering that less than two years ago, in July 2016, it reached a peak of 8.97% on a yearly basis, its highest level since 2000. Several factors contributed to this significant reduction of inflation, among them the normalization of climatic conditions and the end of the pass-through of the depreciation of the exchange rate to prices, particularly in the tradable goods sector, and the weakening of aggregate demand. Additionally, the timely reaction of the monetary policy, as will be stated herein, was another factor that played a crucial role by reversing the increase in inflation expectations, which threatened to make price shocks of a transient nature more persistent.

The management of the National Government's finances has been another important ingredient to macroeconomic adjustment. As is well known, the oil shock significantly affected the government's fiscal balance, considering that oil revenues in 2013 amounted to the equivalent of 3.3% of GDP, which contributed 19.5% of the nation's total income. In 2016, this income had disappeared. Between those years, the Government's deficit increased from 2.4% to 4.0% of GDP, i.e. 1.6% of GDP, only half of the fall in oil revenues. This was possible thanks to the 2014 tax reform and the behavior of spending, which remained constant at 19% of GDP. The new tax reform which came into effect in 2017 allowed to resume the path of adjustment in the deficit by reducing it from 4.0% in 2016 to 3.6% in 2017. According to the Government's Financial Plan, this adjustment will continue in 2018, when it is projected to reach a deficit of 3.1% of GDP. It should be noted that over these years the structural balance (discounting the cyclical component of the deficit) has complied with the limits set by the fiscal rule.

Several factors that affected the economy begin to be reversed. In the first place, the international environment for Colombia is improving, as there is a greater dynamism of developed economies and several Latin American countries. Recovery in the terms of trade is also expected thanks to the increase in the prices of oil and other commodities exported by the country. Domestically, an impulse is expected from investment in civil works and from the increase in exploration and exploitation activities of crude oil as a response to their best prices. The recent reductions of the benchmark interest rate by the Central Bank of Colombia should contribute in the same direction, inasmuch as they stimulate consumption and investment. In this context, economic activity is expected to start recovering, as suggested by the forecasts of the Bank's technical staff, the Government, and the IMF, which coincide in estimating a 2.7% GDP growth for this year, compared to the 1.8% expansion recorded in 2017.

Thus, everything leads to expect that in 2018 the Colombian economy will close its adjustment phase after a negative shock, and will be close to its long-term equilibrium, characterized by an inflation rate on the target and a sustainable current account deficit, while output growth will come close to its potential. Despite this, there are still delayed effects of the shock to the terms of trade, as is the case with investment, whose growth decreased during the adjustment process, and continued to be low in 2017. The issue is particularly interesting, because a slow pace of investment limits potential growth, and with this the possibility of long-term growth, which could not be improved with countercyclical policies.

This *Report* includes a box that describes the channels through which a shock to the terms of trade impacts investment, and identifies the types of investment that have been affected the most. It shows that the slowdown of the economy generates situations that feed back the fall in investment, such as loss of confidence and deterioration in growth expectations; larger budgetary constraints for public investment; and tightening of credit conditions. Added to this is the rising cost of imported capital goods due to the depreciation of the peso and the fall of the profits of oil and mining companies. As could be expected, investment in the mining sector and that which depends on imported capital goods such as industrial machinery and transport equipment have been the most affected. In contrast, investment in civil works, housing, and buildings (until 2016) exhibited a better performance, partly thanks to infrastructure programs and subsidies to the interest rate for the purchase of housing. For 2018, improvement in the terms of trade, higher profits from the oil sector, and advances in infrastructure programs are expected to reflect a greater dynamism of investment.

As part of the adjustment process, economic growth slowed down, as happened in other countries that export commodities, which were affected by similar shocks. However, this slowdown has been moderate, considering the magnitude of the shocks. Thus, the Colombian economy has once again proved its resilience, as it had already done after the international financial crisis in 2009, which also affected its macroeconomic performance. However, unlike that shock—which was strong, but transitory—this time the adjustment of the economy has proved to be longer, given the persistence of the shock to the terms of trade, and its interaction with the other subsequent shocks. Despite this, access to external financing and good macroeconomic fundamentals contributed to achieve an orderly adjustment and to buffer their effects. Within these fundamentals, the flexibility of the exchange rate, the fiscal rule, the soundness of the financial system, the high level of international reserves, and the clearing of payroll taxes stand out.

Monetary policy, in the framework of inflation targeting, has played a fundamental role in the process of adjustment. In retrospect, the management of the benchmark intervention rate completed a 'cycle within the cycle.' After the start of the shock to the terms of trade in July 2014, the benchmark interest rate remained unaltered at 4.5% for a little over a year. This may seem paradoxical given the inflationary pressures that were beginning to surge as a result of the pass-through of depreciation to the prices of tradable goods, and, subsequently, by the increase in food prices that began to be affected by *El Niño*. However, both pressures were considered to be temporary, as a result of supply shocks. An increase in the benchmark interest rate at the time would have accentuated the deceleration of growth without preventing the increase of prices. Only when there was evidence that inflation expectations were beginning to become unanchored did the Board of Directors of *Banco de la República* (BDBR) decide to initiate, in September 2015, a gradual increase in the intervention rate, bringing it to 7.75% in July 2016. Enduring through an uncontrolled increase of inflation expectations would have strengthened the indexation mechanisms of prices and wages and with it the inflationary inertia. The evidence shows that inflation expectations never exceeded 5.0%, despite the fact that the inflation reached a peak of 8.97% in July 2016.

Since December 2016, upon noting that inflation expectations had declined, and that the effects of the pass-through of depreciation to the prices of tradable goods and those caused by *El Niño* on food prices were weakening, the Board decided to initiate a progressive reduction in the policy interest rate, which accumulated a 325 bp decrease until January 2018. This completed the cycle of increase and reduction of the benchmark interest rate during the adjustment process.

The increase in the benchmark intervention interest rate moderated the growth of domestic demand, and contained inflation expectations, thus attenuating inflationary inertia during 2017. Added to this was the relative stability of the peso and the normalization of food prices once the effects of *El Niño* and the trucking strike in June and July 2016 were overcome. Subsequently, the reduction of rates was possible without disrupting the process of convergence of inflation to its target, nor the required adjustment of inflation expectations, despite the pressures that resulted from the increase in the value added tax (VAT) and other indirect taxes at the beginning of 2017. At present, the monetary policy stance is moderately expansionary, given that the real policy interest rate is below the neutral interest rate. This will provide a stimulus to economic activity that will become more visible in the coming months, as the recent cuts to the policy rate are transmitted to the economy as a whole.

As already noted, consumer price inflation at the end of February recorded a 3.37% annual variation rate. This shows a significant decline during the first two months of the year *vis-à-vis* the 4.09% inflation figure in late 2017. Much of this decrease was due to the disappearance of the statistical effect of the increase in VAT and other indirect taxes, which came into force a year ago. Additionally, at the beginning of the year, certain specific price increases that took place at the end of 2017 were reversed. On the other hand, food inflation continued to decline to a level of 0.94% on a yearly basis, while inflation of tradable goods (excluding food) stood at 3.11% annually. These indicators confirm that convergence of inflation towards its 3.0% target is becoming stronger.

However, it is still possible to identify certain mechanisms that could maintain some inflationary inertia, delaying somewhat the process of convergence of inflation towards the target. Such is the case of non-tradable goods (excluding food), which at the end of February exhibited a 5.14% annual inflation, reflecting the increase in the minimum wage (5.9% for 2018), which puts upward pressure on the prices of labor-intensive services, such as health and education. Similarly, the recent increase in the international price of oil has led to increases in the prices of fuels, which partly explains the high inflation of regulated items (6.14% on a yearly basis) in February. Also, some pressures from inflation expectations persist, which, according to recent surveys, were in a range of 3.3% to 3.6% for different terms. Finally, possible increases in food prices in the second half of 2018 must not be ruled out, either due to smaller crops or by the effect of climate changes.

This suggests that, despite the important progress observed in the convergence of inflation to the target and the normalization of prices for food and tradable goods, monetary policy needs to be prudent in order to continue providing a stimulus to the recovery of economic activity without compromising the inflation target.

As for the labor market, the behavior of the national unemployment rate stands out, which remained relatively stable (mainly until the end of 2016), despite the slowdown observed in GDP growth. This was examined in a box of the July 2017 *Report*, which concluded that the decline in labor force participation, particularly in the thirteen major cities, was the explanation of this event. This began to change during the previous year, when an increase in the national unemployment rate it was observed from 9.1% in December 2016 to 9.5% in the same month of 2017. This was the result of a deterioration of the occupancy rate (OR) that could not be offset by the fall of the global participation rate (GPR). Something similar happened in the thirteen major cities.

The national unemployment rate is substantially lower than the one observed for the 13 (or even 23) main cities of the country. The explanation for this lies in the low unemployment rate reported by DANE for the rural area. Thus, for example, for the moving quarter of November 2017 to January 2018, the unemployment rate in the 13 cities was 10.9%, while for the rural area it was 5.4%. In order to understand this behavior, the present *Report* includes a box that examines the dynamics of agricultural employment and compares it with the behavior of the labor market in urban areas. The text highlights the dynamism observed in 2017 in agricultural employment located mainly in the “other municipalities” and the rural area (with 182 thousand new positions), which places agriculture as the branch of activity that generated more jobs at the national level last year.

The baseline projection scenario for 2018 prepared by the technical staff confirmed that the economy would be approaching the end of the adjustment process. As noted, GDP growth is estimated at 2.7% for this year, which was confirmed recently after examining indicators of economic activity for the first two months of the year. On the other hand, inflation is expected to continue converging towards the 3.0% target, as it has been doing since the beginning of the year. Finally, the current account deficit will continue approaching 3.0%, following the good record observed at the end of 2017. These forecasts are subject to the risks considered for the alternative scenarios, which take into account changes in external conditions, the trajectory of domestic demand, and unforeseen pressures from food prices and other components of the consumer price index. The Central Bank will continue informing the country about the behavior of these variables through its periodic Inflation Reports.

Aside from being a mechanism of accountability of the Board of Directors of the Central Bank to the Congress of Colombia, the detailed diagnostics contained in this *Report* on the situation of the Colombian economy and the management of monetary policy is an important study document that enables the public and external analysts to understand the advances in the process of economic adjustment and the work that remains to be done.